# Better Banking for Britain

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# Abstract

The global financial crisis had devastating effects on the financial system, economic growth and national debt of Western countries. The focus of this thesis is an examination of certain identifiable weaknesses in the corporate governance at UK banks which, it is posited, constituted an underlying cause of the crisis. It then considers the main regulatory responses to these identified weaknesses and assesses to what extent these have led to improvements in corporate governance at banks. This research is based on an examination of all the major failures at UK banks during and after the crisis, and of its related responses. In addition to UK responses, several solutions to the weaknesses identified at UK banks are also currently addressed through EU legislation and by the international Basel Committee. These are also reviewed. The principal conclusions are that: board effectiveness was low due to a lack of knowledge and of challenging of senior management; there was a culture placing growth and profit over risk management; and remuneration was inappropriately structured leading to unacceptable risk taking and scandals. It is further concluded that the mechanisms to limit the impact of a failure of a bank on its stakeholders, such as depositors and the taxpayer, were inadequate. A comparative case study of the financial crisis in Japan during the 1990s is also undertaken to consider whether, and to what extent, the Japanese regulatory response offers lessons to UK regulators and legislators. The principal finding is that comparative analysis of regulation and corporate governance at banks is problematic. Although there were similarities between the two financial crises and their impacts, the organisation and culture of the UK and Japanese banks is so different that different regulatory responses follow. Despite similarities in financial crises, different regulatory responses are more likely due to distinctive national contexts.

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# Contents

# Abbreviations

| | |
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| BCCI | Bank of Credit and Commerce International |
| BRRD | Bank Recovery and Resolution Directive |
| CCB | Capital Conservation Buffer |
| CDO | Collateralised Debt Obligation |
| CMA | Competition and Markets Authority |
| CPC | Ceylon Petroleum Corporation |
| CRD IV | EU Capital Requirements Directive IV |
| CRR | EU Capital Requirements Regulation |
| EBA | European Banking Authority |
| ECB | European Central Bank |
| EU | European Union |
| FPC | Financial Policy Committee |
| FSA | Financial Services Authority |
| FS(BR)A | Financial Services (Banking Reform) Act 2013 |
| FSCS | Financial Services Compensation Scheme |
| FSMA | Financial Services and Markets Act 2000 |
| FCA | Financial Conduct Authority |
| HBoS | Bank formed by merger between Halifax and Bank of Scotland |
| ICB | Independent Commission on Banking |
| IM | Investment Mandate (UKFI) |
| LDP | Liberal Democratic Party (Japan) |
| LTCB | Long Term Credit Bank |
| METI | Ministry of Economy, Trade and Industry (Japan) |
| MITI | Ministry of International Trade and Industry (Japan) |

| | |
|---|---|
| OFT | Office of Fair Trading |
| PLAC | Primary Loss Absorbing Capacity |
| PPI | Payment Protection Insurance |
| PRA | Prudential Regulatory Authority |
| RBS | Royal Bank of Scotland |
| RWA | Risk Weighted Assets |
| SCB | Standard Chartered Bank |
| SRFD | Shareholder Relationship Framework Document (UKFI) |
| UK | United Kingdom |
| UKFI | UK Financial Investments |
| US | United States of America |

# Chapter 1 – Introduction

## 1. The Background and Importance of this Project

On Friday 14 September 2007, account holders were queuing outside the Northern Rock branches.[1] They were desperately trying to withdraw their savings so they could deposit them with other banks. Two days earlier, Northern Rock had acquired a liquidity support facility from the Bank of England as it was no longer able to provide its own funding from the money markets. On this news, its share price practically collapsed. Despite assurances from politicians that people did not have to worry about their savings, on the first day that the branches opened following the news, people queued outside to withdraw their savings as quickly as they could. After the weekend, the share price collapsed further, and depositors continued to withdraw even more money. To turn the tide, later that Monday, the UK government announced that it would guarantee all deposits at Northern Rock. Whilst changes to the board were made, a private sector solution was sought. In the end, on 11 January 2008, Northern Rock was effectively nationalised.

On the morning of 7 October 2008, the UK Chancellor of the Exchequer, Alistair Darling, was on his way to Luxembourg in a chartered plane to meet with the other EU finance ministers to discuss the financial crisis.[2] The morning newspapers were running the story that the bosses of the UK's largest banks had visited the Treasury the night before to discuss their desperate need for capital to stay afloat. Banks' shares were collapsing and by the time Mr Darling's plane had landed, RBS's share price had already dropped by forty percent. Later that morning, Mr Darling was called out of the meeting by his aides to take a call from Sir Tom McKillop, chairman of RBS. His question had been simple: his bank would go bust that afternoon, what would the government do? The problem with RBS was that, unlike Northern Rock, it was one of the world's largest financial institutions and its default would very swiftly bring the global financial system down with it.

It is perhaps one of the most astounding observations that at the height of the financial crisis there was almost nobody, apart from those who were intimately familiar with financial markets, who would have had any idea about the potential disaster that was hanging over their heads. About how close the financial system had come to a meltdown, where markets would effectively freeze and shut down, branches would close and cash

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[1] BBC, 'Northern Rock shares plunge 32%' (14 September 2007) <http://news.bbc.co.uk/1/hi/business/6994328.stm> accessed 4 July 2016

[2] Alistair Darling, *Back from the Brink: 1,000 Days at Number 11* (Hart Publishing 2011)

machines would no longer provide cash. For the remainder of that 7 October, the Bank of England provided as much liquidity support as was needed. The next morning, before the markets re-opened, the UK banks, including RBS, had received a capital injection from the UK government.

This thesis focusses on the weaknesses of corporate governance at UK banks during the crisis of 2007 to 2009 and on how to diminish these weaknesses. The suggested approach is, first, to provide a solid theoretical background of corporate governance and, second, to analyse the failures at UK banks and the responses that followed. A case study is introduced, which entails a comparative analysis with corporate governance reforms in Japan following their financial crisis in the nineties. The objective is to compare the weaknesses of corporate governance at Japanese and UK banks as well as to compare the measures taken to address these. Any parallels that can be drawn between the weaknesses or reforms would strengthen the conclusions. The case study of Japan will present a problem of comparative analysis, because of difficulties associated with translated source material. Another difficulty is the fact that the case study will contain a comparison between two completely different countries and legal systems. The case study is therefore also expected to provide insights into how far such a comparative case study can deliver new insights.

The background of the research is formed by the recent global financial crisis, including the failure and rescue of several large financial institutions, and the introduction of new legislation to ensure future financial stability.[3] Swift responses, such as regulatory measures, have followed the crisis. However, bailing out large financial institutions has created a large burden on governments' finances and the global economy. Several of these debt-laden countries are now facing the prospect of potentially defaulting on their debts, whilst the general public feels the pain of the economic crisis through measures of austerity imposed by governments to restore public financial health. It is no wonder that many people feel anger and resentment towards the financial institutions who, correctly or not, they see as responsible for their drop in living standards.

This puts pressure on policymakers to improve the banking system, but a deeper analysis is required if one is to go beyond mere banker-bashing. There is no doubt that corporate governance at banks at the time of the financial crisis was generally very weak, although

[3] See for an overview: David Wessel, *In FED We Trust: Ben Bernanke's War on the Great Panic* (Reprint, Crown Business 2010).

some institutions stood out. It is important to establish what exactly was wrong with it, how it is changing as a result of the measures taken and how it can be further improved. These insights can show how the overall stability of the banking system can be improved. Furthermore, it can help to define what realistic expectations one can have of the banks' role and behaviour in our society. Although they are companies whose objective is to make a profit, they perform an important role in the economy and in the functioning of society as a whole. Banks are the primary place to go to for savings, loans, mortgages, credit cards, cash machines and any other forms of financial infrastructure that society at large depends upon in its daily life. It is impossible to imagine modern day society functioning without it. This is something that most likely should be more fully recognised in the banks' system of corporate governance. This research will lead to a set of basic guidelines on banks' behaviour and their social responsibilities.

Understandably, governments have already commissioned various reports in order to analyse the crisis and to suggest improvements. In the UK, the FSA published reports on the failure of Northern Rock[4] as well as the failure of the Royal Bank of Scotland.[5] The Labour government commissioned the Walker review.[6] This review examines corporate governance at financial institutions, including board composition, the role of institutional shareholders and the governance of risk. The subsequent Conservative and Liberal Democrats government commissioned follow-up reports, in particular the report by the ICB.[7] The ICB focussed on two areas: the first is the improvement of financial stability through structural reforms of the banks, including retail ring-fencing and increasing capital. The second area is how to encourage competition in the banking sector, in particular in the retail sector. Finally, there is the report on the banking crisis by the Treasury Select Committee,[8] which examines the government's responses to the banking crisis, in particular the bail-out of several institutions, the introduction of the Banking Act 2009 and

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[4] Financial Services Authority, 'The Supervision of Northern Rock: A Lessons Learned Review' (2008) <http://www.fsa.gov.uk/pubs/other/nr_report.pdf> accessed 14 Nov 2015

[5] Financial Services Authority, 'The Failure of Royal Bank of Scotland: Financial Services Authority Board Report' (2011) <http://www.fsa.gov.uk/static/pubs/other/rbs.pdf> accessed 14 Nov 2015

[6] Sir David Walker, 'A Review of Corporate Governance in UK banks and other financial industry entities – Final Recommendations' (26 November 2009) <http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf> accessed 14 Nov 2015

[7] Independent Commission on Banking, 'Final Report – Recommendations' (September 2011) <http://www.ecgi.org/documents/icb_final_report_12sep2011.pdf> accessed 14 Nov 2015

[8] House of Commons Treasury Committee, 'Banking Crisis: Dealing with the Failure of UK Banks' (2009) <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/416/416.pdf> accessed 14 Nov 2015

the creation of UKFI. This research project will draw from these three major pieces of work and build upon them. It will seek to provide a solid theoretical base from which to examine the corporate governance at UK financial institutions and how it has changed during and after the crisis. Where the three aforementioned reports serve a purpose of informing the government on how to respond immediately after the crisis, this research provides the opportunity for a deeper examination of the situation in the UK.

## 2. Outline of the Thesis

### a. The Hypothesis and the Research Questions

The hypothesis of this thesis is: corporate governance at UK banks prior to the financial crisis was weak and post-crisis reforms did not address these weaknesses. The research questions are based on this hypothesis. They allow a careful analysis of corporate governance at banks. Based on its answers, improvements may be suggested and basic guidelines for banks' social responsibilities may be formulated. The three main research questions are:

1. What weaknesses in corporate governance at UK banks contributed to their failure?
2. What is the effect of new legislation and other initiatives on corporate governance at UK banks?
3. What is the effect of (part-) state ownership of UK banks on their corporate governance?

These questions are inevitably linked as they all relate to corporate governance at banks. The first two are especially interlinked: firstly, what went wrong and secondly, what has been done about it? Identifying these issues and their proposed solutions, which need to be evaluated to see whether or not they are appropriate, allows for a set of recommendations on banks' social responsibility and behaviour based on the experience of the crisis. The third question adds to that by taking into account that a large proportion of UK banks are or have been at least partially controlled by the government. This in itself introduces a different set of dynamics that need to be considered.

It is important to establish what this project does not cover and thereby set limitations. In the wake of the crisis, much research had been conducted into the reduction of systemic risk in the financial markets through, for example, the creation of clearing houses and other measures. The aim was to introduce transparency in the complex derivatives markets.

Many such measures have been introduced to improve the way financial markets work. Although they have received much attention,[9] they are not directly linked to the research questions on corporate governance and they will not be covered here. Likewise, there is much discussion on macro-economic aspects and other causes of the crisis, such as the failure of the US housing market (and hence the issues with the derivatives based on it[10]) and a long period of low interest rates. Although it is important to recognise that there are many other aspects and causes of the crisis, these will not be covered here. The main focus, driven by the hypothesis and the research questions, is on corporate governance at UK banks. It will ask why it was in such a weak state that these institutions could be so severely hit during the crisis and how it can be improved. Finally, because this is a fast moving area with many developments at both national and international level, there is a limitation on the research period: the material used is up to 1 December 2015.

### b. Outline of Answering the Research Question

This first chapter provides the background to and importance of the research, the research hypothesis and the research questions. It also analyses the research methods that are needed to answer the research questions. It lays out the issues of methodology that are expected to arise during this research. This starts with the general methodological questions, examining how to conduct legal research. Reports and legislation introduced after the crisis will be important primary sources. Archives, for example of newspapers, provide a valuable source for historical information. After the general discussion, the focus is on the narrower field of comparative methodology. This study is required because this project, by nature, involves a large amount of comparative methodology. It is therefore desirable to describe upfront what the expected issues will be so they can be addressed. Some of the issues include the harmonisation at a global level in reports produced by the Basel Committee[11] and by the Senior Supervisors Group[12] and their transplantation into national regulatory frameworks. Another issue is the comparative analysis between

[9] Christopher L. Culp, 'The Treasury Department's Proposed Regulation of OTC Derivatives Clearing and Settlement' (2009) Working Paper No 09-30, CRSP Working Paper <http://ssrn.com/abstract=1430576> accessed 14 Nov 2015

[10] William Poole, 'Causes and Consequence of the Financial Crisis of 2007-2009' (2010) 33 Harv J L & Pub Pol'y 421

[11] Basel Committee on Banking Supervision, 'The Basel Committee's Response to the Financial Crisis: Report to the G20' (October 2010) <http://www.bis.org/publ/bcbs179.pdf> accessed 14 Nov 2015

[12] Senior Supervisors Group, 'Risk Management Lessons from the Global Banking Crisis of 2008' (21 October 2009) <http://www.financialstabilityboard.org/publications/r_0910a.pdf> accessed 14 Nov 2015

different countries: corporate governance, board structure and even what exactly a company is, will vary.

After this analysis of the research methodology, the theoretical foundations need to be built. These will provide the necessary background for the remainder of the thesis and form the answers to the research question. The second chapter will start with a discussion of the difference between the company as a legal entity and a real world entity. This includes different theories about the existence of the company. It is necessary to understand what a company actually is as it will inform the analysis of control of the company, and thus of corporate governance. With this difference between a real world company and the legal entity in mind, various theories of existence of the company are introduced. This is followed by a discussion of the main theories of corporate governance. An understanding of these fundamental theories is required to analyse what went wrong with corporate governance specifically at banks and to find ways to improve it. This includes an analysis of internal and external corporate governance, as this distinction will be particularly important for corporate governance at banks. Not only the main theories are examined, but also the leading report including the Cadbury report[13] and subsequent reports. These reports are used to derive other working concepts of a system of good corporate governance and will inform the analysis of corporate social responsibility. Corporate governance is in essence concerned with the control of the company. Corporate social responsibility is concerned with the role of the company in its wider community and thus its behaviour towards its stakeholders. It is important to analyse this as stakeholders at banks, for example depositors, should play a significant role.

These concepts of the company, corporate governance and corporate social responsibility, need to be discussed in general terms before a specific analysis can be done for banks. Corporate governance at banks is essentially the same as that of any other company but with added extras. In particular, the roles of depositors, the regulators, credit rating agencies and other gatekeepers, as well as the specific capital requirements and the greater role for risk management make corporate governance at banks a special case compared to companies. As a consequence, the distinction between internal and external corporate governance becomes more important when analysing corporate governance at banks.

[13] Sir Adrian Cadbury, *Report on the Committee on the Financial Aspects of Corporate Governance* (London, Gee&Co, 1992)

Having set out the necessary tools of the research methodology and the theoretical background, it is possible to analyse the failures of UK banks and the consequences in the third chapter. In particular, the failures of Northern Rock and RBS are examined in detail. This study is needed to answer the first research question: what weaknesses in corporate governance contributed to their failure. Furthermore, this detailed analysis and the identified weaknesses will inform the debate on whether new measures and legislation address these weaknesses and improve corporate governance. It must be clear from the outset that it is unrealistic to assume that it is possible to prevent such a failure from ever happening again. In fact, the objective of the regulator is not to prevent defaults from happening, but to ensure that when they do they occur in an orderly fashion and without costs to the general public.[14]

Building on the analysis of the failures and weaknesses of corporate governance at UK banks, the following two chapters analyse the various responses. Of these two chapters, the first contains a discussion of the immediate responses, including the emergency measures. The second chapter contains the analysis of longer term solutions. In the first of the two chapters, there is a discussion of the important emergency tools including the revised protection of depositors and the newly introduced Banking Act 2008 and 2009. These were used to resolve the failures of the Icelandic banks, of Northern Rock and RBS, which are examined in more details. Aspects covered include the protests of existing shareholders and the intervention of the EU on competition. Once failing institutions were being nationalised, UKFI was created to manage the government's investments at arm's length. The role of UKFI and government ownership on corporate governance as well as on the performance of the nationalised banks is examined. The rights of minority shareholders are discussed as well as the conflicts between government policy, company objectives and regulatory requirements.

The next chapter discusses the regulatory measures introduced, the major reports commissioned and their impact on corporate governance of UK banks following the crisis. The question is whether this new regulation addresses the failures identified. Starting from

[14] Hector Sants, 'Reforming Supervisory Practices: Progress to Date' (Speech Reuters Newsmakers Event 13 December 2010) <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/1213_hs.shtml> accessed 14 Nov 2015

a global level with the international responses, such as those by the G20,[15] the Financial Stability Board,[16] the Basel Committee[17] and the Senior Supervisors Group,[18] it leads on to the reports, national responses and implementation of international recommendations. This includes implementation of the various EU directives as well as an examination of major reports by the Independent Commission for Banking,[19] the Walker Review[20] and various others. Based on this analysis, an informed answer can be given to the research questions.

### c. Case Study: Japan

To gain further insight into failures of corporate governance at banks, a comparative analysis between the current crisis in the UK and Japan's financial crisis in the nineties[21] will be undertaken. This period has exposed weaknesses of corporate governance at Japanese banks. It has led to gradual reform of corporate governance and the comparative analysis will focus on how these reforms and their impact compare to the UK. The period for the case study starts at the beginning of the 1990s, when Japan experienced the bursting of an asset pricing bubble. It greatly impacted the national financial sector as well as the overall economy leading to what is now generally called 'the lost decade'. After 1991, failures of small financial institutions started to occur throughout Japan, but none of them were significant enough to pose a threat to the overall financial system. In December 1994, two credit cooperatives threatened to go under: Anzen Credit Bank and Tokyo Kyowa Credit Association.[22] It was the first time that public funds were used by the Bank of Japan to prevent the failure of financial institutions. Despite paying high interest to attract funds, including that of politicians and political parties, the two institutions were alleged to be

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[15] G20 Leaders, 'Leaders' Statement: The Pittsburgh Summit' (24-25 September 2009) <https://g20.org/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf> accessed 14 Nov 2015

[16] Financial Stability Board, 'FSB Principles for Sound Compensation Practices – Implementation Standards' (25 September 2009) <http://www.financialstabilityboard.org/publications/r_090925c.pdf> accessed 14 Nov 2015

[17] Basel Committee on Banking Supervision (n 9)

[18] Senior Supervisors Group (n 10)

[19] Independent Commission on Banking (n 5)

[20] Sir David Walker (n 4)

[21] See for an overview: Nakaso, Hiroshi, 'The Financial Crisis in Japan during the 1990s: How the Bank of Japan responded and the lessons learnt' (October 2001) <http://www.bis.org/publ/bppdf/bispap06.pdf> accessed 14 Nov 2015

[22] Steven Brull, 'Japan Rescues Thrifts with Public Funds' *New York Times* (Tokyo, 10 December 1994) <http://www.nytimes.com/1994/12/10/business/worldbusiness/10iht-rescue.html> accessed 14 Nov 2015

mismanaged and state prosecutors stepped in.[23] The Bank of Japan was criticised for the use of public funds for the bailout. There was a need for a more structured way of dealing with bank failures, especially after more banks needed to be rescued in the summer of 1995. In 1996, Japan introduced its first Deposit Insurance Law, giving the authorities more tools to deal with failures of financial institutions.

However, in October 1997, the financial crisis hit in full force as several of Japan's financial institutions could no longer adequately deal with the non-performing loans on their books. Major financial institutions, including Sanyo Securities, Hokkaido Takushoku Bank, Yamaichi Securities and Tokuyo City Bank, failed. Japan saw at least one major financial institution collapsing every week leading to the Bank of Japan providing funds as lender of last resort on an unprecedented scale.[24] Although new measures were introduced, in 1998 the next wave came as two large banks, Long Term Credit Bank of Japan[25] and Nippon Credit Bank,[26] failed and were nationalised. This led to new regulatory measures and the establishment of the Financial Reconstruction Commission. This regulator assessed the unrealised losses that the banks had on their books and calculated the capital injection that would be needed for the major banks. In March 1999, the government provided the banks with this capital injection to stabilise the financial markets.

There are clear parallels between the UK case and the Japan case. From some of most immediate causes, such as unknown and unrealised losses as well as insufficient capital, to some of the measures, such as nationalisation, the similarities between the two banking crises justify a thorough comparative analysis. Whilst in the roaring eighties alliance capitalism and the keiretsu were placed firmly at the forefront of Japanese business practice,[27] the slump in the nineties brought doubt that these models were still adequate for Japan to be competitive in the global markets. The Main Bank system, large cross-shareholdings and lifetime employment were characteristics of Japan's corporate

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[23] Steven Brull, 'Prosecutors Set to Study Credit Bailout in Japan' *New York Times* (Tokyo, 13 February 1995) <http://www.nytimes.com/1995/02/13/business/worldbusiness/13iht-jcred.html> accessed 14 Nov 2015

[24] Nakaso, Hiroshi (n 19) 8-12

[25] 'Major Japanese Bank Seeks Nationalization' *New York Times* (23 October 1998) <http://www.nytimes.com/1998/10/23/business/major-japanese-bank-seeks-nationalization.html> accessed 14 Nov 2015

[26] 'Acting Quickly, Japan Seizes a 2nd Big and Failed Bank' *New York Times* (14 December 1998) <http://www.nytimes.com/1998/12/14/business/acting-quickly-japan-seizes-a-2d-big-and-failing-bank.html?src=pm> accessed 14 Nov 2015

[27] For an overview, see: Michael L Gerlach, *Alliance Capitalism: The Social Organisation of Japanese Business* (University of California Press 1992)

governance,[28] but with the major financial reforms in 1997 and the following changes to the Commercial Code an attempt was made to bring Japan's corporate governance more in line with US practices.[29]

There are significant similarities between the crisis in Japan and the current financial crisis that more than justify this comparative analysis. In the chapter on Japan, this comparative analysis seeks to draw conclusions about the effectiveness of the current proposed measures for the UK banking systems including the changes to corporate governance. Furthermore, some of the more recent problems of corporate governance for non-financial institutions in Japan, such as TEPCO and Olympus, are discussed. The objective is to examine how effective the attempts to reform corporate governance have been in Japan itself and whether they provide valuable lessons for the UK. Besides the large amount of financial regulation that was introduced at the end of the nineties, changes to Commercial Code were made as well. These changes, including the choice of board structure, the establishment of a Board of Statutory Auditors and the introduction of stock option schemes, were aimed at improving corporate governance.[30] A comparative analysis between corporate governance reforms in the UK and in Japan can assess whether there were both different and similar issues of corporate governance and how these were addressed.

## 3. General Consideration in Methodology

### a. Legal Sources and Methodology

As part of the response to the financial crisis, lawmakers have issued new legislation and asked specialised commissions to write recommendations on the prevention of future crises. Both are valuable sources, both for their actual contents as well as for the context and purpose for which they have been written. The larger pieces of relevant legislation in the UK and EU are clearly identifiable, just as those introduced during the 'Big Bang' in 1997 in Japan. Several reports have been written at a transnational level by various influential commissions that set up guidelines for new financial regulation. Likewise, there are important national reports. In some situations, case law is available. It is worth considering some particular aspects with the use of case law: although judges are deemed

[28] Masahiko Aoki, 'Towards an Economic Model of the Firm' (1990) 28 J Econ Lit 1
[29] Hiroshi Oda, *Japanese Law* (3rd edition, OUP 2009)
[30] Ronald J. Gilson and Curtis J. Milhaupt, 'Choice as Regulatory Reform: The Case of Japanese Corporate Governance' (2005) 53 Am J Comp L 343, 347 and Hiroshi Oda, *Japanese Law* (3rd edition, OUP 2009) 219

to be impartial, it does not mean that they always reach the correct decision.[31] It is the judicial interpretation of the law that is transmitted. A benefit of common law (and case law) is that it has been developed over a long period of time. Statutes, however, can be made by parliament in the heat of the moment.[32] As such, it is for example a better tool to manage a crisis. Case law can also be changed to reflect the changes in society over time.[33] But although it can change, it would require a relevant case to be brought before a sufficiently senior court, which can take a long time.

But how does one use these legal sources, i.e. statutes and case law? One approach is to use legal reasoning in the way judiciary might use it. This leads to a form of reasoning based on taking the law as axioms, already formed and shaped.[34] Such a black-letter-law approach may be very useful in answering the questions regarding the direct effects of the new regulation and legislation that is being introduced. However, by examining legal resources in only such a way, and effectively regarding legal reasoning as something special, one disregards a link with the social sciences. Looking beyond the rules, there is much relevant information and there are many facts to consider. Without summing up potential ways of approaching the problem from a social sciences background,[35] it is sufficient to say that they can greatly add to a mere rule-based approach. Hence this wider approach will be helpful in answering the questions to why certain new statutes and regulations have been introduced by lawmakers in this particular form or what their wider, perhaps unintended, consequences might be.

### b. Additional Sources: Biographies and Archives

Getting the historical facts right, with objectivity and without relying on a selective memory to what events took place and how they happened exactly, is required for the accuracy and credibility of the research. It will therefore be important to consult extensively with archives, in particular those of respected newspapers, to establish a clear timeline of the historical events. It can also serve to identify the different standpoints of the actors at each stage during and after the crisis. For lawmakers, additional archives such as Hansard are available, to trace down reasoning and arguments concerning emergency measures taken. Using these widely and extensively before reaching one's own conclusion is generally necessary, but especially important for this research. An additional source of information

[31] Margaret Davies, *Asking the Law Question* (3rd edn, Lawbook Co 2008) 40-45
[32] ibid 47
[33] ibid 57
[34] Geoffrey Samuel, 'Can Legal Reasoning Be Demystified' (2009) 29 Legal Stud 181, 185
[35] ibid 192

can be the bibliographies of various high-profile figures during the financial crisis. These could include Hank Paulson and Alistair Darling, who have published their accounts in various bibliographies.[36] Although one cannot take these writings at face value, it does provide their version of the events.

### c. Methodology for the Japan Case Study

As mentioned before, with limitations on the use of Japanese language sources, there will be a great reliance on secondary sources and translated work such as the handbook of Japanese commercial law in German[37] and a more general work in English.[38] These sources must be used with care, as it is not known what may have been lost in translation. Using many different sources from different authors on the same topics allows a comparison between them, hopefully revealing any mistranslations or other issues.

One has to consider the comparative problem concerning the different structures of the company in Japan. Before the financial crisis in the nineties, Japanese companies were structured together in a keiretsu in accordance with the main bank system.[39] These Japanese companies had specific characteristics, as described by the theory of J-Firm,[40] such as lifetime employment. Cultural differences in society had led to differences in capitalism.[41] This in turn raises the question whether there really is a 'Japanese Style of Management'.[42] It will be very important to take these social and cultural aspects into consideration in this case study. Moreover, after carefully tracking the changes from the Big Bang Reforms in 1997 and the subsequent Commercial Code Changes, it will be important to establish a methodology for measuring change. One can look at individual cases, such as the Daiwa trading scandal in New York and hostile take-overs such as Livedoor - Fuji TV and UFJ Sumitomo, but is this the right way of measuring change? In this case study, previous research has shown that individual but isolated cases can always be found to argue that change has occurred, but that any study at national level will show that

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[36] See Hank Paulson, *On The Brink: Inside the Race to Stop the Collapse of the Global Financial System* (Headline Publishing Group 2010) and Alistair Darling, *Back from the Brink: 1,000 Days at Number 11* (Hart Publishing 2011)
[37] Harald Baum and Moritz Bälz (eds), *Handbuch Japanisches Handels- und Wirtschaftsrecht* (Carl Heymanns Verlag 2011)
[38] Hiroshi Oda (n 27)
[39] Michael L Gerlach (n 25)
[40] Masahiko Aoki (n 26)
[41] Yoshio Sugimoto, *An Introduction to Japanese Society* (3rd edition CUP 2011) 88-
[42] Tomoko Hamada, 'The Anthropology of Japanese Corporate Management' in Jennifer Robertson (ed) *A Companion to the Anthropology of Japan* (Blackwell 2008)

no change has occurred.[43] It has been suggested that the most appropriate way to examine changes is by taking a small field and examining changes in that specific area.

## 4. Comparative Methodology in Law and Corporate Governance

### a. General Problems of Comparative Analysis

Because of the comparative nature of this research, it is necessary to establish upfront how to approach the problems associated with comparative analysis. Whilst the next sections outline the specific comparative elements for each of the chapters, some basic groundwork needs to be done first. Comparative law is 'the comparison of different legal systems in the world'.[44] A distinction can be made between macro-comparison and micro-comparison: where the former looks at the handling of legal materials or the role of those involved in law, the latter looks at specific legal institutions and problems.[45] But it is perhaps clearest to describe comparative law by pointing out what it is not: comparative law is not merely a descriptive analysis of foreign law as it requires specific comparative reflections on the problem.[46] Comparative law touches on many other fields, including sociology. It is generally accepted that society, or human behaviour and preferences, and with it social changes, whether economic, political or demographic, influence the legal system.[47]

The basic methodological principle for comparative law is that of functionality: Zweigert and Kötz argue that it is only possible to compare things that have the same functionality.[48] The two things that are compared must have the same purpose or functionality, but that does not mean that they can be found in a similar section of a similar statute or other piece of legislation. It is necessary to keep an open mind as to how objectives have been achieved differently in different jurisdictions. Not everyone believes that such a functional approach is satisfactory. A narrow view of 'the comparative enterprise', reduced to 'the dry juxtaposition of the rules of one legal culture with those of another' does not constitute a full comparative analysis but a mere 'contrasting'.[49] The point is that there is much outside the legal texts and judgments of great relevance for a comparative analysis that needs to be considered.

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[43] Bruce E Aronson, 'Changes in the Role of Lawyers and Corporate Governance in Japan: How Do We Measure Whether Legal Reform Leads to Real Change?' (2009) 8 Wash U Global Stud L Rev 223
[44] K Zweigert and H Kötz, *An Introduction to Comparative Law* (Tony Weir tr, 3rd edn, OUP 1998) 2
[45] ibid 4,5
[46] ibid 6
[47] ibid 10
[48] ibid 34
[49] Pierre Legrand, 'How to Compare Now' (1996) 16 Legal Stud 232, 234

For the comparison, it is important to phrase a question in a more general form. This avoids limitations and restraints, in particular with regard to sources of law, if one is to find an answer in different legal systems. Besides asking the correct question, it is important to determine a suitable legal system for comparison.[50] Depending on a country's history, its legal system may not be extensively developed in particular areas. However, once the right questions have been formulated along a functional line and an appropriate foreign legal system has been chosen for comparison, the task remains of building a system for comparison.[51] Such a system is in essence a loose concept containing words, syntax and concepts needed for the analysis.

The international nature of the financial markets and the fact that banks have become large worldwide institutions underlines not only the global dimension of the research project but also that globalisation has become an increasingly important factor in legal analysis. A national system no longer stands on its own as it did a few hundred years ago: international trade and interaction with other nations has a great influence at national level. Globalisation, which is in itself a problematic word, especially in legal terms,[52] brings many challenges of comparative law.[53] One of the most important challenges that is relevant for this research project is that of 'legal phenomena' at different levels, including global, regional or national, need to be considered with their own history, interaction and transplants.[54] Transplants, or 'the borrowing from another legal system', are a common form of legal change.[55] This terminology, 'transplant', is sometimes regarded as misleading: it seems to suggest that one could surgically cut-and-paste a piece from one country's legislation into that of another without any problems. It is, however, more likely that this 'transplanted' piece of legislation causes friction with existing legislation as well as with domestic culture, leading to a 'legal irritant' instead.[56] The use of one country's legislation by those who make the law in another country should be done with care.[57]

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[50] K Zweigert and H Kötz (n 42) 42
[51] ibid 44
[52] Peter Muchlinski, 'Globalisation and Legal Research' (2003) 37 Int'l L 221, 225
[53] William Twining, 'Globalisation and Comparative Law' (1999) 6 Maastricht J Eur & Comp L 217, 238
[54] ibid 240
[55] Alan Watson, 'Legal Change: Sources of Law and Legal Culture' (1983) 131 U Pa L Rev 1121, 1146
[56] Gunther Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergence' (1998) 61 Mod L Rev 11, 12
[57] O. Kahn-Freund, 'On the Uses and Misuses of Comparative Law' (1974) 73 Mod L Rev 1

Globalisation brings with it more concepts, such as "legal convergence", "legal diffusion" and "harmonisation".[58] Legal convergence can be defined as the process of attaining the same results in different legal systems or more specifically to eliminate differences between common law and civil law. Legal diffusion refers to a change of a legal system by another outside legal system, either through transplantation, legal borrowing or simply inspiration. Finally, harmonisation covers the attempt to bring about a form of legal similarity. These are important concepts as both financial regulation and corporate governance code is ever more determined at an international or regional level before finding its way into national legislation. The next sections outline specific issues of comparative analysis for each of the chapters.

### b. Comparative Analysis of Corporate Governance

To lay the groundwork for the actual research, the next chapter establishes what is meant by terms such as corporate governance, a system of corporate governance and corporate social responsibility. Defining these concepts is quite problematic: what is included or excluded in the definition already indicates what is regarded as important and hence depends on the background and views of who is defining it.[59] What is understood precisely by corporate governance varies per country. Different corporate laws, codes or rules, as well as different economic, social, political or historical paths and developments, have led to different notions of corporate governance.[60] With corporations expanding across national boundaries, whilst attracting money from investors globally, corporate governance is being brought outside national boundaries and is caught up in the process of globalisation.[61] Although various transnational institutions, such as the OECD, produce guidelines on corporate governance,[62] these reports as well as the emergence of transnational corporations and global capital markets do not necessarily mean that there is

[58] Camilla Baasch Andersen, 'Defining Uniformity in Law' (2007) 12 Unif L Rev 5, 12-15

[59] Donald C Clarke, '"Nothing But Wind"? The Past and Future of Comparative Corporate Governance' (2011) 59 Am J Comp L 75, 79

[60] See Mark J Roe 'Some differences in Corporate Structure in Germany, Japan, and the United States' (1993) 102 Yale L J 1927 or Lucian Arye Bebchuk and Mark J Roe, 'A Theory of Path Dependence in Corporate Ownership and Corporate Governance' (1999) 52 Stan L Rev 127

[61] Arthur R Pinto, 'Globalisation and the Study of Comparative Corporate Governance' (2005) 23 Wis Int'l L J 477, 485-488

[62] OECD, *OECD Principles of Corporate Governance* (Paris, OECD Publication Service 2004) <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf> accessed 14 November 2015

convergence on corporate governance.[63] In any definition and analysis of corporate governance national economic, political and other historical events need to be considered.

A direct comparative analysis between countries' corporate governance is complicated. Consider for example the different legal structure of a company, the different board structure (one- or two-tier) in different countries or the difference in representation of labour at board level. All these matters need to be taken into account when discussing corporate governance: it requires consideration, for example, for the role of directors or which stakeholders to consider. One solution is to compare parts of the system that perform the same function. This approach searches in the different structures for parts that are not necessarily exactly the same in title or mandate in the structure but perform, amongst others, the same function that one is after. One of the problems of functional analysis is that it assumes that one knows what function to look for. Furthermore, the functional approach is insufficient as it still ignores the context of the system.[64] Even if by using this approach some 'functional convergence' between systems of corporate governance of different countries can be observed, the path dependency will lead to differences.[65]

Path dependency implies that many of today's differences in corporate ownership structure can be explained by circumstances and decisions made in the past. In particular, structure-driven path dependency and rule-driven path dependency can be distinguished: structure-driven means that the initial ownership structure has a great effect on how the ownership structure develops thereafter[66] whilst rule-driven means that initial ownership structures have affected the development of legal rules.[67] A wider description of path dependency would include the complete social and economic development of a country, as these can be helpful in describing the attitude and understanding of concepts as transparency and disclosure.[68]

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[63] Some academics argue differently, see Henry Hansmann and Reinier Kraakman 'The End of History for Corporate Law' (2001) 89 Geo L J 439
[64] Lucian Arye Bebchuk and Mark J Roe (n 58) 133, 134
[65] Klaus J. Hopt, 'Comparative Corporate Governance: The State of the Art and International Regulation' (2011) 59 Am J Comp L 1, 8-10
[66] Lucian Arye Bebchuk and Mark J Roe (n 58) 139
[67] ibid 153
[68] Hopt (n 63) 9

The definition of corporate social responsibility is complicated, as different actors emphasise different aspects – depending on their viewpoint.[69] It is generally used as an all-encompassing term for relations between the company and its external stakeholders, varying from employees to the environment. The main difficulty is whether good corporate social responsibility means adhering to the relevant law, or going above and beyond it. It raises the difficult question whether corporate social responsibility is voluntary, driven by ethics, or whether it is already enshrined in the companies' legal obligations. The comparative analysis of corporate social responsibility is equally difficult, because it extends the problems faced with a comparative analysis of corporate governance.[70] In the same way the structure of the company, as well as the social, legal and economic development of the country, shape the system of corporate governance, it will also define what is understood by corporate social responsibility.

As part of the comparative analysis, it is necessary to consider the influence of harmonisation in relevant international reports or the influence of foreign legal systems on individual nations. In defining a 'system of corporate governance', elements from different nations may be compared if possible. The analysis may need to start off with general corporations but ultimately needs to focus on financial institutions, which have specific elements of corporate governance. Based on this analysis, it will be possible to assess what was wrong with banking corporate governance in the period leading up to the financial crisis and whether sufficient adjustments are being made.

### c. Comparative Analysis of Financing and Insolvency

The ability to allow for an orderly default of a financial institution is important: it is after all not the objective of the financial regulator to prevent the default of financial institutions. It is not regarded as a regulatory failure if such a default occurs with minimal costs to the economy, tax-payers and customers. Hence part of the answer to the research questions will come from the study of default mechanisms and what had been done if these were not sufficient. The relevant areas include some insolvency law to cover default events, law relevant to the (temporary) nationalisation of financial institutions and anything that follows from that, such as competition laws. It is not surprising that finance, insolvency and corporate governance are linked. All of these are connected to the history of the country in

[69] Jennifer A Zerk, *Multinationals and Corporate Social Responsibility: Limitations and Opportunities in International Law* (CUP 2006) 29-32

[70] Cynthia A Williams and Ruth V Aguilera, 'Corporate Social Responsibility in a Comparative Perspective', in Andrew Crane, Abagail McWilliams, Dirk Matten, Jeremy Moon and Donald S Siegel (eds), *The Oxford Handbook of Corporate Social Responsibility* (OUP 2008) 457

which a particular form has emerged, although it is difficult to attribute particular systems to particular countries.[71] The point is that alternative conditions at different points in time have created the different evolutions of governance which exist today.

Insolvency law inevitably relates closely to the history of finance within each country. The influence of the different history in commerce and finance is clear from differences in relevant law between countries even as geographically close as England and France.[72] The different history of finance of countries, although there was influence through early trade and commerce, can be found in basic elements such as different financial terminology or different coinages.[73] From the loan sharks and banks of Northern Italy in the thirteenth century and from innovations such as the establishment of the first foreign exchange bank in Amsterdam in 1609 and the Bank of England in London in 1694, to today's world of finance,[74] it is clear that each country has its own rich traditions and attitudes towards finance. This also means that each country has different insolvency laws. These insolvency laws in effect do little more than prescribe the priority given to creditors of a failing company. This is very much determined by the financial history of that country.

One of the problems with insolvency is that in the UK it does not travel through the system. This is due to the limited liability structure adopted by companies. The history of limited liability can be closely linked to the ideas at various times and its creation was certainly far from obvious.[75] It can even be argued that it causes corporate irresponsibility because it poses no obligations, responsibilities or liabilities on the owners of the shares despite the fact that they enjoy income from the company.[76] Note that for debtors, the only assets available to them in case of failure would be those of the company, not of its owners. The strict separation between ownership and the company itself grew further by the creation of corporate groups, extending the concept to subsidiary companies. One can now understand how limited liability prevents insolvency to travel through an organisation and how this may further complicate the failure of a large bank.

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[71] Garry Herrigel, 'Corporate Governance: History without Historians', in Geoffrey Jones and Jonathan Zeitlin (eds), *Handbook of Business History* (OUP 2007)
[72] Nicholas H.D. Foster, 'Comparative Commercial Law' in Esin Örücü and David Nelken (eds), *Comparative Law: a Handbook* (Hart Publishing 2007), 269-273
[73] Irene Finel-Honigman, *A Cultural History of Finance* (Routledge 2010) 11-42
[74] Naill Ferguson, *The Ascent of Money: A Financial History of the World* (Penguin Books 2009)
[75] Rob McQueen, *A Social History of Company Law* (Ashgate 2009)
[76] Paddy Ireland, 'Limited Liability, Shareholder Rights and the Problem of Corporate Irresponsibility' (2010) 34 Camb J Econ 837

There are other solutions besides insolvency laws that countries have adopted to reduce the social and economic impact of a banking failure: consider the stabilising impact of the Asset Protection Scheme or the Financial Services Compensation Scheme. Different measures have been taken to achieve the same goal of financial stability in the face of a banking failure and it is necessary to compare the complete set of these measures. Lifting out one measure ignores the context of this measure in the whole package of measures available. The history is important.[77] The comparative law aspect is therefore similar to that discussed above in the context of company law or financial regulation in general.

Another consequence of bank insolvency has been the nationalisation of failed banks. The swift capital injection into the failing financial institutions by governments has led to the unexpected return of state-owned enterprises. Again, this has worked out differently in various countries: in the US almost all recipients have repaid this capital whilst the UK looks set for a much longer time period with state-run banks. Comparative aspects include not merely how different governments have legally structured their investments in these banks, but also how they deal with issues such as competition law and conflicts between their policy and the commercial objects of the banks. Issues that will arise are similar to that of company law or regulatory law as discussed above. Competition rules should be examined at both national level and international level, within the EU or globally. Competition rules should also be examined considering any form of state-aid, whether this is a direct capital injection or the insurance of impaired assets. The potential conflict of government policy, social pressures and the commercial objectives of a (temporarily) nationalised financial institution are interesting from a corporate governance point of view. The comparative law issues concerning corporate governance have already been discussed previously.

### d. Comparative Analysis of Financial Regulation

There are two immediate issues of comparative law with regard to these newly introduced measures: 1) harmonisation and transplants and 2) direct comparative analysis. The first issue is based on the observation that many regulatory measures or reports produced are done at a global level.[78] As capital markets operate globally, the need for uniformity[79] in regulation globally has increased; something that is underlined by the creation of

[77] Gabriel Moss, 'Comparative Bankruptcy Cultures: Rescue or Liquidation? Comparison of Trends in National Law – England' (1997) 23 Brook J Int'l L 115

[78] Loukas A. Mistelis, 'Regulatory Aspects: Globalization, Harmonization, Legal Transplants, and Law Reform – Some Fundamental Observations' (2000) 34 Int'l L 1055, 1056-1057

[79] For a detailed discussion on the use of 'uniformity' in law see: Camilla Baasch Andersen (n 56)

organisations such as the Basel Committee, IOSCO and the SSG. An absence of uniformity can easily lead to regulatory arbitrage or competitive (dis-) advantages for financial centres. These global agreements and reports are, however, compromises between national interests and ideas as they seek to harmonise regulation. This raises the question of whether the measures remain effective and whether they can achieve what is intended. The next phase is to implement these harmonised measures at a national level, at which stage it becomes a legal transplant. As with harmonisation, legal transplants raise questions about effectiveness and, more generally, how they will work within the host nation.[80]

An example of this first issue of comparative law is the agreed capital ratio in Basel III.[81] The agreed number represents the amount of capital a bank is required to hold, yet as it is agreed on a global level, it is an average of what all individual nations have agreed to. Their decision to agree with this can be based upon many different reasons, both economic and political. In turn, this ratio is implemented into each nation's regulatory laws. The effects of this will differ greatly between different nations: some may be in recession and the figure may constrain banks in lending more, restricting the economy further. For other nations, the agreed ratio may actually be lower than what is currently held by banks anyway, having little effect. The capital ratio is a good example of harmonising the ideas of many nations into a single number. However different the transplant may work out between these nations, for transnational financial institutions such a global agreement is far preferable over having many different local regimes without harmonisation.[82]

To deal with the first issue of comparative law, the first part of this chapter will contain the international harmonised responses. Thereafter the implementation at group- and national level are discussed, i.e. at EU level and at UK level. The discussion at UK level also includes national initiatives and reports, which do not necessarily contain the same recommendations as the international reports. These global and national reports, as well as national legislation and, where available, case law, will give a picture of how the responses have first been formulated at G20 level and are ultimately being implemented in national legislation.

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[80] Gunther Teubner (n 55) 12 or Nicholas H.D. Foster, 'The Journal of Comparative Law: A New Scholarly Resource' (2006) 1 JCL 1, 8

[81] Basel Committee on Banking Supervision, 'Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems' (December 2010) <http://www.bis.org/publ/bcbs189_dec2010.pdf> accessed 14 November 2015

[82] Loukas A. Mistelis (n 76) 1168

The second issue of comparative law is that of direct comparative analysis. This means the comparison of one aspect within one system with another.[83] A direct comparison can be hindered by a variety of things, such as different language used or slightly different legal concepts. For purposes of comparison, it is important to derive the underlying assumptions and the background to each legal system to come to a meaningful comparison. In other words, a simplistic and narrow contrasting of the rules in two legal and regulatory systems via black-letter-law would be inadequate if only because legal terms from different systems (and in different languages) will be difficult to compare.[84] For the purpose of comparison, the analysis must go beyond these sets of rules, beyond the surface, to examine the history, the politics and the social economic context.[85] As an example, some aspects of financial regulation may be harmonised, such as capital requirements and depositor protection. But there are national institutes other than governments and financial regulators that influence financial regulation, such as stock exchanges regulating their members and consumer watchdogs representing depositors' interest. Hence comparing regulatory measures on their own with the closest apparent equivalent in a different country can be misleading if a more complete picture is not considered.[86]

To deal with the second issue of comparative law, the following are discussed: the problem of direct comparative analysis, the specific UK context of the national implementation and initiatives, as well as the events in other countries driving the international initiatives. These different events have resulted in different approaches: the international initiatives perhaps have a greater emphasis on reducing global systemic risk, while national initiatives may be in part motivated by problems surrounding the rescue of what once were the national financial champions. For an accurate historical picture, archives of respectable newspapers can be consulted. Additionally, interviews, speeches and biographies of major political players can be used to provide a background to historical decisions made at the time.

### e. Comparative Analysis in the Case Study of Japan

Japan, which during the nineties faced a financial crisis followed by more than a decade of reforms, is an important case study. Part of Japan's responses to the crisis amount to a

[83] Nicholas H.D. Foster (n 78) 7
[84] Pierre Legrand (n 47) 234
[85] ibid 236
[86] Other company law specific examples are provided by Nicholas H.D. Foster, 'Comparative Commercial Law' in Esin Örücü and David Nelken (eds), *Comparative Law: a Handbook* (Hart Publishing 2007)

gradual legal transplantation of selected Delaware laws to change its corporate governance.[87] There are many problems of comparative law. First and foremost, there is the language barrier in accessing Japanese (legal) sources. Some of the relevant legislation and codes are available in English: the Ministry of Justice publishes the most important new laws in both English and Japanese on their website.[88] The difficulty is that not all laws are published and that, unlike for example in Westlaw, it is difficult to see which parts of the laws are repealed or in force. Another example is the Japanese Corporate Auditors Association, which publishes codes, rules and parts of relevant law in Japanese but with an English translation on their website.[89] There is also a fair amount of German[90] and a growing amount of English[91] secondary source material available. As with the official English versions of Japanese laws, one is relying on their accuracy and on the fact that nothing has been lost in translation. Especially when going from Japanese via German to English, this is a substantial risk.

The methodology of studying Japanese law in the English speaking world has shifted over the last years to consider seriously the relevant cultural aspects in the analysis.[92] Where early research did often take very limited statistical data into consideration and then generalised, in the eighties a shift towards econometrically sound analysis accompanied English studies of Japanese law. The analysis was accompanied by a realisation that merely understanding the rules was insufficient. In particular with reference to Japan, which is in many ways so different from European nations, it is important to understand how and why rules were made. This full analysis has more explanatory value than merely studying the impact of legislation in Japan.[93] This increased use of socio-economic analysis when studying Japanese law enriches the analysis by understanding why laws are made and how they interact with rules in society. It draws away from conclusions as to whether Japan is now converging to similar legal systems as seen in the West. Instead, Japan is still recognised as a nation on its own with its own political, economic and social factors and it

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[87] Hiroshi Oda (n 27)
[88] For example: Ministry of Justice, Japan, 'Companies Act (Part I, Part II, Part III and Part IV) Act No 86 of July 26, 2005' (2012) <http://www.japaneselawtranslation.go.jp/law/detail/?ft=3&re=02&dn=1&ia=03&bu=8&_x=97&_y=18&ky=&page=7> accessed 14 November 2015
[89] For example: Japanese Corporate Auditors Association, 'Rules of the Kansayaku-kai (Model Form)' (6 June 2006) <http://www.kansa.or.jp/en/el001_070926-1.pdf> accessed 14 November 2015
[90] Harald Baum and Moritz Bälz (eds) (n 35)
[91] Hiroshi Oda (n 27)
[92] Luke Nottage, 'The Cultural (Re)Turn in Japanese Law Studies' (2008) 39 V U W L R 755, 770
[93] ibid 771

is regarded as having a complex and gradually shifting legal system of its own right.[94] It underlines the fact that, despite the legal transplants, Japan is a nation with its own rules and socio-economic history and context.

When studying Japanese law one has to consider the problem of legal transplants because parts of Japanese laws are taken from German and US legislation. But a rule that is being transplanted has a meaning and interpretation in its original system; it has a context and comes from legal tradition or legal culture.[95] Hence any comparative legal analysis needs to examine the 'original context' as well as the 'receiving context'. For a legal transplant to be successful and work as in the original context, this original context would need to be transferred along with the transplanted rule. In practice this cannot be the case. This re-emphasises the importance of the study of Japanese law within its social- and economic context and why it is what it is as outlined above. It becomes necessary to think about Japan's legal culture, especially, because of the legal transplants, it is necessary to go beyond current national context.[96] One could go as far as by looking at Japanese anthropology. Anthropology is the field of studying foreign cultures and therefore very helpful in the comparative analysis.[97] By including the anthropological analysis, it allows the inclusion of an examination of a set of unwritten rules within Japanese society[98] that may explain certain phenomena that black-letter law cannot.[99] These sorts of codes, values and rules must be included in this research, for example to explain the role of directors as 'company elders'.

## 5. Conclusions

This research is based on the hypothesis that corporate governance at UK banks was weak and that improvements are needed. This has led to the formulation of three separate research questions, which look at these weaknesses in corporate governance at UK banks. To answer the questions, this thesis contains an investigation into the failures of UK banks during the recent financial crisis, and the short- and long-term responses. Additionally, it contains a comparative analysis with Japan's corporate governance reforms. One of the main difficulties of this research project is that it will involve a significant amount of

[94] ibid 777
[95] Pierre Legrand, 'The Impossibility of "Legal Transplants"' (1997) 4 Maastricht J Eur & Comp L 111, 114
[96] David Nelken, 'Using the Concept of Legal Culture' (2004) 29 Austr J Leg Phil 1, 4
[97] Pierre Legrand (n 47) 238
[98] Tomoko Hamada (n 40)
[99] Clifford Geertz, 'Off Echoes: Some Comments on Anthropology and Law' (1996) 19 PoLAR 33, 36-37

comparative analysis. When investigating the failures of banks, with the objective to identify risks and weaknesses of corporate governance, it needs to be done with the understanding that corporate governance itself is not uniquely defined. In different countries, or in fact within a single country, different systems of corporate governance can exist. Published reports and recommendations are often written from a specific background or, when done at international level, form a compromise of different views. Thus, when analysing the failures of UK banks and their corporate governance, one needs to be aware of the comparative analysis that is being made.

Similar problems surround the analysis of the responses to the financial crisis. The international reports, as well as their implementation at EU and UK level, must be approached with the right methodology for comparative analysis in the forefront of our minds. The global response, unified as it might have appeared at the height of the crisis, is inevitably a merger of problems, ideas and experiences at various national levels. Likewise, the important Basel Committee and its reports are international compromises that will find their way into national legislation. In the case of the UK, these will go through the extra legislative layer that is the EU. Whilst investigating the effectiveness of these measures in addressing the shortcomings of corporate governance at UK banks this must be kept firmly in mind.

The case study of Japan's changes to corporate governance is by definition a comparative analysis. Likewise, any comparison and conclusions must be reached within the right framework with the right methodology. This thesis sets out to answer questions on corporate governance at UK banks. The research plan starts at theories of the company and corporate governance, leading to an analysis of the bank failures and measures taken in response. It is imperative that, whilst following the outlined plan, the comparative element receives the attention it needs at each stage.

# Chapter 2 – Theory on the Corporate Governance of Banks

## 1. Introduction

This chapter lays the groundwork of the theory of corporate governance as required to construe an answer to the research questions. This theoretical framework will form the basis for the analysis in the following chapters. In order to analyse the weaknesses and failures of corporate governance at banks, one must have a full understanding of this theoretical framework. It will aid in identifying these weaknesses and, furthermore, it will inform the debate on the appropriateness of the responses and legislative measures that have been following the financial crisis.

The concept of corporate governance is generally about the control of companies. A discussion about what is really meant by the word company is required to undertake even more preliminary groundwork. Without a clear understanding of what makes a company, the discussion about the control of it is meaningless. This basic groundwork consists of analysing the main theories of existence of the company, which is discussed in the first section. These different theories seek to address the question what a company actually is. Particular distinction is drawn to the legal concept of a company and the real world concept.

This first section informs the second one on theories of corporate governance. Without understanding what a company is, it not meaningful to talk about its systems of control and governance. This second section describes the main theories of corporate governance as well as the historical development through important reports on corporate governance. This discussion includes the distinction between internal and external corporate governance. It is necessary to analyse these concepts in the general setting before looking at the specific and narrower case of banks.

This analysis of corporate governance is extended in the third section to include risk management and corporate social responsibility before the fourth section narrows the focus of all these concepts to banks. This fourth section contains bank specific aspects of corporate governance, including those highlighted by the Basel Committee for Banking Supervision. The concepts of risk management, corporate social responsibility as well as internal and external corporate governance each take on a special meaning in the case of banks. Hence the general theory is here complemented by bank specific elements.

In the analysis as outlined above comparative methodology plays a central role. The discussion on what a company is will differ greatly per country, where different historical developments have led to different types and forms of companies. Likewise, the governance of these companies varies greatly per country, consider for example the different board styles in Germany and the US. Even within countries themselves there exists a variety of different governance structures. The debate about the role of the company towards its employees or its role within the society and environment in which it operates will be informed by each country's historical development. These notions must be firmly kept in mind when discussing any of the theories presented in this chapter.

## 2. Defining the Company

### a. What is a Company?

Before considering the governance of a company, it is necessary to consider the philosophical question of what a company actually is. Sometimes, the company is not clearly defined at all. In early literature, it is sometimes defined merely implicitly as activities that take place under an entrepreneur, which is less costly than relying on outside markets.[1] This person has the control to direct the employees what to do and it is this existence of control which creates the company. This approach was criticised because it may not be the authority of this single person but the contractual relations that bring people together.[2] This criticism led to the development of the contractual theory, which will be discussed in more detail later.[3] In this approach, the company is arguably seen implicitly as the real world entity.

There are, however, two different companies that must be distinguished. On one side, there is the real world entity, whilst on the other side there is the legal entity, which is merely an abstract thing.[4] The real world entity consists of the physical assets, such as buildings, machinery, inventory and workers. Whether the law describes them or not, whether the law declares that they are a company or not, these physical aspects will be there: the machinery and workers would carry on. On the other side, consider a group of

[1] Ronald H. Coase, 'The Nature of the Firm' 4 Economica 386
[2] Armen A. Alchian and Harold Densetz, 'Production, Information Costs, and Economic Organisation' (1972) 62 American Economic Review 777
[3] Michael C. Jensen and William H. Meckling, 'The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 J F E 305
[4] Nicholas H D Foster, 'The Theoretical Background: the Nature of the Actors in Corporate Social Responsibility' in Stephen Tully (ed), *Research Handbook on Corporate Legal Responsibility* (Edward Elgar 2005) 4-6

people that decide to go through the application process to form a company. Once done, the legal entity is created, but in the real world very little has changed. This fundamental observation impacts the following sections, which describe different theories of the existence of companies. All of these theories are in some way problematic once the question is asked what a company really is and these theories must therefore be approached with care.[5]

The study of corporate governance should be seen in the context of the theories of the existence of companies. Each theory has its own implications for corporate governance. There are various different theories of existence of the company, including contractual, communitarian and concessionary theories.[6] Different authors use slightly different categories, if only in name, but these three as outlined by Professor Dine will be particularly helpful for this research. It appears that the different theories can be matched with the different circumstances and behaviour by the UK banks before and after the financial crisis. RBS, for example, behaved much along the lines of contractual theory before the crisis. After the crisis, with a large part in government ownership, the communitarian theory is more appropriate to describe the situation. Before the crisis, investment bankers at RBS behaved individualistically, focussing on their own performance for which they would be rewarded. The performance contracts the driving force behind the high performing investment banks. The combined good performance of individuals would lead to a good performance of RBS as a whole. After the part nationalisation, the objectives of RBS became blurred. On one hand, the government asked it to stimulate the economy by lending more to small business, on the other hand RBS needed to reduce its bloated balance sheet both for regulatory purposes and to free up capital allocated to non-profitable activities. RBS was faced with conflicting regulatory, commercial and political objectives. Although these theories may originally not have been drawn up for the purpose of examining individual companies, its application in this manner helps in answering the research questions concerning the changes in corporate governance of UK banks.

[5] Nicholas H.D. Foster, 'The Journal of Comparative Law: A New Scholarly Resource' (2006) 1 JCL 1, 11

[6] Janet Dine, *The Governance of Corporate Groups* (CUP 2006) 3

### b. Contractual Theory

The contractual theory[7] describes the company as a nexus of contracts. It can be argued that it forms the basis of corporate law. If one takes the company as a complex set of explicit and implicit contracts, then corporate law can arguably enable the participants to select an optimal arrangement of risks and opportunities that are available.[8] Corporate law, due to the freedom of contract, would thus play a more important role than for example regulation. There have been many critics of the contractual theory. One line of criticism is that these contracts do not always exist, or sometimes only partially.[9] In such a case, assumptions would have to be made to fill in the gap. For example, one could assume that both parties would fill in the gaps in such a way that maximises both their wealth position. It is clear that in reality this would not necessarily be the case.

A possible solution is to split contractual theory into legal contractual theory and economic contractual theory. In legal contractual theory, the company is regarded as an association or aggregation of individuals, brought together through contractual relations between its members.[10] The contractual conception can be useful to examine the relationship between the board and directors or other internal relationships. It does, however, limit the model to company internal relationships as external parties or regulators are not directly part of the contracts that make up the company. The company is placed in the sphere of private law and it is purely regarded as a legal entity.[11] It is further limited as it does not describe a company for what it really is, either in a physical form or as a legal entity.

In economic contractual theory, the firm remains a nexus of contracts. The view is that the individuals inside the company seek to operate with maximum efficiency and to minimise any transaction costs. The key concepts are that an individual in the company acts rationally, based on full information available, to gain efficiency.[12] The concept of individualism is linked with liberal thought[13] making the working of the company rely on

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[7] Ronald H. Coase (n 1); Michael C. Jensen and William H. Meckling (n 3); Melvin A. Eisenberg, 'The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm' (1989) 24 J Corp L 819

[8] Frank H. Easterbrook and Daniel R. Fischel, 'The Corporate Contract' (1989) 89 Colum L Rev 1416, 1418

[9] Lewis A. Kornhauser, 'The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel' (1989) 89 Colum L Rev 1449, 1452

[10] Stephen Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' (1990) 19 Fed L Rev 203, 208

[11] Michael J Phillips, 'Reappraising the Real Entity Theory of the Corporation' (1994) 21 Fla St U L Rev 1061

[12] Janet Dine (n 6) 9

[13] Bottomley (n 10) 205

self-correction (or market correction) instead of any regulatory interference. As a result, the company remains internally focussed, satisfying internal contracts between the individuals, without any regard for moral obligations or social responsibilities. The risk of following contractual theory is thus that it has the potential to create "very bad companies", i.e. by creating companies without morals or social responsibility, with a preference for as little regulation as possible – or as they can get away with.[14]

This was not always the commonly held view. Thirty years ago, the contract theory was far more positively regarded, probably aided by the dominant views of the Chicago School of Economics. Viewing the company as a nexus of contracts allows for different groups to contribute what they are good at whilst reducing overall costs. Likewise, shareholders provide capital whilst leaving the management to professional managers and entrepreneurs, providing managers with the objective of maximizing shareholder value to align interests; to manage divergence of interests, fiduciary duties should approximate the bargain investors and managers would reach if there were zero transaction costs.[15] The criticism that this omits any accountability to society raises the question what is public interest and when should profit maximisation be sacrificed for this. Taking a step back, one could ask the question: do companies behave in a socially responsible manner?[16] Efficient profit making companies provide many jobs and products or services that consumers want to buy whilst companies in difficulty are more likely to cut corners and provide unsafe working conditions or cause pollution.[17] Taking the example of decisions on pollution of a nearby river, it is not a question of corporate governance, in the sense of the structure of governance of the company, but a matter of agreement or contract that can be reached between the company, local authorities and the local population.[18] Furthermore, corporate social responsibility defined as accountability of management to not only shareholders but also society is problematic, for the company, defined as a nexus of contracts, cannot have social or moral obligations.[19] Managers do not have a contract with society, but with shareholders, hence their objectives are defined accordingly. This means that recognition of the interests of stakeholders outside the company cannot take place because they are

[14] Joel Bakan, *The Corporation: A Pathological Pursuit of Profit and Power* (2003 Random House)
[15] Daniel R Fischel, 'The Corporate Governance Movement' (1982) 35 Vand L Rev 1259, 1264
[16] ibid 1269
[17] ibid 1269
[18] ibid 1270
[19] Ibid 1273

not part of the nexus of contracts, and that taking these interests into account can mean not fully fulfilling shareholder interests.[20]

As stated before, this view from thirty years ago, although useful for this research, is becoming more difficult to defend today. The contractual theory, together with the dominance of shareholder value to which it is linked, resulted in the "asocial corporation" and, by influencing legislation, promoted what can be termed "deregulatory globalisation".[21] In the post-crisis UK financial sector there is a shift in the debate: regulation is becoming more intrusive and defining social functions of the banks is becoming more important. The categorisation of theories of existence of the firm by Professor Dine[22] can be used: in an ante-crisis world, the behaviour of financial institutes and the environment in which they operated can be brought back to the contractual theory. In banks, individuals were driven by their own performance-related contracts, which in the short-term improved the performance of the company. In a post-crisis world, there is not merely a search for an alternative, such as the concession theory, but there is the emergence of state-owned financial institutions, which can be linked to the communitarian theory. The government would seek to achieve some its goals by instructing the part nationalised banks, for example to lend more to businesses in an attempt to stimulate the economy.

### c. Concession and Communitarian Theory

The communitarian theory and the concession theory take a different starting point as both have a role for the state in the creation of the company. The concession theory, as its name indicates, views the existence of a company as a concession by the state.[23] The term concession hints at a very long history and comes from the time of the rise of the national state when it was at conflict with religious congregations and organisations of feudal origin.[24] At that time, any organisation would draw its legitimacy from an express grant of supreme power, in this case the state. The company can thus exist as a legal entity itself once granted power by the state. A more recent point of departure is found in *Dartmouth*

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[20] Peter Muchlinski, 'Implementing the New UN Corporate Human Rights Framework: Implications for Corporate Law, Governance and Regulation' (2012) 22 Business Ethics Quarterly 147, 164

[21] Peter Muchlinski, 'The Changing Face of Transnational Business Governance: Private Corporate Law Liability and Accountability of Transnational Groups in a Post-Financial Crisis World' (2011) 18 Ind J Global Legal Stud 665, 669

[22] Janet Dine (n 6) 3

[23] Bottomley (n 10) 207

[24] John Dewey, 'The Historic Background of Corporate Legal Personality' (1926) 35 Yale L J 655, 666

*College v Woodward*,[25] in which it was said that a company is an artificial being, possessing only those properties which the charter of its creation confers on it. This can be extended to the view that the state grants special advantages, including limited liability and favourable treatment in the accumulation of assets.[26] As such, it could even be said that this approach forms the bases for the Companies Act 2006 in the UK.

A straightforward criticism of the concession theory is that the state may actually have the opposite objective. It sometimes seeks to curtail the company and to thwart rather than facilitate organisational development.[27] Another fundamental shortcoming of this approach is that it only covers the company as a legal entity, because that legal entity is granted a status by the state. Nothing is said about the physical aspects of the company, something the state has no say in. The state allows companies to operate with minimal interference except that it seeks to ensure that governance structures are "good". It does so without imposing its own goals upon the company as it does in communitarian theory.

Bottomley introduces "Constitutionalism" which also allows the state to regulate corporate governance.[28] With the claim that legal regulation of corporate governance should reflect the values of public political life, he arrives at three core elements of constitutionalism: first dual decision making, outlining the differences between the board of directors and the meeting of shareholders in the life of the company; second, deliberate decision making which implies an open process of decision making that takes all relevant aspects into account; third, the idea of separation of powers to create accountability throughout the company. By putting these together, Bottomley tries to create a framework in which the quality of decision making is improved and moves beyond creating profits for the shareholders.

The communitarian theory goes further than the concession theory in that it views the creation of the company as the creation of an instrument that the state can utilise. A problem with this approach is that it defines a company in terms of social aspects instead of any legal basis or even physical assets. An extreme example of communitarian theory is the German Corporation Law 1937. Besides its changes to the influence of the

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[25] *Trustees of Dartmouth College v* Woodward (1819) 17 US 518

[26] Paul G. Mahoney, 'Contract or Concession? An Essay on the History of Corporate Law' (2000) 34 Ga L Rev 873

[27] Gary M Anderson and Robert D Tollinson, 'The Myth of the Corporation as a Creation of the State' (1996) 3 Int'l Rev L & Econ 107

[28] Stephen Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney L Rev 277

management board and the board of directors, it prescribes an objective for companies: they must operate to improve the general welfare.[29] If a company was found in breach of this objective then the state could dissolve it. This was driven by the ideas of the National Socialist movement, which wanted to see the state in control of economic activity in order to produce a socially acceptable outcome. The communitarian model is also adopted in former communist countries,[30] standing directly opposed to the contractual model based on individualism and liberalism. The company no longer has commercial objectives but it will have political objectives. These objectives can serve the society in which the company operates, leading to an extreme form of corporate social responsibility. It is more likely, however, that, as a political tool, the company will be faced with conflicting commercial and political targets.

## 3. Corporate Governance

### a. The Main Theories

The different theories of existence of the company can now inform the discussion on to control these companies. This section will provide different theories of corporate governance, which are ultimately about the control of the company. As least several of these existential theories appear to have been developed separately from those on corporate governance. As such, there is not always a clear relationship between the two fields. It is thus not necessarily possible to match a theory of corporate governance with one of existence of the company. However, the understanding of why companies exists will inform discussion of the main theories of corporate governance: the agency theory, the resource dependence and stewardship theory and the stakeholder theory.

Consider the control of the company and separation of ownership and control.[31] In the agency theory, the problem is how the dispersed shareholders, in effect the owners, can control the board, their agents, to look after their property, the company.[32] The assumption is that the agent will try to act in his self-interest rather than in that of the company. Thus the shareholders need to create incentives, coined the agency costs, that align the interests of the agent with that of the shareholders. Agency theory was developed

[29] William Conrad Kessler, 'The German Corporation Law of 1937' (1938) 28 Am Econ Rev 653, 661
[30] Janet Dine (n 6) 17
[31] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (1932, Macmillan)
[32] Margaret M. Blair, 'Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century' (1994 Brookings)

in a wider context of corporate governance.[33] It could be extended to cover employer and employees or company and creditors. This theory is closely related to the contractual theory as the agents are controlled by contractual agreements. However, these contracts need to be monitored and enforced, creating agency costs.

Closely related to the agency theory is the transaction cost economics.[34] The difference is that it does not regard the firm as a nexus of contracts but as a governance structure. The firm seeks to minimize transactions costs by undertaking transactions internally rather than externally, thus growing in size. The choice of governance structure reduces the costs of misaligned transactions. Other researchers have stated that, as contracts will always be incomplete and never cover for every situation, where agency problems are present the form of governance structure will be important.[35]

Rejecting the negative assumption of the agency theory is the stewardship theory.[36] The assumption is made that people join the board with the best interests of the company at heart and look after it in the long term as stewards. The question is whether the organisation has the right structure that enable the steward to do this. The stewardship theory is thus concerned with empowered management issues, a typical example of which might be whether the role of chief executive officer and chairman should be combined or separate.

The last main theory discussed here is the stakeholder theory. This theory has been promoted by various international organisations, such as the OECD. The main difference with the previous theories at that it no longer assumes shareholder supremacy. One might thus simplify the situation and say that it introduces elements from other countries, such as Germany or Japan, into US corporate governance. Although it recognises that shareholders

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[33] See Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305; Eugene F. Fama and Michael C. Jensen, 'Separation of Ownership and Control' (1983) 26 J L E 301; Kathleen M. Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14 Academy of Management Review 57

[34] See Oliver E. Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (1979) 22 J L E 233; Oliver E. Williamson, 'Corporate Governance' (1984) 93 Yale L J 1197

[35] Oliver Hart, 'Corporate Governance: Some Theory and Implications' (1995) 105 The Economic Journal 678

[36] See Lex Donaldson, 'The Ethereal Hand: Organisational Economics and Management Theory' (1990) 15 Academy of Management Review 369; Jay B. Barney, 'The Debate between Traditional Management Theory and Organisational Economics: Substantive Differences or Intergroup Conflict?' 15 Academy of Management Review 382; Lex Donaldson and James H. Davis, 'Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns' (1991) 16 Australian Journal of Management 49;

are the owners, the theory argues that everyone with an interest in the company should be looked after. The most direct stakeholders include employees, customers and suppliers, but this can easily be extended to the community and environment in which the firm operates. Note that it shares this broader view of the company sitting within the company's wider environment with the resource dependence theory.[37] This theory starts with the same assumption as the stewardship theory: that the board, when hired, will act in the best interest of the company. The problem for the resource dependency theory becomes one of managing the dependence on outside groups for resources. This can include sourcing its board's members, seen as a source of management skills, knowledge and connections.

### b. Internal and External Corporate Governance

Another way to look at corporate governance is to split it into internal and external corporate governance or controls.[38] Internal controls are internal to the company. One could regard the board as the highest control in the firm, exercising control over the decisions made by senior management.[39] The idea of such internal control mechanisms closely aligns with agency theory, as the issue of control of the agents by the shareholders could be done by way of performance contracts. Consequently, the performance and the skills of the board as well as how they influence and steer the company play a central role in internal corporate governance.

On the other side stands external corporate governance.[40] This can be summarised as the control exerted by the markets over the company. It could be seen as a method of last resort, which becomes active when all the internal control mechanisms have failed.[41] Assuming current management is inefficient, the potential fight for management with other company's management can be a way to improve performance. A potential hostile take-over would thus be an external mechanism to control management. It ties into contractual theory if one regards the implementation of the contracts with minimal

[37] Jeffrey Pfeffer, *The External Control of Organisations: A Resource Dependence Perspective* (1978 Harper & Row)
[38] James P. Walsh and James K. Seward, 'On the Efficiency of Internal and External Corporate Control Mechanism' (1990) 15 Academy of Management Review 421, 423
[39] Eugene F. Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 Journal of Political Economy 288, 294
[40] James P. Walsh and James K. Seward (n 38) 434
[41] Eugene F. Fama (n 39)

transaction as the objective of this external mechanism. Large investors as well as large creditors can thus exercise significant control over the company.[42]

### c. The Cadbury Report and Its Successors

Having set the theoretical background regarding the existence of companies, the next step is to define what is understood by a system of corporate governance. Although internationally harmonised principles do exist, what is implemented as a system of corporate governance is country specific. This research is focused primarily on the UK,[43] although where possible arguments from international reports, such as OECD's report on corporate governance,[44] can inform the debate through comparative analysis. Using both UK and international reports of various time periods, this section outlines what is meant by a system of corporate governance. Note that the OECD published an updated version of its principles[45] in September 2015; the theory in this chapter largely relies on the previous version that was in place during the crisis.

In 1992, the Cadbury committee defined corporate governance as 'the system by which companies are directed and controlled'.[46] Although the Cadbury report has now been replaced by the UK Corporate Governance Code (formerly the Combined Code) this definition still stands.[47] The definition is rather compact and not necessarily helpful; it quickly gives rise to the questions: who directs and controls it? And what system is used? To the first question Cadbury answers that the 'Boards of directors are responsible for the governance of their companies',[48] whilst the system is completed by adding the remaining actors: 'the shareholders' role in governance is to appoint directors and the auditors and to satisfy themselves that an appropriate governance structure is in place'.[49]

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[42] Andrei Schleifer and Robert W. Vishny, 'A Survey of Corporate Governance' (1997) 52 J Fin 737, 753

[43] With the exception of the case study of Japan.

[44] OECD, *OECD Principles of Corporate Governance* (Paris, OECD Publication Service 2004) <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf> accessed 14 November 2015

[45] OECD, *G20/OECD Principles of Corporate Governance* (September 2015) <http://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf> accessed 14 November 2015

[46] Sir Adrian Cadbury, *Report on the Committee on the Financial Aspects of Corporate Governance* (London, Gee&Co, 1992) 2.5

[47] Financial Reporting Council, 'The UK Corporate Governance Code' (2010) <https://www.frc.org.uk/getattachment/b0832de2-5c94-48c0-b771-ebb249fe1fec/The-UK-Corporate-Governance-Code.aspx> accessed 14 November 2015, 1

[48] ibid 2.5

[49] ibid 2.5

The Cadbury report was followed by various reports, some of which have already been mentioned. The Financial Reporting Council is responsible for maintaining high standards of corporate governance in the UK and does so by, inter alia, publishing the UK Corporate Governance Code. The Cadbury report had been folded in to the Combined Code, together with the Greenbury report on remuneration and the Hampel report on the implementation of Cadbury and Greenbury. After several updates, this Combined Code has now been renamed as the UK Corporate Governance Code.[50] Although it describes the purpose of corporate governance as 'to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company',[51] it does not extend the actors in a system of corporate governance beyond the board and the shareholders. In this case, 'long-term success' does not imply that different stakeholders should be considered.

### d. International Reports

Looking at the international reports which have harmonized the practices of different countries, the system of corporate governance can be extended to include more actors. Ten years after Cadbury, the OECD, for example, states that

> 'employees and stakeholders play an important role in contributing to the long-term success and performance of the corporation'.[52]

Although the OECD remains neutral towards the different approaches of corporate governance, in this statement, the contribution of stakeholders to the 'long-term success' of the company is recognised. The OECD provides examples of some important stakeholders.

> 'The competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors and suppliers'.[53]

Other international reports, which are the result of harmonising different practices across countries, such as Basel II[54] and the Winter Report,[55] also use this enlarged definition. The main national differences brought together in these international reports concern labour

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[50] Financial Reporting Council (n 47)
[51] ibid 1
[52] OECD (n 44) 12
[53] ibid 43
[54] Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* (Bank for International Settlements, 2006)
[55] Jaap Winter, 'Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe' (Brussels, 4 November 2002) 59 <http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf> accessed 14 November 2015, 105

co-determination and whether shareholders should extend their concern from profit maximisation to wider social and environmental issues outside the company.[56] However, these national differences are gradually declining as elements of the harmonised reports are implemented in national statutes. In the UK, the directors have a fiduciary duty towards the shareholders as well as, per the Companies Act 2006, s172, to promote the success of the company whilst having regard for employees, suppliers, customers and others as well as impact on the community and environment. Alistair Darling, then Secretary for Trade and Industry, commented that

> 'directors will be required to promote the success of the company in the collective best interest of their shareholders, but in doing so they will have to have regard to a wide range of factors, including the interests of the employees and the environment'.[57]

This progresses from the view held in the Companies Act 1985, s309, which merely specified that directors should have regard for 'the interests of the company's employees in general, as well as the interest of its members'. It has remained entrenched in the concept of shareholder value as the directors are merely to have regard for these wider issues whilst promoting the success of the company. These sections of the Company Act 2006 have therefore been branded 'enlightened shareholder value' as it goes somewhat further than merely shareholder value.[58] Moving even further away from shareholders towards stakeholders allows for corporate social responsibility, defined as 'the responsibility towards the company's stakeholders' where the term 'stakeholders' is quite widely defined.[59]

Identifying the actors is not necessarily sufficient to determine the entire system: consider the difference between the UK's single board and the dual board as is adopted in Germany.[60] It is not obvious which of the two is better, if that is possible to say at all given the difficulties in directly comparing the two. It is, however, clear that in both cases the

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[56] Klaus J Hopt, 'Comparative Company Law' in Mathias Reimann and Reinhard Zimmerman (eds), *The Oxford Handbook on Comparative Law* (2008 OUP) 1183

[57] HC Deb 6 June 2006, vol 446, col 125

[58] Peter Muchlinski (n 20) 160

[59] Domènec Melé, 'Corporate Social Responsibility Theories', in Andrew Crane, Abagail McWilliams, Dirk Matten, Jeremy Moon and Donald S Siegel (eds), *The Oxford Handbook of Corporate Social Responsibility* (OUP 2008) 61

[60] Government Commission German Corporate Governance Code, 'German Corporate Governance Code' (26 May 2010) <https://www.unodc.org/documents/treaties/UNCAC/WorkingGroups/workinggroup4/2012-August-27-29/Responses_NVs_2012/20120504_Germany_English_3.pdf> accessed 14 November 2015

directors are important actors in a system of good corporate governance. As discussed, the Companies Act 2006 outlines the responsibilities of directors. These include their fiduciary duties towards the company; although the company can enforce these duties, the shareholders will be able to enforce them as well through derivatives action.[61] The directors will therefore have to act in the best interests of the company, otherwise they can be held to account.

### e. Elements of a Good System of Corporate Governance

With the concept of a system of corporate governance comes the question: what principles constitute a good system of corporate governance? Here the distinction is made between the processes and the principles. There is more international agreement on these general principles than there is on the system itself as, taken on their own, the principles do not prescribe a specific implementation. There is a distinction between the accepted principles and the actual processes that are implemented: a general principle such as transparency is easily committed to, but to ensure there is full transparency in risk management processes is something different. Another problem is that what is regarded as a good level of transparency varies greatly per country, leading to comparative problems. What constitutes an accepted or expected level of transparency varies greatly between for example UK companies and Japanese companies. What is regarded as transparent in Japan is often not regarded as transparent at all in the UK. Consider as an example the years of absence of transparency in the non-performing loans in Japan during the nineties. The uncertainty about the extent of the problematic loans on banks' books, compared with an unwillingness to deal with it, resulted in what was effectively a very long credit crunch. A more recent example is the lack of transparency provided by TEPCO at the time of the nuclear disaster at Fukushima. The most accurate and up-to-date information appeared to be coming from US sources instead of Japanese. This will be discussed in more detail in chapter six.

Returning to Cadbury, the important principles are 'those of openness, integrity and accountability'.[62] Openness or transparency allows stakeholders to scrutinise actions and decisions taken within the company. A good code on transparency is set out by the IMF,[63] which despite being written for transparency on fiscal policy is highly relevant for

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[61] Patrick Beale, 'Directors Beware?' (2007) 157 NLJ 1033

[62] Sir Adrian Cadbury (n 46) 3.2

[63] International Monetary Fund, 'Code of Good Practices on Fiscal Transparency' (2007) <http://www.imf.org/external/np/pp/2007/eng/051507c.pdf> accessed 14 November 2015

companies as well. It defines four pillars for good practice on openness and transparency: clarity of roles and responsibilities, open budget process, public availability of information and assurances of integrity. In a company, there should also be clarity on the roles and responsibilities as well as integrity. The openness required to the outside world is different for a public body but should perhaps be increased for a private company as well. A high level of transparency allows employees or other stakeholders to participate. The participation of stakeholders can correct bad decisions taken before the situation escalates: consider the example of *Hazell v Hammersmith and Fullham LBC*, where the council had exceeded their mandate by investing in risky assets.[64] Due to the council's openness in its investments, members of the general public had adequate information to participate and, in this case, conclude that legal action was required. The difference here is that the council is a public body and therefore has more requirements towards openness and transparency than private companies, as was the case with IMF recommendations, but perhaps this suggests that private companies should be subject to similar requirements of transparency.

The other principles, i.e. integrity and accountability, can refer to internal information systems but also to integrity or fairness in remuneration and taking action in the case of failure. Cadbury defines integrity as 'straightforward dealing or completeness'.[65] The integrity of internal information systems and internal control has been described by the Turnbull Guidance and subsequent updates; it places clear responsibility for designing such a system of control with the directors.[66] International reports, such as those by the IMF[67] and by the OECD[68], refer to integrity as 'the quality of the information that is supplied'. The final point is accountability, which Cadbury claims is made effective 'through the quality of information [the board of directors] provide to the shareholders, and shareholders through their willingness to exercise their responsibility as owners'.[69] Hence accountability works in two directions: the directors need to provide good information and the shareholders need to act on it, especially in the case of failure. The three principles of transparency, integrity and accountability are closely linked; it is difficult to take any of them away as the remaining principles will not be sufficient on their own.

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[64] [1992] 2 AC 1
[65] Sir Adrian Cadbury (n 46) 3.3
[66] Financial Reporting Council, 'Internal Control: Revised Guidance for Directors on the Combined Code' (2005) <https://www.frc.org.uk/getattachment/5e4d12e4-a94f-4186-9d6f-19e17aeb5351/Turnbull-guidance-October-2005.aspx> accessed 14 November 2015, 9
[67] IMF (n 63) 3
[68] OECD (n 44) 15
[69] Sir Adrian Cadbury (n 46) 3.4

## 4. Risk Management and Social Responsibility

### a. Risk Management

Risk is inherent in any business operation that is undertaken. A definition of risk is provided by the Basel II report as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events'.[70] Risk management is aimed at identifying, measuring and managing risks. Unfortunately, not all risks can be measured and a distinction can be made between quantifiable and unquantifiable risks.[71] There is a clear link between corporate governance and risk management and social responsibility. It is clear that without elements such as transparency, integrity and accountability there cannot be a system of good risk management within the company. This comes back to the duties of directors, who are universally identified as important actors in the system of corporate governance. The duties of the director, as per Companies Act 2006 s172, relate directly to risk management of the company. Likewise, the UK Corporate Governance Code states that 'the board … should maintain sound risk management systems and internal control'.[72] This is further supported by the recent paper by the Financial Reporting Council concerning the board and risk, stating that

> 'Transparency and clear lines of accountability through the organisation were essential for effective risk management'.[73]

The link between corporate governance and risk management translates directly into corporate social responsibility. This becomes the link between internal and external corporate governance. Good external corporate governance becomes corporate social responsibility and describes what can be expected from a company's behaviour within society. Consider for example the Deepwater Horizon disaster, an environmental disaster in the Gulf of Mexico and the US coast due to an explosion on board an oil drilling rig.[74] The commission that investigated concluded that

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[70] Basel Committee on Banking Supervision (n 54) s644

[71] Frank Knight, 'Risk, Uncertainty and Profit' (1964 reprint) <https://mises.org/sites/default/files/Risk,%20Uncertainty,%20and%20Profit_4.pdf> accessed 4 July 2016

[72] Financial Reporting Council (n 47) 7

[73] Financial Reporting Council, 'Boards and Risk: a Summary of Discussions with Companies, Investors and Advisers' (2011) <https://www.frc.org.uk/FRC-Documents/FRC/Boards-and-Risk-A-Summary-of-Discussions-with-Comp.aspx> accessed 14 November 2015, 2

[74] National Commission on the BP Deepwater Horizon Oil Spill and Offshore Drilling, 'Deep Water: The Gulf Oil Disaster and the Future of Offshore Drilling, Report to the President' (January 2011) <http://www.gpo.gov/fdsys/pkg/GPO-OILCOMMISSION/pdf/GPO-OILCOMMISSION.pdf> accessed 14 November 2015

> 'In years [...] neither industry nor government adequately addressed these risks. Investments in safety, containment, and response equipment and practices failed to keep pace with the rapid move into deepwater drilling. ... given the financial returns [...] the business succumbed to a false sense of security. The Deepwater Horizon disaster exhibits the costs of a culture of complacency'.[75]

This highlights two aspects of corporate governance: firstly, the focus on 'financial returns' signifies that returns for shareholders have been sought above all else. Secondly, the 'false sense of security' and 'culture of complacency' indicates that there was insufficient internal control, transparency and accountability as risks at the production level have been ignored or not communicated upwards in the organisation. Good internal corporate governance and thereby risk management could have helped to prevent this disaster which so dramatically affected the society and community it operated in.

### b. Corporate Social Responsibility

Corporate social responsibility is difficult to define; different people define it differently depending on their own position and viewpoint, but it always appears to involve, to some extent, an obligation of the company to exercise some concern towards the environment in which they operate. It has largely been a voluntary affair in the UK, but, through the Companies Act 2006 and case law, there is a legal basis emerging to support it.[76] As discussed previously, the acknowledgement of any moral or social obligations of the company moves away from the contractual theory, in which a company as nexus of contracts cannot have a social or moral conscience. Milton Friedman, in a now classic newspaper article, makes in this context the distinction between the companies and those who manage it.[77] First, he argues that managers come with their own background and beliefs and in their personal capacity they may fulfil any social responsibility they see fit. However, as an agent of the owners of the company, in their time and with their money, Milton Friedman asks the question: what it would mean to be socially responsible? His examples show that all decisions that would fulfil some social goal would automatically be at the expense of the shareholders' profits, effectively taxing the company, meaning that he does not work well as their agent. Furthermore, Milton Friedman argues that it is impossible for the management to determine which social goals it should chose to fulfil –

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[75] ibid ix

[76] Doreen McBarnet, 'Corporate Social Responsibility beyond Law,through Law, for Law: the New Corporate Accountability', in Doreen McBarnet, Aurora Voiculescu and Tom Campbell (eds), *The New Corporate Accountability: Corporate Social Responsibility and the Law* (CUP 2009) 33

[77] Milton Friedman, 'The Social Responsibility of Business is to Increase Its Profits' *The New York Times* (New York, 13 September 1970)

something that is normally done, as is the case for taxes, through a democratic process. He does point out, that, besides the objective of making money, there is the obligation to operate within the bounds of the law and that by doing so there is social responsibility.

Can Milton Friedman's exposition be married to the earlier argument that a system of good corporate governance, containing the necessary elements, gives rise to good risk management and corporate social responsibility? There are two observations to be made. Firstly, the owners of the company themselves may consider objectives other than profit making.[78] This may take the form of a moral or social conscience of the investors, from divestment in countries where human rights are violated to simple charitable giving. The impact of reputational considerations next to these moral considerations should not be forgotten. In practice, the investors may not be inclined to do so, considering that not only are they very dispersed, leaving decisions to the board, they are also under pressure themselves to obtain good returns on their investments. Secondly, there is a difference between Milton Friedman's social objectives and the prevention of disasters in the community the company operates through sound risk management. In other words, what is exactly meant by corporate social responsibility is not the same amongst researchers and may in fact be very difficult to define.[79]

The problem with Corporate Social Responsibility is then that it has become a wide term under which anything ranging from saving the planet to merely honesty and fairness in business transactions can be placed.[80] Many of the large companies are producing a report on their social responsibilities in some form or other. Whether this reflects a commitment as a result from genuine beliefs or a reputational and public relation concern is the question.[81] The pressure piled on companies by various NGOs, including Greenpeace in the case of environmental disasters or Amnesty International in case of human rights abuses, aided by an increase in global media and communication, is tremendous, influencing consumers but also employees. For this research, all these considerations will be important. Firstly, corporate social responsibility for banks needs to be defined: is it limited to dealing fairly with account holders? Does it include wider concerns regarding the

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[78] José Salazar and Bryan W. Husted, 'Principals and Agents: Further Thoughts on the Friedmanite Critique of Corporate Social Responsibility', in Andrew Crane, Abagail McWilliams, Dirk Matten, Jeremy Moon and Donald S Siegel (eds), *The Oxford Handbook of Corporate Social Responsibility* (OUP 2008) 141

[79] Jennifer A Zerk, *Multinationals and Corporate Social Responsibility: Limitations and Opportunities in International Law* (CUP 2006)

[80] Doreen McBarnet (n 75) 10

[81] ibid 14

stability of global financial markets and the world economy or is that merely an effect of good risk management? Should finance be provided to polluting oil companies or should it be provided to small businesses in the UK to simulate the economy? Both these questions go back as far as the theory of existence of the company and, although banks may be considered a special case, these general theories remain valid and should be applied. It would appear that, in the case of banks, one should perhaps not so much consider Friedman's social causes that are chosen seemingly at random, but instead the social causes covered here should include the responsibility to society at large to provide a sound financial infrastructure. This would include financial stability and a minimal disturbance to the economy if a bank failure ever were to happen.

## 5. Corporate Governance at Banks

### a. Why Banks are Different

Corporate governance for banks adds an extra dimension to the analysis of corporate governance due to a few specific elements that banks have over other companies. Corporate governance for banks has several very specific issues including extensive regulation and supervision, 'debt-governance' and a much greater emphasis on risk management.[82]

Because of several bank failures, international groups such as the Basel Committee have set out global standards for risk management and capital requirements, such as Basel I[83] and Basel II.[84] These initiatives have been widely adopted in national regulatory law. In the EU, they have been implemented through the Capital Requirement Directives, which in the UK is looked after by the Financial Services Authority. As with related EU directives, such as the Markets in Financial Instruments Directive, this has been added to the FSA's Handbook of Rules and Guidance. Minimum capital is only the first of the three pillars of Basel II; supervisory review and market discipline are the other two. The argument is that all three pillars are required to make the whole system work. Underlying these pillars are general principles as transparency which was earlier identified as an element of a system of good corporate governance. The impact of the Basel accords on the banking industry has been

[82] Gottfried Wohlmannstetter, 'Corporate Governance von Banken', in Klaus J Hopt and Gottfried Wohlmannstetter (eds), *Handbuch Corporate Governance von Banken* (Verlag 2011) 67-69

[83] Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' (July 1988) <http://www.bis.org/publ/bcbs04a.pdf> accessed 14 November 2015

[84] Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards: a Revised Framework' (June 2004) <http://www.bis.org/publ/bcbs107.pdf> accessed 14 November 2015

enormous, especially in the context of this research project, hence the next paragraphs examine the main two accords preceding the financial crisis.

### b. Internal and External Corporate Governance at Banks

When discussing the general theory of corporate governance, the distinction was made between internal and external corporate governance. This distinction still applies for corporate governance at banks. It is, however, more complicated because there are additional components to each of these two areas.[85] The internal corporate governance may include aspects such as a good corporate culture and good ethics and behaviour. The risk management function will also play a more prominent role and the role of the Chief Risk Officer is even more important. This also has implications for the function of the board and how it controls the bank. Related to these topics is also the reward structure for employees.

External corporate governance at banks still has the important control by the markets, as is the case with any large company. There are a few important additions. One of the most important external players for the bank are the regulators, who play an important role in the running of a bank. The traditional model, which describes the management of a company as agents of the shareholders, does not allow for financial regulation to play the role of representing the general public as stakeholders. Instead, the principal agent problem could be extended to include for example depositors, borrowers and other customers; the regulators could play the role of ensuring that the objectives of each of the participants with regards to risk preferences and corresponding incentives are aligned.[86] Hence the regulator needs to balance the interests of the various stakeholders in the economy that can be affected by the risks banks take and the potential social costs that arise from it.[87] The regulator may also be concerned with the moral hazard arising from information asymmetry between the bank and stakeholder: for example, a depositor may not have the same insight in the bank's risk profile as the bank does for the depositor. This particular issue is solved by regulation on protection or guarantee of deposits.[88] The point is that regulators should be considered a stakeholder and can play an active role in the

[85] Gottfried Wohlmannstetter (n 81)
[86] Kern Alexander, 'Corporate Governance and Banks' (2004) 7 Stud Int'l Fin Econ & Tech L 245, 249
[87] ibid 250
[88] ibid 251

agency problem: in the UK, the FSA is playing an active role in designing internal systems at the banks to achieve protection for all stakeholders, including the broader economy.[89]

The Bank of England Act 1998 takes power away from the Bank of England and establishes the Monetary Policy Committee. The FSA was created through the Financial Services and Markets Act 2000, or FSMA. This act superseded the Financial Services Act 1986, which had created the Securities and Investment Board. This regulator replaced various smaller regulating bodies and ended self-regulation. It consolidated the financial regulation into one main body. The name was changed to FSA following the passing of the FSMA. It later got additional regulatory responsibility for mortgage businesses in 2004 and for insurance intermediaries in 2005. The FSA's objectives are, pursuant the FSMA s2(2), market confidence, public awareness, the protection of consumers and the reduction of financial crime. Market confidence is further defined as maintaining confidence in the UK financial system, including financial markets and exchanges and regulated activities. The public awareness implies improving public understanding of the financial system, including awareness of the risks and benefits associated with investments and financial dealing. Protection of consumers means that there is an appropriate degree of protection for consumers; the level of this degree being determined by the types of investment and the knowledge of different consumers as well as consumers' need for accurate advice and information. The reduction of financial crime includes reducing crime such as fraud, misconduct and misuse of information in financial markets and handling the proceeds of crime.

Besides the financial regulator, banks are subject to the standard gatekeepers like any company is, such as external accountants. These bring the same concerns for banks as they do for other companies, as ineffective gatekeepers can contribute to failures such as Enron.[90] A special category of gatekeepers are the rating agencies. Although these agencies come with many flaws, the ratings they provide hold (or, perhaps, held) enormous cloud in the financial markets. These many flaws have contributed to the failure of rating agencies to do their job properly. Hence they are regarded as at least a contributing factor to the

[89] Kern Alexander, 'UK Corporate Governance and Banking Regulation: the Regulators as Stakeholder' (2004) 33 Stetson L Rev 991, 995

[90] Peter Muchlinski, 'Enron and Beyond: Multinational Corporate Groups and the Internationalization of Governance and Disclosure Regimes' (2005) 37 Conn L Rev 725 or John Coffee Jr, 'What Caused Enron? A Capsule Social and Economic History of the 1990s' (2004) 89 Cornell L Rev 269

financial crisis and in need of reform.[91] They are, however, an independent entity[92] that can provide information concerning credit worthiness to all market participants including banks, shareholders and regulators.

### c. Basel I: A First Step

The first guidelines by the Basel Committee, now referred to as Basel I, were contained in what is only a thirty-page document, half of which are annexes. Agreement on these guidelines was reached between the G-10 countries and endorsed by their respective central bank supervisors. It contained a basic framework for measuring capital adequacy and the minimum standards that were to be achieved. Although agreed by only ten countries, the document was circulated to the relevant institutions worldwide. Its framework had two objectives: firstly, to 'strengthen the soundness and stability of the international banking system' and, secondly, to 'be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks'.[93] A level playing field was created by applying such standards uniformly, however, the Committee emphasises that it is merely setting the minimum standards.[94] National authorities could set the bar higher.

The basic type of capital identified was equity in combination with disclosed reserves. It was common in all countries and visible in published accounts. This constituted the Tier 1 capital. Any other amount of capital that could be legitimately considered, including undisclosed reserves and revaluation reserves, was referred to as Tier 2 capital. Tier 1 capital must make up at least fifty percent of the total capital base. Other elements would be deducted from the capital base, such as goodwill and investment in banking subsidiaries that were not consolidated in national systems. One important issue that the Committee raised was that of double-leveraging, where banks cross-hold their capital rather than drawing capital from non-financial investors.

Besides defining capital, Basel I took the first step in defining risk weights for different categories of assets. It was a crude framework that weighs the assets in accordance with their riskiness. Six aspects of the weighting framework were highlighted. The first was the

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[91] John Coffee Jr, 'Rating Reform: The Good, The Bad and The Ugly' (2010) ECGI Working Paper Series in Law Number 162/2010 <http://ssrn.com/abstract=1650802> accessed 14 November 2015

[92] Although they may not be entirely independent as they do get paid by those who require a good rating.

[93] Basel Committee on Banking Supervision (n 82) 1

[94] ibid 2

risk that was taken into account by the weightings. This risk was restricted to the risk of default of the counterparty. Consequently, many other risks, most notably market risks such as interest rate risk and exchange rate risk, were not considered. The second point was that risk attributed to countries and their public institutions was determined by whether or not they are an OECD member and, if it was not an OECD member, whether the asset was denominated in the local currency.[95] The third aspect was that similar types of public sector entities could be assigned different weights if they were in different countries. The fourth aspect was that the recognition of collateral in reducing the risk weighting was limited to the case where collateral was either cash or OECD government bonds. The fifth aspect concerned loans or mortgages backed by residential property: this special category attracted a risk weighting of fifty percent. Finally, the sixth aspect concerned the off-balance-sheet activities. Recognising the diversity and increasing complexity of these activities, the approach was to multiply the principal nominal amount by a credit conversion factor and weighing the result by considering the credit risk of the counterparty. The credit conversion factor depended on the nature of the activity: interest rate swaps attracted a very low factor whilst direct credit substitutes attracted a very high factor.

Finally, Basel I set the target standard ratio for the amount of capital a bank should hold: the ratio of capital to risk weighted assets should be at least eight percent, of which at least four percent must be Tier 1 capital. Giving banks a transition period of just over four years, this target standard ratio had become the international norm for banks to hold. Despite its flaws arising from its obvious simplistic approach, it was a major step because it forced banks to maintain higher capital levels in line with a uniformly adopted standard. On the downside, it is very likely that the simplicity stimulated widespread capital arbitrage and encouraged the growth of the securitisation.[96]

### d. Basel II: The First Pillar – Minimum Capital Requirement

Improving on the first standard set by Basel I, the Basel II report[97] covers two hundred and thirty-nine pages, or roughly eight times the size of its predecessor. Basel II is widely implemented into financial regulation and, until Basel III is phased in, this is what is followed in current practice. The fundamental objective has been to:

[95] As an example, all claims on governments within the OECD attract zero weight whilst public sector entities in the OECD will attract a very low weight.
[96] Juliusz Jablecki, 'The Impact of Basel 1 Capital Requirements on Bank Behavior and the Efficacy of Monetary Policy' (2009) 1 International Journal of Economic Sciences and Applied Research 16
[97] Basel Committee on Banking Supervision (n 58)

> '… develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks'.[98]

The main benefit, in the view of the Committee, is that Basel II will 'promote the adoption of stronger risk management practices by the banking industry'.[99] It has done so by trying to introduce more risk-sensitive capital requirements, where those in Basel I were very much static and determined upfront. It further allows a much greater use of the assessment of risk provided by the banks' internal systems as input for the capital calculations, subject to some minimum requirements. Basel II is build around three pillars. The first pillar is the minimum capital requirement, which in itself can be split into credit risk, operational risk and trading book issues including market risk. The second pillar is the supervisory review process and the third pillar is market discipline.

The first pillar, which describes the calculation of the minimum capital requirements, offers two approaches for credit risk. The first is the standardised approach, which gives a revision and extension of the standard risk weightings set by Basel I. The risk weightings depend both on the type of obligor, for example a sovereign, a bank or a corporate, and on the rating given to the obligor by a rating agency, such as Standard & Poor's. The second approach to measuring credit risk is the banks' internal rating-based approach. Banks can be given approval by their regulators, subject to disclosure requirements and other minimum conditions, to use their own internal estimates of risk components in determining the capital requirement for their exposures. This means that these banks have to measure for each exposure the probability of default, the loss given default, the exposure at default and the effective maturity. Note that the internal rating-based approach needs to cover the unexpected losses and not the expected losses: minimum capital requirements are after all set purely for the unexpected losses.

The other two elements of the first pillar are operational risk and trading book issues. Operational risk is defined as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events'.[100] It includes legal risk but it excludes strategic risk and reputational risk. As with credit risk, there are several approaches banks can take, varying in their level of sophistication and risk sensitivity. The simplest is the basic indicator approach, followed by the standardised approach. The third

[98] ibid 14
[99] ibid 14
[100] ibid 149

approach, the advanced measurement approach, is based upon the bank's internal operational risk measurement system but satisfying a set of specified criteria. It is up to the bank's supervisor to determine whether a bank is allowed to use a more advanced method for part or all of its operations. The final part of the first pillar, trading book issues, encapsulates and updates the Market Risk Amendment.[101] A trading book consists of 'positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book'.[102] They are subject to trading book capital treatment provided that the instruments are either free of any covenants on their tradability or could be hedged completely. Naturally, the instruments need to be accurately and frequently valued, at least daily, depending on market changes, either by marking-to-market or by marking-to-model. It is important to point out that the minimum capital requirements for the trading books are far lower than that for the banking book discussed earlier. As will be discussed in the next chapters, it is this difference that becomes problematic during the height of the crisis when mortgage-backed securities, whilst becoming more illiquid and ever riskier, need to be transferred from trading book treatment to banking book treatment, creating a surge in the minimum capital requirements for the banks.

### e. Basel II: The Second Pillar – Supervisory Review Process

The second pillar of Basel II describes the supervisory review process. The purpose is to 'encourage banks to develop and use better risk management techniques in monitoring and managing their risks'.[103] The supervisor must challenge the bank on the strength and effectiveness of its risk management systems. It should do so by not merely imposing higher capital requirements, but through other means as well, including improving internal controls and strengthening risk management. Four key principles are identified; the first principle is

> 'Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels'.[104]

Such a process should have several key elements. The Committee is very clear in that the bank's management is responsible for 'understanding the nature and level of risk being taken by the bank' and for 'ensuring that the formality and sophistication of the risk

[101] Basel Committee on Banking Supervision, 'Market Risk Amendment' (1996)
[102] Basel Committee on Banking Supervision (n 82)
[103] ibid 170
[104] ibid 171

management processes are appropriate in light of the risk profile and business plan'.[105] As such, capital requirements and planning are an essential part of the strategic objectives. The Committee is also very clear on the role of the directors as they are responsible for 'setting the bank's tolerance for risks'.[106] Furthermore, the directors need to ensure that management creates a framework to assess the various risks and how they impact the bank's capital. Finally, directors also need to ensure that appropriate internal policies are designed, communicated, monitored and adhered to. All of this should lead to sound capital and risk assessment based on good internal systems of monitoring, reporting and internal control.

> 'Principle 2: Supervisors should review and evaluate bank's internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process'.[107]

The second principle gives supervisors the task to review the adequacy of risk assessment within the bank. The supervisor should also review the assessment of capital adequacy and of the control environment. The banks need to be held to operate above the minimum level required.

> 'Principle 3: Supervisors expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum'.[108]

Although the capital requirements from the first pillar will prescribe a minimum amount of capital to be held, it is based upon the fact that the bank will operate with a good risk management and internal control system as well as a diversified risk profile. In short, a supervisor may judge that in particular circumstances assumptions underlying the first pillar are not met and that more capital may need to be held.

> 'Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored'.[109]

A supervisor should have a range of options to intervene when capital threatens to drop below the required minimum, varying from merely more intrusive supervision to forcing

[105] ibid 171
[106] ibid 172
[107] ibid 174
[108] ibid 176
[109] ibid 176

the bank to raise its capital. The Committee points out that additional capital is not always the solution to a bank's problem: it may instead, for example, need to improve its internal systems and controls.

### f. Basel II: The Third Pillar – Market Discipline

The third pillar introduces additional disclosure requirements for banks. The underlying thought is that, through disclosure, the market will enforce a discipline upon the banks that complements the first two pillars. It ensures that other market participants have access to key information about the soundness of the bank, including its capital and risk exposures and assessment processes. The Committee recognises that its disclosure requirements must not clash with other disclosure requirements arising from, for example, accounting standards. The scope is therefore limited to only those matters that concern the bank capital adequacy. It should only disclose that what is considered to be material: meaning that an omission or a misstatement could influence the assessment or decision of the user.

### g. Critique on the Basel Reports

It is obvious that Basel I had its shortcomings, if only because it has already been superseded by Basel II. It is however worth highlighting some of its major deficiencies so that the preogress and changes of Basel II can be better understood. It may even be argued that Basel I had made the financial system less stable, not more.[110] That conclusion is reached on the basis of several shortcomings. Firstly, there is the arbitrary categorisation and weighting of risk which is often a far cry from the real world. Secondly, the risk of a portfolio is assumed to be the sum of the individual assets, without any regard for the correlation or overlap between them. The assumption may hold for a very well diversified portfolio, but not for one where the risk is concentrated. Thirdly, the risk weights assigned to OECD governments are zero, implying that no capital needs to be held against them; even for non-OECD governments the capital requirements are less than those for safer corporate borrowers. Sovereign defaults after the introduction of Basel I, including Argentina and Russia, have proven how disastrous this assumption is. Fourthly, and perhaps most telling of the attitude of the banking sector towards regulation, is the fact that the divergence between real world economic risk and the measures of required capital has led to universal practices of capital arbitrage. In order to gain higher returns on their capital, banks started to take ever larger risks without having to increase their capital.

[110] L. Jacobo Rodriguez, 'Banking Stability and the Basel Capital Standards' (2003) 23 Cato J 115, 119

It is often claimed that Basel I led to an increase in lending to Asian banks as the capital required for interbank loans with a maturity less than a year is far less than that required for lending to non-banks.[111] At the end of 1997 over sixty percent of all international bank lending to Asia had a maturity of less than a year; this has contributed to the Asian crisis, surely the opposite of what Basel I had set out to achieve. Others are more positive about Basel I, claiming that it has achieved its principle objectives of improving stability whilst providing a level playing field amongst banks, despite its simplicity.[112] But even those that are positive acknowledge that banks are "gaming" the regulatory framework by taking excessive risk with those assets that require relatively low capital.[113]

Basel II sought to address some of the issues of Basel I by allowing the banks to use their more sophisticated internal methodologies to measure the risk of their assets and portfolios. Since the development of Basel I, large and internationally operating banks have invested resources into developing better ways of assessing their risk. Their in-house systems were often vastly more sophisticated than the crude methods of Basel I and Basel II sought to use these improved techniques. It would allow a far better link between risks, capital required and hence reward as return on capital.[114] This in turn raises two questions. Firstly, what will stop banks from "gaming" this system by designing their internal methodology in way favourable to them and, secondly, will this give an unfair disadvantage to smaller banks that do not have the capability or resources to invest in their own methodology?[115] In the US, to address this second issue, the scope of application of Basel II has been reduced to only the large and internationally operating banks. They have a greater need for a sophisticated way to measure their risks due to the complexity and scale of their operations. The smaller US banks, which are the vast majority of the US banks, are already considered to be well capitalised according to Basel I standards.[116]

The coming into force of Basel II had significant consequences for specific areas of banking, including project finance. Unless the bank would qualify to use the internal rating-based approach, the loans would likely attract a weight beyond the 100% set by Basel I. Apart from qualifying for using an internal methodology, banks had several other major options:

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[111] ibid 120
[112] Roger W. Ferguson Jr, 'Capital Standards for Banks: The Evolving Basel Accord' (2003) 89 Fed Res Bull 395, 396
[113] ibid 397
[114] ibid 397
[115] L. Jacobo Rodriguez (n 109) 121
[116] Roger W. Ferguson Jr (n 111) 400

to use securitisation, to use monoline insurance, or even to merge with competitors.[117] The first way to reduce capital requirements is to securitize a large part of the repayment obligations of a loan portfolio. Investors would buy these CDOs, basing their selection on the underlying portfolio and the ratings. In the next chapters it will become clear that the increase in securitisation has played a large role in the current financial crisis and specific bank failures. The second way to reduce the required level of capital is to use monoline insurance. In this case, the loan would be wrapped with the guarantee of timely repayment by a monoline insurer. The capital that needs to be held against this wrapped loan is that which would need to be held against the monoline insurer and is typically much lower than the loan on itself. Again, in the next chapters, it will become apparent that monoline insurers were not the riskless institutions that everyone thought, thereby contributing to the financial crisis. The third way that is suggested, especially for smaller institutions, is that of a merger to create efficiencies. This also creates more systemically important institutions.

### h. The Financial Crisis

The next chapters will seek to answer the main questions set for this research projects concerning corporate governance of banks and the financial crisis. This paragraph introduces some of the main concepts that will come up frequently in answering these questions. The prevention or reduction of systemic risk has become a major focus since the financial crisis. Systemic risk can be defined as

> 'the risk that the failure of one significant financial institution can cause or significantly contribute to the failure of other significant financial institutions as a result of their linkage to each other. Systemic risk can also be defined as to include the possibility that one exogenous shock may simultaneously cause or contribute to the failure of multiple significant financial institutions'. [118]

But what is the connection, if any, between systemic risk and banks' corporate governance? There are many (firm-level) risks specific to banking that can be addressed by corporate governance and regulation, however, systemic risk is far more difficult to address.[119] The answer may not be to merely impose higher capital requirements and to reduce risk appetite of the banks, but, in the case of failure, prevent a wide-spread crisis of

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[117] Nick Bliss and Victoria Harud, 'The Mother of Invention' (2007) 26 Int'l Fin Rev 38

[118] Hal S Scott, 'The Reduction of System Risk in the United States Financial System' (2010) 33 Harv J L & Pub Pol'y 671, 673

[119] Peter O. Mülbert and Ryan D. Citlau, 'The Uncertain Role of Banks' Corporate Governance in Systemic Risk Regulation' (2011) ECGI Working Paper Series in Law Number 179/2011 <http://ssrn.com/abstract=1885866> accessed 14 November 2015, 20-21

confidence by planning for potential large external events. Such an argument goes back to Cadbury and other early reports on corporate governance highlighting the importance of internal communication, risk management and education of senior management and directors.[120] Klaus Hopt discusses a range of such improvements to banking corporate governance in great detail.[121] In particular, he describes that stakeholder governance and goals should not be introduced for banks, instead promoting changes such as a less opaque structure and group-wide governance to improve the overall risk assessment.

As a result of state aid to failing financial institutions, the Western world has seen a return of the state-owned enterprise. Financial giants in the US, such as Citigroup and AIG, have used temporary state aid provided under the "troubled asset relief program" (TARP); in the UK several financial institutions such as Lloyds and the Royal Bank of Scotland have received capital injections from the government. This makes governments shareholders, in some cases even majority shareholders, in global banks. To have controlling power over financial institutions can trigger various clauses in company and security laws, as is the case in the US, bringing with it many additional complications.[122] The government becomes a controlling shareholder under TARP which implies that it has significant liability to other shareholders. However, the political objectives that the government has forced several banks to implement, such as being more lenient in repossessing homes when mortgage payments are not made, are not in the commercial interest of the company and potentially damaging to the other shareholders. Unfortunately, the US is immune from suit unless it has waived this immunity, which it has not under TARP. From a theoretical standpoint, contract theory can no longer be applied in government controlled banks and the sole objective for managers is no longer the generation of profit for shareholders.[123] These conflicts are further explored in the chapter on state-ownership of financial institutions.

## 6. Conclusions

This chapter has built the theory from the ground up, starting with the theories about the existence of companies, leading to a broad analysis of corporate governance, to the top with the framework of corporate governance at banks. By taking these steps in this logical order, it has set a clear foundation for the remainder of this research. It has proven

[120] ibid 25
[121] Klaus Hopt, 'Corporate Governance of Banks after the Financial Crisis' (2011) ECGI Working Paper Series in Law Number 181/2011 <http://ssrn.com/abstract=1918851> accessed 14 November 2015
[122] J.W. Verret, 'Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice' (2010) 27 Yale J on Reg 283, 302-307
[123] ibid 315-318

necessary to provide much detail on corporate governance at banks, simply because of the additional complexity that this type of company brings. Armed with this foundation, it is possible in the following chapters to analyse the weakness and failures of corporate governance at banks during the crisis as well as the impact and effectiveness of the responses and measures that follow. This informed analysis will provide the answers to the research questions.

The next chapter contains the analysis of UK banks which failed during the financial crisis. The broad discussion in this chapter will allow an equally broad analysis of these failures. In other words, the analysis of the failures should in no way be restricted to bank specific elements of corporate governance. Although these may certainly form an important part of the analysis, the failures can also be analysed against basic concepts of the general corporate governance. It is very well possible that there were weaknesses in these general elements and these must not be forgotten simply because the study focusses on banks. A similar warning holds for the chapter thereafter, which is concerned with the short and long term responses to the bank failures. To be effective, the measures must address the shortcomings identified. These shortcomings can reside anywhere within the corporate governance framework. The measure taken should seek to address these without limitations on bank specific elements only.

# Chapter 3 – UK Bank Failures

## 1. Introduction

This chapter provides an overview of the way that the global financial crisis hit the UK banks. The aim of this chapter is to seek an answer to the question what weakness in corporate governance at UK banks contributed to their failure during or following the crisis. Through careful examination of the case studies, it is expected that several shortcomings can be identified. The selected case studies that played out during the crisis are Northern Rock, the Royal Bank of Scotland and Lloyds Banking Group. These three are chosen because of their differences and thus potentially cover a variety of reasons. As is discussed in detail in this chapter, Northern Rock was a retail bank with a customer base mainly in the North of England. The Royal Bank of Scotland was an aggressively expanding global wholesale bank, which had acquired NatWest at the turn of the Millennium and was involved in the audacious takeover of ABN Amro, a Dutch lender. Lloyds, with the image of a solid or even conservative UK bank, was faring relatively well during the financial crisis until the disastrous takeover of HBoS.

Following an analysis of the failures that took place during the crisis, there is a discussion of a range of banking scandals that have come to light over recent years. However, as these scandals played out or have their roots before the financial crisis, it is expected that they can provide insight into the weaknesses of corporate governance at UK banks before and during the crisis. The events include several failures of conduct that occurred at several UK banks simultaneously. They include the mis-selling of payment protection insurance and the rigging of LIBOR and exchange rates. Following these industry-wide scandals, two UK banks are examined in more detail: Barclays and the Co-operative Bank. These two banks operated a different business model: Barclays is dominated by an aggressive investment banking arm, whilst the Co-operative Bank aims to be an ethical bank. Both banks were hit by a series of scandals. It is argued that these scandals support the hypothesis that corporate governance of UK banks was weak. It is expected that they can assist in identifying weaknesses in corporate governance, in particular that the board was ineffective, that internal controls were lacking and that there was a disregard for the various stakeholders.

## 2. Historical Overview

### a. The Development of the Financial Sectors

This historical overview starts at the Great Depression in the US in the 1930s. The main reason for doing so is because at this point in time some fundamental principles such as disclosure were for the first time drafted into statutes. Following the crash of 1929 there was a great need to protect investors from fraudsters. In order to provide this protection, the Securities Act 1933 was passed. It was the first major act in the US to regulate the offer and sale of securities. The Securities Act 1933 was built around the principle of disclosure. The issuer is required to make full disclosure towards potential investors. This principle of disclosure has remained central to the operation of financial markets. It is a pre-requisite for the third pillar of Basel II, namely that of market discipline, which requires transparency and disclosure. The Securities Act 1933 regulates the initial offering of securities. The Securities Exchange Act 1934 regulates the secondary trading of securities. It also establishes the Securities and Exchange Commission. Finally, the Banking Act 1933 established the Federal Deposit Insurance Corporation. This is the US institution that safeguards the deposits in the banks. The Banking Act 1933 is often called the Glass-Steagall Act, usually referring to merely a few sections of this act, which limited the affiliation between commercial banks and securities firms. It effectively forces a separation between commercial and investment banking. This concept of separation between the two types of banking is revisited in more detail in the chapter on long term solutions.

In contrast to the US, the UK financial services sector was largely self-regulating. The only exception was the Prevention of Fraud (Investments) Act 1956, which was the only statutory form of regulation at the time. It worked, mainly because the City was a domestic affair.[1] The financial industry in the UK experienced a 'Big Bang' in 1986 when the financial markets were opened to foreign entrants. The then prime minister, Margareth Tatcher, introduced these reforms, together with a more formal system of financial regulation, to allow the city of London to compete with the world's other financial centres such as New York. It sought to introduce more free market principles whilst replacing the unofficial regulation of "old boy networks". Regulation was introduced in the form of the Financial Services Act 1986, based upon Professor Gower's first report,[2] a government white paper[3]

[1] Christopher Blair, 'Financial Services and Markets Bill: Bill 121 of 1998-1999' (24 June 1999) <researchbriefings.files.parliament.uk/documents/RP99-68/RP99-68.pdf> accessed 14 November 2015, 7

[2] Laurence C.B. Gower, *Review of Investor Protection: Report Part 1* (Cmnd 9125, Jan 1984)

and later the second part of the Gower Report.[4] The Securities and Investment Board was set up under this act. It established a system of two-tier regulation, with several self-regulating bodies existing besides the Securities and Investment Board.

Regulation of deposit-taking activities was a matter for the Bank of England, but was changed by the Bank of England Act 1998. This part of the regulation was transferred to the Securities and Investment Board, which was combined with the self-regulating bodies into the Financial Services Authorities ("FSA") by the Financial Services and Markets Act 2000. The Bank of England and the FSA were the two main UK regulators at the time of the financial crisis. Their establishment was a further departure from self-regulation in financial services in the UK. At that time in the US, the Glass-Steagall Act was repealed, allowing the merger between commercial and investment banking into large universal banking groups. Although such a merger was formerly not allowed, the Act was largely ignored in the years before the repeal. A year before its repeal, for example, Citibank took over the US security firm Salomon Smith Barney, effectively merging commercial and investment banking. These events paved the way for a further enormous growth of the financial institutions and markets. This growth of financial markets, the innovation and increasing complexity in financial products and the consolidation of players into large global banks was at its height just before the financial crisis.

### b. Banking Failures

Banking failures have been around as long as banks themselves. In principle, there is nothing wrong with a badly run company going bankrupt. It will affect employees, suppliers, customers and so on. The problem is that banking failures often carry a much wider social and economic impact. Hector Sants, the former head of the FSA and then designated head of the Prudential Regulatory Authority ("PRA"), pointed out that

> 'orderly failure with minimal cost to the economy should not be seen as a regulatory failure. The PRA should be judged by the avoidance of failures which incur a cost to the economy and in particular to individual tax payers and customers'.[5]

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[3] Department of Trade and Industry, *Financial Services in the United Kingdom: A New Framework for Investor Protection* (Cmnd 9432, Jan 1985)

[4] Laurence C.B. Gower, *Review of Investor Protection: Report Part 2* (1985)

[5] Hector Sants, 'Reforming Supervisory Practices: Progress to Date' (Speech Reuters Newsmakers Event 13 December 2010) <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/1213_hs.shtml> accessed 14 November 2015

It is this potential wider impact that makes the failure of a bank problematic. There have been many examples of bank failures over the past decades.[6] The following short and by no means complete overview[7] illustrates that banking failures are quite common even in mature economies and that banks have been allowed to fail in the recent history. In 1974 there was the failure of the Herstatt Bank, which failed due to large open currency positions of DM 2 billion at the moment that the Bretton Wood system collapsed. It was this failure that led to the establishment of the Basel Committee on Banking Supervision, which later published the Basel Accords.

The Financial Crisis in Japan, during which many Japanese banks got into difficulties, started with a stock market collapse in 1991. The property bubble, fuelled by cheap loans, burst. Chapter six contains a detailed case study of Japan's financial crisis, the reforms that followed and the nationalisation of some of Japan's largest banks such as Long Term Credit Bank. In Europe, countries such as Norway[8] and Sweden[9] also experienced a banking crisis. The UK suffered failure of banks, including the scandal at the Bank of Credit and Commerce International ("BCCI").[10] BCCI had been involved in large scale money laundering operations and was forced to close down in 1991. A few years later, in 1995, Barings, the oldest merchant bank in London, collapsed after unauthorised trades resulted in enormous losses. The collapse of Barings resulted in some of its directors being disqualified.[11] These banking failures usually stood in isolation, often triggered by individual actions.

### c. Systemic Risk

If banking failures are nothing out of the ordinary, then what made the global financial crisis different? The main differences are, firstly, that several banks had become so large that they were deemed to be too-big-to-fail and, secondly, that the interconnectedness in the financial system had increased dramatically. Systemic risk, which was defined in more detail in section 2.4.7, was high. Years of financial innovation had led to securitisation of loans and mortgages. It had further developed into synthetic products, where the

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[6] Basel Committee on Banking Supervision, 'Banking Failures in Mature Economies' (April 2004) <http://www.bis.org/publ/bcbs_wp13.pdf> accessed 14 November 2015

[7] For an overview of banking failures in the UK: Patricia Jackson, 'Deposit Protection and Bank Failures in the United Kingdom' (1996) <http://www.bankofengland.co.uk/archive/Documents/historicpubs/fsr/1996/fsrfull9610.pdf> accessed 14 November 2015, 38

[8] ibid 14

[9] ibid 34

[10] Richard Dale, 'Reflections on the BCCI Affair: A United Kingdom Perspective' (1992) 26 Int'l L 949, 959-961

[11] *Baker v Secretary of State for Trade and Industry* [2001] BCC 273

underlying of the CDOs where no longer real world mortgages. Instead the underlying financial instruments would be credit default swaps, which pay on the credit event at a reference legal entity. This further accelerated the growth of financial markets and increased the interconnectedness in the financial system. Additionally, these developments marked a shift in the banks business models: it moved from originate-to-hold to originate-to-distribute.[12] In other words, rather than holding a loan on its own books, banks would now actively seek to move it to a third party.

Unfortunately, not all of the underlying mortgages were of high quality, thus reducing the quality and increasing the risks of the packaged product. With a collapse of the US mortgage markets, many of these products produced losses.[13] Further problems arose when the funding mismatch played up. Short term commercial paper was no longer available to fund the long term securitised products as investors wanted cash instead.[14] This amounted to a run on the shadow banking system, effectively a run on the banks but one without the queues in front of the branches. Banks did not want to let the special purpose vehicles that contained the securitised products default, so they took the obligations onto their banking book instead. The fact that these off-balance sheet instruments were being brought back onto the banking book meant that extra capital needed to be held for it.

The effects were disastrous.[15] The next section deals with the bank failures in the UK, but there were many other high profile casualties. A detailed analysis of the failures in the US and the underlying causes was conducted by the US Financial Crisis Committee, which published its report in January 2011.[16] The first big US name to fall was Bear Stearns in March 2008, which was taken over by JP Morgan. In the autumn of 2008, disaster struck home with the collapse of Lehman Brothers and the rescue of Merrill Lynch by Bank of America. It is in particular the collapse of Lehman Brothers in September 2008 that

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[12] Richard J Rosen, 'The impact of the originate-to-distribute model on banks before and during the financial crisis' (2010) <http://www.chicagofed.org/~/media/publications/working-papers/2010/wp2010-20-pdf.pdf> accessed 4 July 2016

[13] Thomas Zimmerman, 'The Great Subprime Meltdown of 2007' (Fall 2007) J Struc Fin 7; Kurt Eggert, 'The Great Collapse: How Securitization Caused the Subprime Meltdown' (2009) 41 Conn L Rev 1257

[14] William Poole, 'Causes and Consequences of the Financial Crisis of 2007-2009' (2010) 33 Harv J L & Pub Pol'y 421, 425

[15] David Wessel, *In FED We Trust: Ben Bernanke's War on the Great Panic* (Reprint, Crown Business 2010); Hank Paulson, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (Headline Publishing Group, 2010)

[16] US Financial Crisis Commission, 'The Financial Crisis Inquiry Report' (Jan 2011) <http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf> accessed 4 July 2016

accelerated the crisis.[17] It had held on to riskier lower rated tranches of mortgage backed securities, which it subsequently overvalued. It became therefore very difficult to determine whether the firm was solvent in the run-up to its failure. This was combined with reliance on short-term funding. In the weekend before its failure, several deals to rescue it fell through and the US government decided not to bail it out.[18] Other well-known casualties of that period include American International Group, Washington Mutual, Wachovia and above all the mortgage companies Fannie Mae and Freddie Mac. In Europe it was much the same story. Financial conglomerates such as Dexia, Fortis, several Irish banks and many others required rescuing. It is clear from even this short list that the scale of this crisis was without precedent.

The fear of contagion between the financial institutions quickly took over from the initial causes of the crisis and drove the responses.[19] It resulted in a credit crunch: banks were no longer prepared to loan to each other because they feared that other parties were close to defaulting. The interconnectedness between the financial institutions had increased, like the interconnectedness between much of the rest of the world had. Progress in telecommunication and IT systems had created a dependence on a global scale. Whereas Barings or BCCI were contained or localised defaults, there now existed financial giants, such as Citigroup, UBS or the Royal Bank of Scotland, which were simply too-big-to-fail. A great amount of systemic risk had been introduced into the financial system.

In the following chapters, when discussing the policies implemented after the crisis, the reduction of systemic risk in the system is a major consideration.[20] Part of the connectedness was created through the explosion in over-the-counter derivatives. Although it is certain that many of the new policies and legislation are being designed specifically to regulate the derivatives market, for example through the use of centralised counterparties, they are not necessarily relevant for this research. This research focuses only on those policies and legislation that have a direct impact on the corporate governance of banks.

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[17] ibid 324
[18] ibid 325
[19] William Poole (n 13)
[20] Hal S. Scott, 'The Reduction of Systemic Risk in the United States Financial Sector' (2010) 33 Harv J L & Pub Pol'y 671

## 3. The Global Financial Crisis hits the UK

### a. A Timeline of the Crisis

This section provides a more detailed time line of the main events immediately before and during the financial crisis. The purpose of this timeline is to provide an historical overview in which the cases studies of Northern Rock, Lloyds Bank and the Royal Bank of Scotland can be placed. Although deeper underlying causes for the financial crisis may well have started earlier, the immediate catalyst to the crisis was the halt in the booming US housing market when prices dropped from the last quarter of 2005 to the first quarter of 2006. The warning signs continued through 2006 and at the end of that year, large US banks such as JP Morgan, started to reduce their own exposure to subprime mortgages whilst others, such as Goldman Sachs, started betting against the housing market.[21] In the first months of 2007 the US subprime mortgage market collapsed and several subprime lenders went bankrupt. In the summer of 2007, there was a worldwide credit crunch as many financial institutions worldwide revealed that they had exposure to US subprime mortgages.

In August 2007 Countrywide Financial, the largest mortgage lender in the US, avoided bankruptcy as it received an $11 billion loan from a consortium of banks. Bear Stearns had to disclose on 17 July 2007 that two of its hedge funds had lost all their value due to the subprime mortgage crisis. This led to large losses for Bear Sterns and ultimately a bailout by the Federal Reserve in March 2008 and the sale to JP Morgan a few days later. Other banks announced losses, including Merrill Lynch announcing a $8.4 billion loss in October 2007.

At the same time in the UK, Northern Rock found it increasingly difficult to attract funding from the wholesale markets. As a result, Northern Rock sought emergency funding from the Bank of England as lender of last resort, which is examined in the next section. This was leaked and resulted in a run on the bank on 13 September 2007. On 17 February 2008 Northern Rock was nationalised. In spring 2007, the battle between Barclays and RBS commenced over the Dutch bank ABN Amro. In April 2007 Barclays announced a deal to buy ABN Amro, followed the month after by a rival, hostile take-over bid for ABN Amro by RBS, Santander and Fortis. As these three offered mainly cash instead of shares, they won the battle in October 2007.

After Northern Rock was nationalised in February 2008 and Bear Stearns failed in March 2008, RBS, after announcing a £6 billion write-down due to credit exposure, raised £12

[21] Michael Lewis, *The Big Short* (Penguin)

billion from a rights issue in April 2008. In the summer the mortgage crisis intensified further as several US lenders go bankrupt. It reached its peak in the early days of September. Fannie Mae and Freddie Mac were nationalised and a week later Merrill Lynch was forced to accept a take-over by Bank of America and Lehman Brothers filed for bankruptcy protection. A few days later the Federal Reserve provided a $85 billion loan to prevent AIG from going bankrupt. In October 2008, the Troubled Assets Relief Program was approved.

In the UK, Lloyds took over the troubled lender HBoS in a £12 billion deal in September 2008. In that same month, Fortis, a member of the consortium taking over ABN Amro, was part nationalised, Bradford and Bingley's branches were sold to Santander whilst the UK government took ownership of the mortgage- and loan books. The Icelandic government took control of Glitnir and the Irish government guaranteed deposits in the Irish banks for two years. The crisis continued the next month when trading was suspended in several Icelandic banks including Kaupthing and Landsbanki. The Icelandic government took complete control of Landsbanki and a major rescue plan was drawn up in the UK by the Bank of England and the Treasury to protect UK financial institutions and markets. This rescue plan included a £50 billion capital injection that would part-nationalise the banks, as well as extended liquidity schemes. Later that month, UK officials travelled to Icelands as UK councils and charities were hit for about £1 billion due to the failing of the Icelandic banks. The Treasury later announced a £37 billion rescue package for RBS, Lloyds and HBoS.

### b. Northern Rock

Northern Rock was an important financial player in the North East of England.[22] It was formerly a building society, demutualised in October 1997. At the end of 2006, it had a consolidated balance sheet of just over £100 billion, largely composed of secured lending on residential properties. Northern Rock described itself as a 'specialised lender, whose core business is the provision of UK residential mortgages funded in both the retail and the wholesale markets'. Although there was no underlying problem with the mortgages itself, the change in funding was problematic. To fund the growth in balance sheet, Northern Rock started to borrow more and more money from the wholesale market. This is referred to as shifting from an 'originate to hold' approach to an 'originate to distribute' approach.

[22] Treasury Select Committee, 'Fifth Report of Session 2007-2008, The Run on the Rock' (2008) <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf> accessed 20 November 2015; Financial Services Authority, 'The Supervision of Northern Rock: a Lesson Learned Reviewed' (2008) <http://www.fca.org.uk/static/documents/fsa-nr-report.pdf> accessed 20 November 2015

Under the 'originate to distribute' model, Northern Rock parcelled up mortgages and used them as collateral for further funds, i.e. securitisation. To grow even further, Northern Rock started to use so called 'covered bonds', a form of securitisation where the banks continue to hold the assets themselves but issue the covered bonds secured against them. Although these techniques allowed for a rapid growth in wholesale funding, retail funding was stagnant. In the first half of 2007, Northern Rock continued to grow at a rapid pace, increasing its loans to customers by £10 billion. However, after signs of trouble in the US subprime mortgage markets, the growth ambitions were adjusted downwards halfway through 2007 and the funding strategy was reviewed. The outcome was an objective to diversify the funding sources geographically.

In August 2007, the US subprime crisis started to gather pace as described previously. The funding markets froze, causing a worldwide liquidity squeeze. Management at Northern Rock was surprised, firstly, because they wrongly believed that their high quality assets and transparency would allow them to maintain liquidity and, secondly, because they had not foreseen that all funding markets would close simultaneously. Northern Rock had conversations with the Bank of England to put a backstop, a support facility, in place if it ever needed it. Ironically, details of these discussions leaked and this caused the run on the bank. This retail run reduced the liquidity even further, making state support a necessity rather than the intended back stop.

The funding risk had been discussed and evaluated by the board and its Risk Committee, chaired by a non-executive director, before these events. On the other hand, the governor of the Bank of England pointed out that the funding strategy was fatally flawed and professor Buiter described it as reckless. The Treasury Select Committee concluded that the directors of Northern Rock were the principal authors of the difficulties that the company faced and that it is right that they had been replaced. It places the blame for devising a risky high-growth strategy, reliant solely on wholesale market for funding without any backup plan, with the board. The Committee also concluded that the board had provided clear information about its strategy, including that of funding, to its shareholders. Although many employees were shareholders, the Committee did not want to make a distinction between institutional investors and employee shareholders and concluded that they all sought a high reward from a risky investment.

On Monday 17 September 2007, the UK government announced its guarantee for all depositors to halt the run on the bank. On Thursday 20 September, this was further

specified to cover all deposits in existence with the bank on Wednesday 19 September. Although the government tried to find a private sector solution, this failed and in the end Northern Rock was fully nationalised on 11 January 2008.

### c. Lloyds Banking Group and HBoS

The findings into the failure of HBoS, published by the Parliamentary Commission on Banking Standards in March 2013, highlighted major some failings.[23] Note that on 19 November 2015, the PRA and the FCA jointly published to further reports into the failure of HBoS: one that examines the failure itself,[24] and one that examines the enforcement actions taken by the regulator.[25] The reasons for the failure identified in the former are in line with those identified by the earlier report. First, there is the failing of internal control. Senior management of the bank had given a large amount of independence to the divisions Corporate, Institutional and Treasury. It was these three divisions that would go on to amass the enormous losses as individuals leading these divisions would, unchallenged, grossly underestimate the risk they were running. The bank's risk function was not adequately designed to put a proper check on these activities. The second major failing was on the part of the regulators. Although the FSA had noted a lack of internal control and an overreliance on funding through the wholesale markets, it did not follow through on this. Additionally, the FSA was, understandably, more concerned with the implementation of Basel II. It shifted focus of top management further away from credit and liquidity to the internal calculation of risk weighting for assets. Thus several opportunities were missed by the FSA to prevent the eventual outcome.

The report further highlights the horrible failure of corporate governance at HBoS. Amazingly, some of the former board members view the board as a beacon of good corporate governance. This complacency was part of the problem as it indicates that there was little room for challenging decisions, rather simply chest beating. The composition of the board also lacked in experience on banking and finance matters. It was simply not

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[23] Parliamentary Commission on Banking Standards, 'An Accident Waiting to Happen: the Failure of HBoS' (March 2013) <http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/144/144.pdf> accessed 14 Nov 2015

[24] Financial Conduct Authority and Prudential Regulation Authority, 'The Failure of HBOS Plc (HBOS)' (18 November 2015) <http://www.bankofengland.co.uk/pra/Documents/publications/reports/hbos.pdf> accessed 1 December 2015

[25] Andrew Green QC, James Segan and Simon Pritchard, 'Report into the FSA's enforcement actions following the failure of HBOS' (18 November 2015) <http://www.bankofengland.co.uk/pra/Documents/publications/reports/agreenreport.pdf> accessed 1 December 2015

within their capacity to fully understand and challenge some of the decisions and risks taken by the bank.

HBoS was rescued by Lloyds and this rescue is put forward as the main reason as to why Lloyds later required government assistance.[26] There are three perspectives to consider in the rescue.[27] The first is that of HBoS, which clearly benefitted. It rescued the firm in the short-term, providing security for customers, funding and employment for most of its staff. From Lloyds' perspective, the question is whether it would generate sufficient additional benefit especially when weighted against a potential negative impact on its financial position. Of particular relevance is the limited due diligence carried out on behalf of Lloyds, which caused the board to make the decision based on insufficient information. Given how events unfolded, the board had possibly reached the wrong conclusions. Finally, there is the perspective from the government. Although the merger is often presented as a shotgun marriage, the then Chancellor and Governor of the Bank of England maintained that their only contribution was to place competition concerns to one side and nothing more. Instead, they put forward the view that it was purely a commercial decision.[28] In any event, their support was clear and, together with the haste required at that point in time, the poor due diligence by Lloyds can be explained. Nonetheless, it does constitute a failure of corporate governance at Lloyds to have pursued the deal, despite the circumstances under which it took place.

### d. The Royal Bank of Scotland

#### *i. Timeline*

The Royal Bank of Scotland is a Scottish bank with its headquarters in Edinburgh. It was founded in 1727 and since then continued to grow to become a large national bank. With the acquisition of NatWest, an English bank, in 2000, it became the second largest banking group in the UK with subsidiaries including Coutts and Ulster Bank. It was the successful integration of NatWest during which Fred Goodwin made a name for himself, resulting in his promotion to CEO in 2001. The acquisition of NatWest included the NatWest Markets division, its investment banking arm. Together with the US banks Citizen Financial Group and Charter One Bank, as well as the Stamford based Greenwich Capital Markets, it leads

[26] House of Commons Treasury Committee, 'Banking Crisis: Dealing with the Failure of UK Banks' (May 2009) <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/416/416.pdf> accessed 14 Nov 2015, 58
[27] ibid 51
[28] Ibid 54

the expansion of the US operations and the investment banking arm of RBS. Through organic growth, RBS set up overseas subsidiaries in many European and Asia-Pacific countries. In the UK, RBS acquired Churchill Insurance and Direct Line. Finally, in 2005, it acquired a ten percent stake in the Bank of China.

By 2007, RBS had become one of the truly global financial conglomerates. But when ABN Amro, a Dutch lender, under pressure from hedge fund TCI, sought to merge with Barclays Bank, RBS launched a hostile bid. It did so in May 2007 together with Santander and Fortis. The plan was to break ABN Amro into three parts: RBS would acquire its wholesale operations, including the Chicago based LaSalle Bank, whilst Santander would acquire the Latin-America based operations and Fortis its Netherlands based operations. Whereas the merger with Barclays was proposed to investors as an exchange in shares, the offer by the consortium was mainly cash based. ABN Amro unsuccessfully sought to defend itself by selling the crown jewels, in this case LaSalle Bank, to Bank of America for $21 billion. This should have made the deal far less attractive for RBS, who sought to expand their US operation by adding LaSalle to its existing US arm. However, by October 2007, with the global financial crisis commencing and Northern Rock receiving government support, the Barclays share-based bid lost in value to €61 billion whilst the consortium's cash bid remained steady at €71 billion. The consortium had won the battle.

The freezing of the wholesale markets hit RBS hard. Additionally, RBS, as leader of the consortium, had to take the whole of ABN Amro's balance sheet with its own until it was split between the consortium members. Furthermore, it turned out that ABN Amro was heavily exposed to the US mortgage crisis. RBS was exposed to severe combined losses from both the mortgage positions of ABN Amro and RBS, whilst it was already low on cash following the takeover. As a result, RBS had to ask investors for £12 billion in capital in April 2008. This was followed by a reporting of major losses in August 2008.

Finally, the UK government had to come to the rescue of RBS. On 29 November 2008 the government took a 58% stake in RBS worth £15 billion. As part of this process, Fred Goodwin was forced out. On 19 January 2009, sometimes called the Blue Monday Crash, the next important events happened at once. RBS released a trading statement in which it announced that it expected to report trading losses of around £7 billion and write downs, mainly in relation to the takeover, of around £20 billion. Simultaneously, the UK government announced that it would inject funds into the UK banking system to guarantee bank loans to stimulate the UK economy. The government also announced that it would

increase its stake in RBS to 70%. On that day, the RBS share price collapsed by 67%, dragging other UK banks with it. On 16 Feb 2009, RBS reported a loss of £24.1 billion for 2008, the biggest ever in UK corporate history.

### *ii. The Immediate Reasons for the Failure*

The failure of RBS was one of the most dramatic failures of a UK bank during the financial crisis. It was led by the well-known Sir Fred Goodwin, [29] nicknamed "Fred the Shred" in the media due to his reputation gained after the successful takeover and integration of NatWest. At the height of the crisis, RBS was involved in the takeover of ABN Amro, together with the Belgian bank Fortis and the Spanish bank Santander. It was in competition with old rival Barclays bank which had tabled an offer to merge with ABN Amro. As a result, RBS and Fred Goodwin had not only featured prominently in the media in the period leading up to the crisis, its financial position and balance sheet were severely compromised. In early October 2008, it survived only through the financial support of the UK government. The support was provided in the forms of both liquidity and solvency support. RBS' and Fred Goodwin's reputation were in tatters, becoming national symbols of what went wrong with the City.

The FSA has conducted an extensive analysis, which forms the basis for this case study.[30] The report can be split into three parts: the reasons for RBS's failure, lessons for regulators, supervisors and management, and finally FSA enforcement. The most valuable parts in this report, for the purpose of this research, are the reasons given for the failure as well as the recommendations made, especially those recommendations that relate to the governance of the bank.

The report finds six key factors that caused RBS to fail. The first factor was that RBS's capital position was in fact far weaker than its published total regulatory capital suggested due to poor definitions of regulatory capital.[31] At the end of 2007, RBS had a capital position of £68 billion which meant that it had a capital ratio of 11.2% against the required 8% by Basel I and Basel II Pillar 1; likewise, its published Tier 1 capital ratio stood at 7.3% against a required 4%. These ratios were relatively low compared to its UK peers: RBS pursued, in the words of Sir Fred Goodwin, a policy of "capital efficiency". Despite these

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[29] As the events of this chapter take place at the time that Fred Goodwin held a knighthood, he is referred to as Sir Fred Goodwin. He had his knighthood taken away at a later stage, well after the nationalisation of the Royal Bank of Scotland.

[30] Financial Services Authority, 'The Failure of the Royal Bank of Scotland' (December 2011) <http://www.fsa.gov.uk/pubs/other/rbs.pdf> accessed 14 November 2015

[31] ibid 40

good ratios, RBS did not have enough capital to convince the markets that it could manage its uncertain future losses. There were several reasons for this. Firstly, in addition to the aggressive capital policy, RBS had worsened its capital position by a large debt-finance of the ABN Amro takeover, reducing its Tier 1 capital ratio to below its own target of 5.25%. Secondly, the capital regime as prescribed by Basel II proved to be severely inadequate. This is being addressed by the introduction of Basel III, which is discussed in more detail in the next chapter. One of the improvements is that the Tier 1 capital ratio for systemically important banks, such as RBS, is increased to 9.5%. The FSA calculated that, applying the new risk weightings and methodology of Basel III, RBS would have held a Tier 1 capital ratio of only 1.97% at the end of 2007. The third reason of its weak capital position was due to the very deficient way in which the required capital for trading books was calculated. Following the Value-at-Risk based approach combined with the low risk weighting attached to the trading book, as prescribed by the regulators, RBS had only £2.3 billion of core Tier 1 capital available to cover all the losses from its £430 billion assets on the combined RBS and ABN Amro trading books. The Credit Trading area alone lost over £12 billion in 2008.

The second factor was that RBS was dependent upon short-term wholesale funding.[32] This was not uncommon for banks at the time, but the situation at RBS was excessive. In general, UK banks' loan books were growing much faster than their deposits: the combined funding gap for UK banks stood at £500 billion at the end of 2006. Although RBS had a capital problem as outlined, it was the liquidity problems that were the immediate driver behind the failure. Other banks, financial institutions and other wholesale money market providers were unwilling to meet RBS's funding requirements. This left RBS relying on emergency liquidity provided by the Bank of England through the ELA. This situation was allowed to exist due to poor regulation of the liquidity regimes; as a result, the proposed regulation in Basel III introduces several liquidity measures and ratios which are discussed in the next chapter.

The third factor was great uncertainty and concern about potential future losses especially in view of the aggressive growth strategy that RBS had pursued.[33] This was not restricted to the losses from their credit trading operation, which is discussed next, but also from the losses from loan impairments. In contrast to trading losses, which are recognised immediately, loan impairments are only taken into consideration when borrowers default. The fact that a large economic recession was due to follow on from the immediate crisis

[32] ibid 43
[33] ibid 47

gave rise to great uncertainty about future loan loss provisions at all banks. The market anticipated that RBS's loan portfolio was of particularly low quality due to its aggressive growth strategy and its willingness to take on risk, all of which was confirmed when RBS had to create large provisions for loan losses. From 2008 to 2010, RBS had to make total impairment losses of around £30 billion.

The fourth factor was the large losses in credit trading of around £12 billion, which directly eroded the capital position and caused great uncertainty about the ultimate losses.[34] Around 2006, RBS had decided to grow its structured credit business aggressively. This included increasing its exposure to monoline bond insurers and leverage finance. It was this area that was driven by the boom in structured credit products based upon US mortgages and created a flurry of complex financial instruments and derivatives relating to credit. When, by early 2007, it was becoming clear that the underlying credits for these complex products were turning bad, RBS, like many others, was slow to react, believing in the high ratings of the trades on their books. Once RBS tried to offload their toxic positions, it found that its "distribution capability" to sell positions that were turning sour to uninformed and uneducated clients was far less than that of other banks. Hence it was stuck with its positions, leaving only the questions whether it was better to close the positions and take a loss, whether hedges would be actually be available and what the best estimate of the losses at any date would be. In 2008, RBS realised trading book losses of £8.5 billion.

The fifth factor was the take-over of ABN Amro, which exposed RBS to an even greater number of risky assets, increased liquidity risk and effectively eroded its capital base.[35] Although the takeover by the consortium of ABN Amro cost €71 billion, only €27 billion was to be paid by RBS for the parts that it wanted. These parts included LaSalle, which had been sold to Bank of America just before the takeover, reducing the amount that RBS had to pay to only €16 billion: a number far smaller than the headline figures suggested and also much smaller than its £23 billion acquisition of NatWest in 2000. However, the credit trading losses made by ABN Amro contributed greatly to RBS's total losses, increasing also the market uncertainty about RBS's position. The acquisition was financed largely by short term debt: over €12 billion was financed by debt of a maturity of less than a year. Further funding restraints arose as the cash from the LaSalle transaction remained stuck in the Netherlands whilst RBS needed to quadruple its funding commitments as it was committed to funding ABN Amro's inherited ABCP conduits totalling around £8 billion at the end of

[34] ibid 50
[35] ibid 54

2008. Additionally, RBS had not foreseen that ABN Amro would not receive approval for its Basel II internally developed credit risk models, meaning that it would need to hold much additional capital. Finally, as RBS was the consortium leader, it needed to consolidate the whole of ABN Amro on its 2007 accounts, before distributing it amongst the other consortium members. This created much uncertainty and a lack of transparency on where the losses would ultimately go, especially as Fortis, another consortium member, failed in October 2008.

Finally, the sixth factor was the increased fear in the financial markets for systemic risk, which hit banks with vulnerable liquidity, low asset quality and low capital ratios, such as RBS.[36] Regulators and policy makers had, at the start of the crisis, failed to appreciate the new element of systemic risk in the banking system. It caused a deterioration of market confidence which culminated with the failure of Lehman Brothers in September 2008. In the weeks after the collapse of this household name, there were further banking failures and the markets were so nervous that nobody was prepared to meet RBS's funding needs. It had to rely almost completely on the emergency liquidity assistance provided by the Bank of England. The report recognises that it is difficult to determine what factors distinguished RBS from its competitors in such a way that it could not attract any more funding. It mentions as a potential explanation the low capital ratios and problems with asset quality signalled by earlier losses.

### *iii. The Deeper Underlying Reasons*

Next to these six immediate reasons that led to the failure of RBS, the FSA report examines the impact of the management, governance and culture at RBS on its failure. It is clear that, although RBS had to deal with the same bad market conditions as other banks, there had been key decisions made by its management that had left it in a more vulnerable position than other banks. They include the six immediate reasons previously discussed. The context in which the FSA has reviewed RBS's management is 'to satisfy a legitimate public interest in understanding the causes of RBS's failure.'[37] After all, the taxpayers footed the bill to bail it out. The second purpose is to learn from the uncovered management failures in order to avoid similar behaviour in future.

[36] ibid 56
[37] ibid 222

The FSA identifies five major areas of management, governance and culture for closer scrutiny. The first area is the overall effectiveness of board oversight and challenge.[38] Although the FSA did not find that there was a basis to successfully bring an enforcement case, the FSA is by no means positive about the quality of corporate governance at RBS in the period before the crisis. The examination is unfortunately hindered by practicalities. Although it is not difficult to check that the formal process was appropriate by reviewing minutes of board meetings, it is difficult to assess whether there was sufficient critical discussion between the board members. This is not necessarily captured in the minutes and inquiring to this after the facts can lead to, not necessarily intentionally, tainted views. In order to conduct effective oversight and to hold effective board level discussions, the members need to have extensive relevant experience, understand the firm-wide risks and be able to challenge the policies and decisions. The FSA concluded that RBS's board and formal processes were all of an acceptable standard.[39] The FSA also concluded that there were substantive failures of RBS's board effectiveness that ultimately led to the failure of the bank.[40] These failures of effectiveness include the failure to challenge the focus on increasing revenue and assets, rather than capital and liquidity, failure to identify the aggregate risk across the businesses and failure to challenge assumption behind the business model, including those behind the US subprime market and behind the funding market.

The second aspect is the board's role in relation to the ABN Amro take-over. [41] The most telling conclusion was drawn by the new chairman, who stated that:

> 'I don't think there can be any doubt that the key decision that led RBS to its difficulties was the acquisition of ABN Amro. That is the painful reality that we can now do nothing to change. With the benefit of hindsight, it can now be seen as the wrong price, the wrong way to pay, at the wrong time and the wrong deal'.[42]

Such a major take-over is the responsibility of the board and this was a particularly risky take-over. It was a very large and complex transaction, financed almost completely by debt on the short-term funding market and with only extremely limited due diligence available. Furthermore, as RBS was the leader of the take-over consortium, ABN Amro would be consolidated completely on its balance sheets before assets were transferred to the

[38] ibid 223
[39] ibid 224
[40] ibid 225
[41] ibid 227
[42] ibid 227

consortium partners. Records show that there was a significant amount of meetings between board members leading up to the take-over, suggesting that the formal process has been adequate. However, it is undeniable that the decision making had been exceptionally poor: again, despite adequate formal processes, the effectiveness of the board has to be questioned. The FSA identifies several reasons for such poor decision making, including an over-reliance on the past success from the NatWest take-over, the acceptance of poor due diligence in case of a hostile take-over, and, above all else, the failure to appreciate the importance of customer and counterparty confidence in the bank.[43] In conclusion, the board's decision did not show 'the degree of moderation and sensitivity to strategic risk appropriate to a bank'.[44]

The third aspect concerns the board's role of oversight of strategy and whether its associated risk profile is deemed acceptable.[45] The strategy was opportunistic with a clear ambition for growth, relying on both organic growth and on acquisitions. Although this is not necessarily an issue in itself, the FSA argues that the board did not pay enough attention to the risk profile associated with this strategy. In 2005 and 2006 there was already growing concern amongst directors that the board needed to better articulate its risk appetite. As an example supporting this view, the investment banking arm did not provide any risk analysis of the markets in which it sought to aggressively grow. A further example is provided by quotes from the Internal Audit Committee, charged at the time with the risk function, which regularly stated that discussions on strategy were not accompanied by discussions on associated risks.

The fourth aspect is the leadership capability and management style of Sir Fred Goodwin.[46] The FSA did not see sufficient proof for an enforcement case, but does raise several questions about his style and impact on RBS. Firstly, there is the question whether his management style has deterred robust challenges from the board or other senior managers. Furthermore, the pay at RBS for executive directors was amongst the highest for UK banks, which may have further deterred any of them from challenging him. The second line of questions concerns whether or not his focus was not too much on growth instead of risk and whether or not his attitude towards the crisis was far too optimistic. Lastly, there is the question whether or not, in his delegation of responsibilities to the

[43] ibid 299
[44] Ibid 299
[45] Ibid 230
[46] ibid 232

management of the investment bank, he had maintained sufficient overview and understanding of the actual business. It should in this context be noted that the head of the investment banking arm, Johny Cameron, settled with the FSA after an investigation and agreed that he would not take up any regulated function or fulltime employment in the financial services industry in future.[47] In return, the FSA would not take any disciplinary action.[48] To illustrate the lack of understanding with Johny Cameron of the transactions his department was involved in, the FSA notes that he explained his knowledge of around May 2007 regarding CDOs to be as

> 'I don't think, even at that point, I fully, I had enough information. Brian[49] may have thought I understood more than I did … And it is around this time that I became clearer on what CDOs were, but it's probably later'.[50]

It is obvious that senior management at the investment banking arm had little knowledge of at least some of the areas that they were active in, let alone had a thorough grasp of the risks associated with it. The board and the CEO in particular should have held the investment bank on a much tighter leash.

The fifth and final aspect is the quality of risk controls and management information.[51] As with the previous aspects, there were not sufficient shortcomings to bring an enforcement case. However, the FSA notes several severe deficiencies. For example, there was no process for proposing and agreeing a risk appetite. The board received a monthly risk report that was purely backward looking instead of forward looking. The Group Risk Officer was not invited to attend important meetings, including the regular morning meetings held by the CEO and his team. The list goes on. To summarise, the point of these deeper underlying reasons reviewed in this section expose significant problems with management, culture and governance at RBS at the time of the crisis. These reasons should inform the improvements proposed.

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[47] Financial Services Authority, 'FSA Statement on Johny Cameron' (18 May 2010) <http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/081.shtml> accessed 14 November 2015

[48] Johny Cameron now works part-time for a boutique investment bank.

[49] Brian Crowe, a senior manager at the investment banking arm of RBS

[50] Financial Services Authority (n 26) 387

[51] ibid 235

## 4. Failures Revealed Post-Crisis

### a. Failures of Bankers' Conduct

Over the last few years, since the height of the financial crisis passed, many cases have been reported in the media with regard to the behaviour or conduct of bankers. Several of the UK banks were implicated. Examples include mis-selling of payment protection insurance, anti-money laundering violations and rigging of the LIBOR rates and exchange rates. The vast majority of these cases of bankers' misconduct either predate or happened during the financial crisis. In itself, none of these cases would directly cause an actual failure of a bank. Arguably, it may not even have contributed to an actual failure. In that sense, a close examination may not assist in answering the research question. However, what does deserve a more detailed discussion is how it demonstrates a breakdown of corporate governance by a disregard from UK banks' employees towards its customers, regulators and other stakeholders and, in return, a complete breakdown in trust from the stakeholders towards the bank itself. This is an argument that closely follows the thread set out previously. It affirms the findings of the previous case studies that there was a lack of understanding and a lack of information flow, that controls were lacking and that challenges between senior management and other employees were absent. It also affirms a lack of appreciation at all levels of the role of the bank in society at large and potential impact of risks taken. It is a topic that has received growing attention in the UK, in particular by the Parliamentary Committee on Banking Standards. The conclusions for corporate governance are discussed in more detail after a brief examination of individual cases of misconduct.

#### *i. Mis-sold Products*

The first major case of mis-sold products to come to light since the financial crisis was that of mis-sold payment protection insurance ("PPI").[52] PPI is an insurance for the borrower that insures repayment of their loan in case the borrower is no longer able to make repayments due to illness, loss of job, death and so on. Due to the way that PPI works, the banks would get the premium of the insurance for the running of the loan as well as the benefit of the pay-out in case of repayment problems. Furthermore, banks would in many cases make little to no profit on the actual underlying loan, but only on the insurance premium paid to them.

[52] *R. (on the application of British Bankers Association) v Financial Services Authority* [2011] EWHC 999 (Admin)

It transpired that UK banks sold PPI to customers as part of their loans or credit card deals. However, many customers where either completely unaware of the fact that they had bought protection or that they were not aware of eligibility criteria for potential insurance pay-outs. Consequently, UK banks are still paying compensation for mis-selling. As recent as October 2014, RBS set aside another £100 million[53], Barclays another £170 million[54] and Lloyds another £900 million.[55] In total, the PPI costs for Lloyds reached £11.3 billion, including £2.5 billion in administration costs.[56] There is no doubt that PPI can be a useful tool for those who actually need it. It is also clear that the banks mis-sold them on a massive scale and are paying a hefty price for it.

Another product that was mis-sold on a large scale were interest rate swaps.[57] These products exchange a fixed swap rate for a floating interest rate. By entering into such a product, a client may for example hedge its uncertain future floating interest rate payments for fixed ones. Depending on whether rates actually move up or down, the client may make a profit or loss by the transaction, but the main point is that he has taken away his uncertainty about the level of future payments. These products have allegedly been sold to small businesses on a large scale as part of fixed rate loans. Unfortunately, with floating rates remaining as low as 0.5% and many of the swaps sold around 2007 having a fixed rate of 6%, they were highly loss making for the clients. The fact that they were sold as protection against rate rises gives little comfort, especially considering that these were sold in an aggressive way, often without telling the customer they were included in the package, and made large profits for the bank. The Treasury Select Committee described the situation as

> 'There is nothing wrong with selling a business a fixed rate loan, however where the bank adds a hedge and fails to tell the customer I regard that, at best as mis-selling and at worst, immoral'.[58]

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[53] BBC, 'RBS reserves £400m for currency probe' (31 October 2014) <http://www.bbc.co.uk/news/business-29839343> accessed 14 November 2015
[54] BBC, 'Barclays sets aside £500m in currency probe' (30 October 2014) <http://www.bbc.co.uk/news/business-29829112> accessed 14 November 2015
[55] BBC, 'Lloyds Bank confirms 9,000 job losses and branch closures' (28 October 2014) <http://www.bbc.co.uk/news/business-29798532> accessed 14 November 2015
[56] Ibid
[57] BBC, 'Banks face new mis-selling scandal' (3 July 2014) <http://www.bbc.co.uk/news/business-28037608> accessed 14 November 2014
[58] ibid

This hits the nail on the head. The conduct and behaviour of banks towards customers, their stakeholders, has been exceptionally poor. It affirms the observation that regard for all stakeholders is a very weak element of corporate governance at UK banks.

As a consequence of the increase in complexity in financial markets and products, mis-selling does not only happen to consumers but also to professional counterparties. The fact that increased complexity in financial products has led to these type of problems is nothing new.[59] It is well illustrated in recent litigation between Ceylon Petroleum Corporation ("CPC") and its banks, brought both in arbitration and before the courts in England. CPC, the national oil and gas company of Sri Lank, a set up as a state enterprise and a body corporate, argued that it did not have the capacity to enter into a certain combination of options on oil on which it made substantial losses. Both Standard Chartered Bank ("SCB") and Citigroup had sold protection to CPC against raising oil prices in the form of simple call options. The dispute with Citigroup resulted in arbitration, whilst that with SCB was fought in the English courts. The trust of CPC's argument, which was accepted in arbitration but rejected by the Court of Appeal,[60] was that it was a transaction of speculative nature, rather than one of insurance, and that CPC as a state enterprise did not have the capacity to enter into such a transaction. Whether one agrees with the arbitration panel or the Court of Appeal, the derivative products sold were relatively straight forward. However, two different groups of legal professionals of high standing reached opposite conclusions. Thus, for any bank, even when it engages with what appears to be a very knowledgeable counterparty, and even when the products are pretty straight forward, it becomes very important, in line with the trust of CPC's argument, to understand and explain the nature of the transaction to the client and, through thorough due diligence, understand whether or not the client actually has the capacity to enter the trades. A bank should do this with any client, with both the large multinationals and with the customer on the high street.

#### *ii. Money Laundering and Violating International Sanctions*

Banks are, by nature, involved in large financial transactions and large international flows of money. Consequently, criminal organisations and others seek to abuse the international financial system and thereby banks to launder money or for other illegal financial activities. Banks therefore have strict compliance and anti-money laundering checks and procedures in place. Several UK banks have recently been accused of violating anti-money laundering

[59] Bankers Trust International plc v PT Dharmala Sakti Sehajtera [1996] CLC 518
[60] *Standard Chartered Bank v Ceylon Petroleum Company* [2012] EWCA Civ 1049

regulations.[61] In December 2012, HSBC settled with the US regulators for a total fine of £1.2 billion for allegedly, amongst others, circumventing restrictions on dealing with Iran and North Korea. A similar settlement of $300 million had been reached between US authorities and UK bank Standard Chartered.

There are two points to be made. Firstly, it involves two UK banks that so far had not required a bail- out and had escaped much of the publicity in other scandals. The second is that even in these cases, there appears to have been weak internal controls, reporting and oversight. It suggests that even at those UK banks that did not fail, there were substantial weaknesses in corporate governance.

### *iii. Market Manipulation*

The LIBOR rate, or the London Inter-Bank Offer Rate, is a benchmark interest rate that is determined daily by averaging a number of submissions, the LIBOR submissions, by traders at various large international banks. The LIBOR rate determines the value of many financial products, ranging from saving accounts and mortgages to complex derivative products. There are international equivalents, such as US LIBOR in the US and EURIBOR for the Eurozone. There is evidence that as early as 2005, traders at Barclays, a UK based bank, sought to influence various LIBOR rates from their regional hubs.[62] When it came to light, it was investigated by the FSA, which concluded that there had been 257 requests to fix LIBOR rates between January 2005 and June 2009.[63] Investigating reports include many conversations held between traders, which have been widely reported in the media. Due to the sheer unprofessionalism and apparent lack of morals, these quotes in the media helped to further damage any confidence that society may have had left in banks after the enormous reported losses and bail-out packages.

For Barclays, the first UK bank to be punished, the total combined fines by various regulators amounted to £290 million. It's CEO, Bob Diamond, who had become the centre of media attention as the stereo-typical American style investment banker and the best paid CEO at a UK bank, refused to go. Three days later he was forced out by the Bank of England, who demanded a cultural change. Barclays' chairman and COO left at the same time. Other banks involved include the Swiss bank UBS, which was fined £940 million in

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[61] BBC, 'HSBC to pay $1.9 billion in US money laundering penalties' (11 December 2012) , <http://www.bbc.co.uk/news/business-20673466> accessed 14 November 2015

[62] BBC, 'Timeline: LIBOR fixing scandal' (6 February 2013) <http://www.bbc.co.uk/news/business-18671255> accessed 14 November 2015

[63] Financial Services Authority, 'Final Notice to Barclays' (27 June 2012) <http://www.fsa.gov.uk/static/pubs/final/barclays-jun12.pdf> accessed 14 November 2015

total. RBS was fined a total of £390 million and the head of its investment bank, John Hourican, resigned.[64]

The LIBOR scandal was not the only case of large scale market manipulation by a handful of traders. More recently, regulators have fined several banks over their traders' attempts to manipulate foreign exchange trades between January 2008 and October 2013.[65] These include the UK banks HSBC and RBS as well as UBS and US banks JP Morgan, City Bank and Bank of America. The collective fine amounts to £2.6 billion dollars, which was reached through a general settlement. Investigations at other banks, including Barclays, continues. It should be noted that, as for the LIBOR scandal, individual traders were prosecuted and lost their jobs. It also appears that it was confined to a handful of traders and several banks who attempted to manipulate the markets for their own personal benefit. It is, however, incredible that they could have done this for such a prolonged period of time. As noted by the Treasury Select Committee, it 'does not look good' that it was not spotted by either the Bank of England or the FSA.[66] But, as they also noted, it also indicates

> 'a prolonged period of extremely weak internal compliance and board governance at Barclays, as well as a failure of regulatory supervision'.[67]

The same observation can be made for the other UK banks involved, in particular RBS. As stated before, none of these scandals may have resulted in the failure of a UK bank, but they do confirm what exactly was wrong with corporate governance at UK banks at the time before and during the global financial crisis.

### b. Barclays

Over the past twenty years, Barclays has grown rapidly from a domestic retail bank to a global universal bank. Its investment banking arm had grown particularly fast, acquiring parts of Lehman Brothers after it had collapsed. The bank has survived the financial crisis without requiring direct government support, raising capital on its own instead. In the years after the crisis, the bank was nonetheless engulfed by negative publicity relating to conduct failures as described previously. It reached its pinnacle when on 2 July 2012 the

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[64] BBC, 'LIBOR scandal: RBS fined £390m' (6 February 2013) <http://www.bbc.co.uk/news/business-21348719> accessed 14 November 2015
[65] BBC, 'Six banks fined £2.6 billion by regulators over forex failings' (12 November 2014) <http://www.bbc.co.uk/news/business-30016007> accessed 14 November 2015
[66] Treasury Select Committee, 'Treasury Select Committee publishes LIBOR report' (18 August 2012) <http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news/treasury-committee-publishes-libor-report/> accessed 14 November 2015
[67] ibid

CEO, Bob Diamond, resigned.[68] Mr Diamond, the stereo-typical, high-earning, flamboyant and outspoken American investment banker who had led Barclays Capital before becoming CEO, had become the focal point of what had gone wrong in the City. Under immense pressure from both politicians and the regulators following the LIBOR scandal, his position had become untenable. The bank announced in July 2012 a review of its business practices, to be led by Antony Salz. This has become known as the Salz Review.[69] In the summary of the report, the rapid growth is regarded as containing the seeds to the problems as they led to a change in focus and culture within the bank both before and after the crisis.

> 'The result of this growth was that Barclays became complex to manage, tending to develop silos with different values and cultures. Despite some attempts to establish Group-wide values, the culture that emerged tended to favour transactions over relationships, the short term over sustainability, and financial over other business purposes. To some extent these characteristics were reflected in the broader business environment. But the overriding purpose at Barclays in the lead up to the crisis and beyond was expressed in terms of increases in revenues and profits, return on equity and competitive position'.[70]

Some of the specific failures that are listed cover those discussed previously. They include under-investment in monitoring compliance, risk and other control processes leading to breaches of international sanctions.[71] Related operational failures include a failure to segregate its own money from that of the customers. This occurred in 2009, for which the bank received a fine from the FSA.[72] The importance of segregation was clearly demonstrated during the collapse of Lehman Brothers, which had not kept a clear segregation. This made it extremely difficult for customers to get any of their money back. Another operational failure was the failing in 2009 relating to submitting data of reportable transactions to the FSA, which it collects to detect and investigate market abuse such as insider trading and market manipulation.[73] The bank simply did not have adequate systems and controls in place for this reporting requirement. These failures collectively paint the picture that the overall systems and controls in place at Barclays were inadequate, which in turn is detrimental for good corporate governance.

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[68] BBC, 'Barclays boss Bob Diamond resigns amid LIBOR scandal' (2 July 2012) <http://www.bbc.co.uk/news/business-18685040> accessed 14 November 2015
[69] Antony Salz, 'Salz Review – An Independent Review of Barclays' Business Practices' (April 2013) <http://online.wsj.com/public/resources/documents/SalzReview04032013.pdf> accessed 14 November 2015
[70] ibid 6
[71] ibid 55
[72] ibid 60
[73] ibid

It also includes the mis-selling of PPI. It is reported that gross premium from Barclays PPI sales exceeded £400 million per year between 2003 and 2008, dropping slowly thereafter to less than £200 million after 2010, whilst the reported cost of meeting claims was under 25% of gross premiums for every year since 2002.[74] In summary, Barclays made a profit from PPI between 2002 and 2012 of an estimated £940 million.[75] As a highly profitable product, it was discussed and reviewed frequently at board level. Schemes were designed to encourage staff to sell PPI, including a two and a half times higher commission for loans sold with PPI instead of without.[76] When the FSA expressed concerns about PPI in 2009, Barclays was one of the banks that brought a legal challenge against the FSA and the Financial Ombudsman Service. The courts decided in favour of the regulators[77] forcing banks, including Barclays, to review their PPI sales. The report concludes that Barclays was too slow in controlling the failures relating to PPI, e.g. in controlling the selling process and setting appropriate incentive schemes; in reacting to customer complaints; and in considering whether the very high profitability was indicative of underlying potential problems.[78]

Barclays was further involved in the mis-selling of interest rate swaps to small businesses, a practice started as early as 2001. This led to large number of complaints, especially since 2008 when interest rates reached a historical low. Following reviews by the FSA, Barclays launched a compensation scheme in 2012. The report concludes that, had Barclays placed greater emphasis on understanding their clients and their needs rather than on profit, this would not have happened.[79] A similar storyline developed in relation to two complex and risky investment funds sold to risk-averse investors.[80] Other customer related problems highlighted in the report include the charges for credit cards and overdraft[81] and unmanaged conflicts of interests within the investment banking arm, Barclays Capital, when advising on transactions.[82] The point of the issues listed in this paragraph and in the previous is that throughout Barclays profitability was the sole driving factor. It was throughout the whole of Barclays, not just within the investment bank, but also in the retail

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[74] ibid 56
[75] ibid 57
[76] ibid 57
[77] *British Bankers Association (BBA) v Financial Services Authority (FSA) and Financial Ombudsman Service (FOS)* [2011] EWHC 999
[78] Antony Salz (n 64) 58
[79] ibid 59
[80] ibid 60
[81] ibid 62
[82] ibid 64

arm. Profit was placed above any needs that the customer may or may not have had. In fact, understanding the customer was not important. Customers are a key stakeholder in good corporate governance and Barclays' behaviour clearly fell below any reasonable standard.

Traders at Barclays Capital were involved in the previously discussed LIBOR manipulation. The report concludes that this was due to cultural deficiencies on the trading floor and a failure to embed ethical values.[83] It was made worse by an ineffective control and supervision of traders and a lack of separation between those trading and those submitting the rates. Not only were the controls ineffective, they were also deemed flawed so that breaches were not discovered. These findings echo those discussed previously. There is one further important point to be made: all these issues, and in particular the LIBOR manipulation, including the publication of communication between traders, have severely dented any trust and confidence that the general public may have had in Barclays. This takes the analysis back to the vital role that banks play within the economy and why the stakeholders of the bank must include the general public. To further emphasize this point, consider the Structured Capital Markets team within Barclays Capital, which was a tax-led transaction structuring business. Put differently, this was a highly profitable business that assisted clients as well as Barclays itself in avoiding to pay taxes. Although Barclays operated in an open way with HMRC, and although there is no evidence to suggest that it aided in tax evasion, this team was operating on the edge of highly abusive and aggressive tax avoidance schemes.[84] When it reached the media, the team was closed down, but not without causing significant reputational damage and a further erosion of public trust in Barclays. The main point is that it is impossible to marry the wider economic importance of a bank and its obligation to the general public, its stakeholder, with assisting others to avoid paying taxes by which public services benefiting these same stakeholders are funded.

The solutions proposed in the report are not to create additional regulation alone. Instead, the report summarises that

> '… regulation alone cannot address the fundamental underlying causes that led to the business practices which are in the spotlight – the cultural shortcomings we found. Barclays and all its stakeholders need to recognise that restoring its reputation requires transformational change to create a bank that must feel very different from when we started our Review: an organisation that feels different – to staff,

[83] ibid 65
[84] ibid 73

> customers, regulators, shareholders and the public at large, with a positive resilient culture that will sustain it as a modern, open and globally influential financial institution'.[85]

There are 34 separate recommendations[86] made on how this can be achieved within Barclays. Although a closer examination of the responses to the failures at banks is the subject of the next chapter, a short summary of the recommendations is insightful into the deeper reasons behind the issues noted above. Some of these recommendations are more abstract than others but overall they point in the same direction. The main ones include the second and fourth recommendations, which state that high values and standards must be set and that, crucially, the board and senior management must be demonstrating these as well as carrying responsibility for implementing these. In other words, responsibility for this lies with the top of the organisation, who also perform an exemplary role. If the focus of the CEO is purely on meeting financial targets, then this will cascade all the way down through the organisation. The third recommendation states that Barclays must develop an understanding of its customers and their needs. The customers' needs and objectives should be met whilst meeting the commercial objectives within the organisation. This is closely connected with the recommendations discussed previously, but also with the sixth recommendation that a Code of Conduct must be published. This gives guidance to employees on how to behave in their daily work. The implication of these recommendations is that one of the deeper underlying problems at Barclays was the importance of profit over customers, a principle emanating from the board and senior management all the way down the organisation.

There is a set of recommendations that fall under the category of board effectiveness. To list but a few, it is recommended that a sufficient number of non-executive directors have substantial banking experience. The non-executive directors must invest sufficient time to adequately discharge their obligations. The board information should be comprehensive. This points to a deeper underlying problem with the capability and commitment of the board members in overseeing senior management at Barclays and the independent challenge that they provided. Finally, there is a set of recommendations that relate to the human resource function, performance targets, pay and incentives. In short, the human resource function was not sufficiently empowered to provide any direction on who was hired and on what staff were paid. A substantial part of pay itself was linked directly to performance targets. These in turn were almost exclusively linked to financial and sales

[85] ibid 6
[86] ibid 12-19

targets. This provided a clear message to staff, namely that the main objective was to make money, regardless of any ethical considerations or understanding the costumers' needs. All these underlying failures are failures of corporate governance. It is clear that they are the direct cause of all the problems, from PPI mis-selling to the existence of tax avoidance teams, listed above.

### c. The Co-operative Bank

The most recent spectacular failure of a bank due to a shortfall in capital is that of the Co-operative Bank. Although linking this failure directly to the financial crisis might be considered somewhat of a stretch, perhaps by way of adverse economic conditions or increased capital requirements, it simply must be included in this research because it is a prime example of the failure of a UK bank with a different model of operation and a substantially different model of corporate governance. In fact, if the failure of the Co-operative Bank was not examined as part of this research, the conclusion might as well have been reached that its approach was a superior model of corporate governance that should be adopted without properly assessing its downsides. The bank has an indirect co-operative model: its customers could become members of its parent, the Co-operative Group, and thus become indirect owners. The bank has a strong ethical policy, which sets out many laudable policy objectives.[87] These include acting with honesty and transparency, being a responsible bank that treat customers fairly and promoting economic and social development in Britain. Some go even further than one might expect from a bank's core objectives, such as promoting human rights, protecting animal welfare and supporting international development. These, combined with its co-operative model, would make a strong case for the bank operating on a superior model than its competitors, if it wasn't for the capital shortfall and other scandals that engulfed it.

#### *i. Timeline*

Before examining the underlying problems in detail, it is necessary to highlight some of the key events in the bank's history because they contributed directly to its fall from grace. In 2009, the Co-operative Bank merged with Britannia Building Society. [88] This merger contained several problems. For example, Britannia had a very different risk appetite,

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[87] The Co-operative Bank, 'Our ethical policy' (20 January 2015) <https://www.co-operativebank.co.uk/assets/pdf/bank/aboutus/ethicalpolicy/ethical-policy.pdf> accessed 14 November 2015

[88] Sir Christopher Kelly, 'Failings in Management and Governance: Report of the independent review into the events leading to the Co-operative Bank's capital shortfall' (30 April 2014) <http://www.co-operative.coop/PageFiles/989442031/kelly-review.pdf> accessed 14 November 2015, 12-30

which included highly concentrated commercial real estate lending. Due diligence was insufficient and provisions had to be made later. Britannia's financial position was in fact deteriorating whilst merger discussions took place. Furthermore, it was unclear how senior management positions would be filled in after the merger and how already complicated IT systems would be integrated. In 2011, two years after the merger, the FSA concluded that Britannia would have failed if there had been no take-over.[89]

In 2011, the Co-operative Bank started its attempt to take over the part of Lloyds Banking Group which it was forced to split off to comply with EU rules on state-aid.[90] This became known as Project Verde, including 632 branches in the UK and around 5 million retail customers. However, the Co-operative at that time was still struggling with the integration of Britannia, in particular the integration of IT systems was proving highly problematic. It would also further stretch its capital resources. Amid these concerns, which were also voiced by the FSA, the bank decided to bring in a new CEO to lead the transaction, which now became its sole focus. It never considered that the transaction might not go through. Despite an independent and highly critical report by KPMG at the end of 2012, and warnings from the FSA that it would increase capital requirements, nobody at the bank considered pulling out of the deal. Finally, after further critical reports and an actual increase in capital requirements, the Co-operative pulled out of the deal in March 2013. It left the bank without any strategy or plan as it never contemplated that this might happen.

The Co-operative Bank was hit by the PPI mis-selling scandal.[91] All of the mis-selling emerged from the Co-operative side, as Britannia had not been involved in this practice prior to the merger. As was the case with other banks, the income generated by PPI premiums vastly outweighed the claims that were actually paid out. The bank had to make provisions of up to £347 million by the end of 2013, but it is especially concerning that the mis-selling practice was also present at this bank despite its ethical commitments. The costs of the PPI scandal, combined with the losses from Britannia's loans, Project Verde and from integrating the IT platform were eroding the bank's capital. After the increase in capital requirements by the FSA, the bank had to announce a £1.5 billion capital shortfall following an industry-wide exercise performed by the regulator. The bank was forced to negotiate a rescue packet with several US hedge funds, who would provide capital in return

[89] ibid 17
[90] ibid 75-81
[91] ibid 39, 40

for 70% control in the bank.[92] It would also result in the closure of around 50 branches. The final part of the bank's fall from grace was the arrest of its former chairman, Reverend Paul Flowers, in connection with an investigation into the supply of drugs.[93]

### *ii. The Kelly Review*

The obvious question is whether one could still run a bank with the Co-operative ideals and principles, or whether this case has proven conclusively that it is not possible. Before looking at the details, it is instructive to examine the headline conclusion of the Kelly report, written by Sir Christopher Kelly as an independent review into the events leading to the bank's capital shortfall.

> 'This report tells a sorry story of failings on a number of levels. The Bank Executive failed to exercise sufficiently prudent and effective management of capital and risk. The Banking Group Board failed in its oversight of the Executive. The Group Board failed in its duties as shareholder to provide effective stewardship of an important member asset. Collectively, they failed to ensure that the Co-operative Bank consistently lived up to its ethical principles. In all these things they badly let down the Group's members. … The lessons set out in Chapter 14 are far from novel. It does no credit to those involved that they should need to be learnt again'.[94]

The main conclusion from this must be that these are basic failures of corporate governance in general. Although the problems are at a bank, the failures are not specific to corporate governance at banks. The problem is that the general elements of good corporate governance, such as effective management of risks, effective board oversight and effective stewardship, were absent. As the report rightly points out, this sadly is nothing novel.

Before analysing the problems with corporate governance at the Co-operative, it is necessary to describe how the group is structured.[95] With over 7 million members, the group is divided into different areas which each have their own committee. There are 45 of these Area Committees, each consisting of 10 to 12 members. In practice, only a small number of the members actively participate in the election of the Area Committees. The Area Committees elect 100 of its members to sit on the Regional Boards. The Area Committees further elect 15 of these 100 members, which sit on the Regional Boards, to sit

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[92] BBC, 'Co-op bank to close 50 branches as part of rescue plan' (4 Nov 2013) <http://www.bbc.co.uk/news/business-24802559> accessed 14 Nov 2015

[93] Jill Treanor, 'Former Co-op bank chairman Paul Flowers arrested in drug inquiry' (22 Nov 2013) <http://www.theguardian.com/business/2013/nov/22/paul-flowers-former-coop-bank-chairman-police-arrest> accessed 14 Nov 2015

[94] Sir Christopher Kelly (n 83) 4

[95] ibid 112

on the Group Board. Note that those sitting on the Group Board still have to sit on the Regional Boards and in the Area Committees, which adds to an enormous time commitment. Furthermore, they need to ensure continuous re-election for all three of these posts. Apart from these 15 elected members, the board has 5 representatives chosen by the 80 independent societies that trade with the Co-operative. Votes are weighted by the share of business done and the persons put forward are typically their CEOs themselves. The board thus comprises 20 persons, which although large, is a reduction from the 33 persons it comprised of in 2009.

The bank itself was held at arm's length from the group. Although it is understandable that there was some form of separation, if only due to regulatory regimes applicable to the bank but not to the group, this should not have meant that the group's board should provide only minimal oversight. There are other retail groups that have a separate bank, for example Sainsbury's Bank and Tesco Bank, which are successful. However, at the Co-operative, the group's board would only review a written statement provided by the bank without much challenge. In fact, the only challenge would arise on values and principles, rather than on core banking matters.[96] The report highlights two reasons for the lack of challenge.[97] The first is ineffectiveness which arose from its size. But the second and most important reason is the board's complete lack of experience in banking and finance. The board, consisting mostly of elected members who had to spend most of their time on their re-election, did not contain any business experience in general. The time commitments required with the job simply would not allow for or attract anyone with substantial business experience. The report states that it was so bad, that several members needed basic financial terminology and concepts to be explained.[98] The 5 representatives from independent societies typically had worked within the co-operative movement and equally lacked the required skills and knowledge. The consequences are clear:

> 'Sustained success requires effective governance. Effective governance requires a high performing board. The composition of the Co-operative Group Board, and the limited pool from which its members were drawn, made a serious governance failure almost inevitable … The current approach to the election of non-executive directors has conclusively shown itself incapable of producing a Group Board with the necessary governance competences or the business and technical skills required for successful stewardship of the Group's assets. It promotes activists with concerns

[96] ibid 114
[97] ibid 115
[98] ibid 115

> about issues important to those who elect them, not individuals with skill sets relevant to overseeing the business'.[99]

It is Sir Christopher Kelly's damning assessment that these problems were simply bound to happen given the poor corporate governance. It is thus a proven essential element of good corporate governance that the board has the required skills and expertise to oversee the group's complex portfolio of businesses. It is further added that the board must have good management information to challenge the board.[100] Finally, as a bank specific element of corporate governance, it is an important conclusion of the report that the bank should develop and implement a robust risk governance and oversight and an appropriate control framework.[101] It is clear that this did not happen and that the board was not capable of addressing this shortcoming.

### *iii. The Myners Report*

The views expressed in the Kelly review are confirmed independently by Lord Myners, who was appointed as Senior Independent Director to the Co-operative Group in December 2013, and who wrote an independent report on its governance.[102] He resigned 4 months later, noting a resistance to change, a denial of responsibility, deliberate delays and a hiding behind values within the group, amongst his reasons for leaving.[103] In summarising his findings, Lord Myners notes that

> '… the present governance architecture and allocation of responsibilities is not fit for purpose. It places individuals who do not possess the requisite skills and experience into positions where their lack of understanding prevents them from exercising the necessary oversight of the Executive … This deeply flawed system of elected member representation has consistently produced governors without the necessary qualifications and experience to provide effective board leadership and to monitor, challenge and provide direction to management … The result has been an inability to hold the Executive to account or to provide the guidance, motivation and counsel that any management team competing in this demanding competitive environment might reasonably deserve and expect'.[104]

This is in complete agreement with the conclusions reached independently by Sir Christopher Kelly, as discussed previously. The recommendations made by Lord Myner are

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[99] ibid 125
[100] ibid 126
[101] ibid 126
[102] Paul Myners, 'The Co-operative Group: Report of the independent governance review' (7 May 2014) <http://www.co-operative.coop/Corporate/PDFs/Myners/Report_of_the_Independent_Governance_Review.pdf> accessed 14 November 2015
[103] ibid 8, 9
[104] ibid 17

therefore no surprise. The main recommendation is to create a new Group Board, with an independent chair, 6 to 7 independent non-executive directors and two executive directors.[105] This would ensure knowledge and skills are present on the board to provide the necessary challenge. It would also remove the convoluted way in which the board is selected. It would not stand in the way of putting additional demands on the board members to demonstrate exceptional commitment to ethical values.

Lord Myners further outlines several proposals to re-organise the Areas and Regions into a different Membership Council and other committees. The point is his proposals seek to maintain the unique characteristics of a co-operative and they do not seek to convert it into a standard exchange listed company. However, the conclusion is that in order to achieve the social goals and objectives, the Co-operative Group must be a commercially successful business.[106] It needs to survive over the long term and generate healthy profits to build its capital base. This is all the more important for this type of organisation because, unlike its competitors, it is not able to raise additional capital by issuing shares. In other words, value creation is necessary for value distribution amongst its members and to achieve any other social goals it might have.

## 5. Conclusions

The first research question that was posed is what weakness in corporate governance at UK banks contributed to their failure during or following the crisis? The case studies examined in this chapter provide some clear answers to this research question. First and foremost, the case studies demonstrate that there can be no doubt that corporate governance at UK banks was in fact weak. There were four main themes that emerged which contributed to this weakness. These are the growth in complexity in financial markets, in products and in institutions leading to a higher minimum standard; the lack of effectiveness at board level; ineffective systems and controls; and the problems associated with a lack of moral values and ethics. A far wider ranging and detailed analysis of the underlying crisis, which goes beyond the scope of this research, can be found in the report by the US Financial Crisis Commission.[107]

[105] ibid 18
[106] ibid 68
[107] US Financial Crisis Commission (n 16)

### a. The Growth in Complexity and Required Minimum Standard

Consider again the growth and increasing complexity of both financial institutions and financial instruments in the decade before the crisis. As described in the previous chapter, Basel 1 was introduced as an international standard, to create a level playing field aimed at making banks safer. It is clear that the rules were too simplistic; in particular, the risk weighting of assets left much to be desired. On one side, regulators can be blamed for designing such a flawed system. But, equally, on the other side, banks can be accused of abusing this system. Banks sought to gain maximum returns on their capital for the shareholders and in doing so allocated capital into assets that would attract a low regulatory risk weighting despite the high real world risk they carried. The question is whether or not the banks stayed within their agreed boundaries of acceptable risk whilst seeking higher returns.

Turning now to complex financial instruments, such as securitized loans and mortgages, the Basel Committee reports that there were several reasons for an explosive growth in this area. Firstly, there was a high demand for these products as they were generally perceived to be safe, often confirmed by their rating, whilst they provided a high yield.[108] Common sense would already dictate that something is amiss here: there is a positive correlation between risk and return; why would that not be the case here? Another reason for the popularity of securitisation is that the originator could transfer risk, often in the form of illiquid assets such as mortgages and car loans, off the bank's balance sheet and into marketable securities.[109] Furthermore, it generates a reduction in capital requirements for the issuers: although the issuers suggest that regulatory arbitrage is not one of the main considerations, supervisors are not convinced.[110] In the years before the crisis, there was weakening of due diligence in securitisation. Issuers weakened their asset screening and monitoring whilst investors often did not understand the risk that they were taking on.[111] This became especially obvious once the US mortgage markets started to collapse.

There are several points to be made in relation to the research question. Firstly, there is again the element of working around legislation and reducing regulatory capital rather than the adherence to what regulation is in fact trying to achieve. Secondly, there is the creation of instruments so complex and non-transparent, that investors really should not have been

[108] Basel Committee on Banking Supervision, 'Report on Asset Securitisation Incentives' (July 2011) <http://www.bis.org/publ/joint26.pdf> accessed 14 November 2015, 8
[109] ibid 10
[110] ibid 11
[111] ibid 14

offered, although arguably it was their own problem that they bought it. Both of these points raise ethical issues, which are discussed in a later paragraph. The main point to draw on here, however, is of a different nature. It is the observation that the complexity in financial innovation and financial instruments increased at an incredible pace over the decade proceeding the global financial crisis. What is more, it was not restrained by the financial regulation that sought to make banks safer, instead, it was stimulated by it. Combined with the rise of financial behemoths that are now coined too-big-to-fail, the financial industry in its entirety had become much more complicated and interconnected. The inevitable consequence, and the main conclusion put forward in this paragraph in answer to the first research question, is that the standard of what constitutes good corporate governance at UK banks was raised considerably in the decade pre-crisis.

This is fully supported by the evidence presented in the various case studies. Northern Rock was mainly a domestic lender, but its aggressive growth plan was based on financial innovation. It sought to take many of its mortgages off its balance sheet via securitisation, thereby relying increasingly on short-term funding. In doing so, it raised the standard of what would constitute good corporate governance. Its systems and controls would have to be raised to a sufficiently high standard to match the complexity of its business model. The skills and knowledge at board level would have to increase to understand the risks flowing from the business model and to understand the effects of reliance on international wholesale markets for funding. The problems demonstrate that the standard of corporate governance at Northern Rock was not raised accordingly, which in turn led to its failure. A similar analysis can be applied to RBS. During a period of aggressive expansion, including the growth of its CDO business and the take-over attempt of ABN Amro, the standard of what constituted good corporate governance kept being raised. In practice, the systems and controls at RBS were sorely lacking. The understanding at senior management level of the new business and products they were entering into was mostly absent. The case studies of Barclays and the Co-operative Bank demonstrate the same or similar shortcomings arising of the increased complexity of its business, products and environment.

It is the conclusion of this research that the standard of what constitutes good corporate governance is not uniquely defined. Elements of what must be present can certainly be identified. However, the standard and minimum requirements differ for each of the UK banks. It is the further conclusion of this research that, in the decade before the crisis, the

standard for each UK bank was raised substantially and all the UK banks covered in the case studies fell below its individually raised standard.

### b. Elements of Corporate Governance

#### *i. Ineffective Board*

Where the previous conclusion related to the increased overall minimum required standard of corporate governance, this paragraph and those that follow contain conclusions on specific elements of corporate governance. In the examination of the case studies, it was a recurring theme that these specific elements where entirely absent or, in any event, fell below the minimum required standard. The case study of Northern Rock, as already discussed under the previous conclusion, was ineffective in challenging its aggressive expansion. At HBoS, the board did not only lack experience in banking and finance, it was beating itself on the chest as a beacon of good corporate governance moments before its collapse. At both RBS and at Barclays, there was a dominant CEO, Sir Fred Goodwin and Bob Diamond respectively. Neither the board at RBS nor at Barclays could provide sufficient challenge. It resulted in the disastrous take-over at RBS and the spread of a profit-focused culture at Barclays.

The case study making the strongest case of all for a strong and effective board is that of the Co-operative Bank. First, it must be noted that, with the take-over of Britannia and Project Verde, the standard of what constituted good corporate governance kept rising without any changes being made to its governance. It was the conclusion of two independent reports, written at about the same time, that the board at the Co-operate Group was completely ineffective and required a substantial overhaul. It was an accident waiting to happen and, as it transpired, it happened in a spectacular way with a large capital shortfall and a former chairman arrested on drugs related charges. The board was not effective because it was too large and it did not contain any business experience, let alone banking experience. It was unable to provide any challenge to or oversight of the banking unit. It did not understand the financial risks or the capital requirements that underpinned the bank. It provides the strongest evidence of the necessity of an effective board, with the knowledge and skills to challenge senior management and to provide effective oversight.

#### *ii. Ineffective Risk Management and Controls*

The second element of corporate governance that was missing in the case studies is that of effective risk management and controls. In the case of RBS, there was no defined risk

appetite. This means that it is impossible to decide whether new transactions or business plans fall within the risk appetite that senior management want the firm overall to adhere to. The risk reports that were written at RBS were always backward looking instead of forward looking. This meant that there was no clear vision of how the various business units or its complex transaction would react to any future adverse conditions. Finally, when these risk reports would be discussed at board level, the CRO would not be in attendance. All these factors combined led to an ineffective risk management and control at RBS. This led to the situation that there was no understanding of the risks that the firm was running and what the consequences would be in adverse conditions. In other words, the firm was hopelessly ill-prepared when the global financial crisis started.

The other case studies provide a similar analysis. At Barclays, with the focus on profit, the risks associated with how the profit was made were not sufficiently considered. At the Co-operative Bank, there was no understanding with the board of what good risk management would look like. The conclusion here is that the risk management, systems and controls must be proportionate to the risks that the bank is taking. As with overall minimum required standard of corporate governance, it is dependent on the specific bank. Simply put, if the bank is an international investment bank engaged in trading complex derivatives structures, then its risk management, systems and controls need to be of a proportionately higher and more advanced standard than that of a local lender. Nonetheless, there is no doubt that at both ends of the spectrum appropriate risk management and controls must exist. It is the conclusion of this research that it did not exist.

#### *iii. Culture, Values and Ethics*

The final element of good corporate governance that was missing throughout the case studies is a less tangible concept of culture, values and ethics. The various scandals, such as PPI-mis-selling, interest rate swap mis-selling, money laundering, violation of international sanctions and market manipulation in LIBOR and foreign exchange markets, paint a picture of an industry sector that has completely lost its moral compass. The case study of Barclays revealed the existence of a highly lucrative unit advising on tax avoidance schemes that were on the aggressive side of the spectrum. It also revealed a culture where profit was clearly placed before customers' needs. The Co-operative Bank's image of the only ethical bank was severely damaged, not just due to its losses and incompetence, but also following the arrest of its former chairman on drugs related charges.

There things matter and are of general importance. For this research, it matters especially from a corporate governance perspective. The banks fulfil an important economic function and it would be difficult to imagine an advanced society without them. They also matter because of the potential consequences of a bank failure. But above all, they matter from a corporate governance perspective because society at large is an important stakeholder. That must be the conclusion that flows from these case studies. And the further conclusion must be that banks did not give sufficient consideration to this, leading to weak corporate governance.

# Chapter 4 – Emergency Measures and Short Term Solutions

## 1. Introduction

This chapter covers the emergency measures implemented by the UK government in response to the failures of UK banks during the financial crisis. It seeks to partially answer the second research question: what is the effect of new legislation and other initiatives on corporate governance at UK banks. The UK government responded to the failures by passing emergency legislation in the form of the Banking (Special Provisions) Act 2008 and by (part) nationalising the failed banks. This chapter contains an analysis of the emergency legislation and a discussion of its effects. The emergency legislation was introduced mainly to facilitate the nationalisation of failed banks. The Banking Act 2009 is also discussed. It replaces the Banking (Special Provisions) Act 2008, which granted emergency powers to the government and the regulators for the duration of one year only. The Banking Act 2009 provides for a Special Resolution Regime and special insolvency rules to handle the failure of a bank. It also contains provisions such as a deposit guarantee scheme. Although the Bank Act 2009 is in itself a long term solution, providing a framework for the handling of a bank insolvency, it is relevant to this chapter as it replaces the Banking (Special Provisions) Act 2008. It is now the primary tool in dealing with the failure of a bank in the UK.

These responses by the UK government to the failures have an impact on the corporate governance of banks because they change the safety net for banks. If the management of the bank and the shareholders know their faith in case of default and if depositors know their deposits are safe, then their behaviour will change. Some of the responses affected competition within the UK and have been scrutinised by the Office of Fair Trading and the European Commission. This has an impact on the banks' customers and on other banks. This chapter also contains an analysis of the effects of government ownership of the failed banks. This seeks to answer the third research question, namely what is the effect of state-ownership on corporate governance at UK banks. The main problems in governing the nationalised banks arise from conflicting objectives. The regulatory objectives, the commercial objectives and the political objectives are often not aligned. This means the board will need to compromise and it makes good governance difficult. An analysis of UK Financial Investments ("UKFI") demonstrates how the UK government intended to manage its investments in the banks and how it is working in practice.

## 2. The Banking (Special Provisions) Act 2008

### a. The Powers granted under the Act

The Banking (Special Provisions) Act 2008 was the first piece of legislation passed in the UK as an immediate response to the financial crisis. It was at least partially designed to assist in the rescue of Northern Rock. The long title of the act states its purpose as

> 'an act to make provision to enable the Treasury in certain circumstances to make an order relating to the transfer of securities issued by, or of property, rights or liabilities belonging to, an authorised deposit-taker; to make further provision in relation to building societies; and for connected purposes'.

It received Royal Ascent on 21 February 2008 and under this act, on that same day, Order SI2008/432 was made. This statutory instrument arranged for the transfer of Northern Rock into public ownership.

Although the powers granted under the Act were immediately used for the nationalisation of Northern Rock, the act itself was drafted generically. It allowed for the creation of statutory instruments to enable the rescue of Northern Rock and potential future bank failures. Contrary to that, Alistair Darling, the Chancellor of the Exchequer at the time, made the comment at the first reading that the Government have no intention at present to use the Bill to bring any institution other than Northern Rock into temporary public ownership.

Although this reflected politicians' opinion at the time, it was soon to be overtaken by the events that followed. The powers granted under this Act have been used for subsequent government interventions in the banking sector, which, given the crisis that was going on, must have been foreseen with at least some degree of certainty. Specifically, the powers were used to nationalise the mortgage and loan books of Bradford and Bingley, which was part-nationalised and part transferred to Abbey National under SI2008/2546 on the 29th September 2009. They were used again to transfer deposits from Heritable Bank, part of the Icelandic Landsbanki, and from Kaupthing Edge to ING Direct, part of the Dutch financial conglomerate ING Group, under a range of statutory instruments SI2008/2644, SI2008/2646 and SI2008/2674 on the 7th and 8th of October 2009. The Act therefore quickly became an important tool for the UK government to handle bank failures.

Sections 3 and 6 of the Act describe the main powers granted to the Treasury. These are powers to transfer securities, property, rights and liability provided certain conditions are

satisfied. These conditions and limitations are discussed in the next paragraph. Section 3(1) provides:

> '3 – (1) The Treasury may, in relation to all or any securities of a specified description that have been issued by an authorised UK deposit-taker, by order make provision for or in connection with, or in consequence of, the transfer of the securities to any of the following—
>
> (a) the Bank of England;
>
> (b) a nominee of the Treasury;
>
> (c) a company wholly owned by the Bank of England or the Treasury;
>
> (d) any body corporate not within paragraph (c).'

For example, Northern Rock was transferred to a nominee of the Treasury, in this case UKFI. In support of the powers granted under section 3, the Treasury is allowed under section 4(2) to extinguish the subscription rights associated with the securities.

Section 3(1) is the core of the rescue operation. In establishing this mechanism, it is implicitly recognised that allowing an authorised UK deposit-taker, such as a bank or building society, to fail has the potential to create a much larger detriment to the economy and society. In establishing section 3(1), one could say that the importance of the general public at large as an external stakeholder is recognised in statute. Any invocation of this part of the statute will be done for their benefit and to safeguard their interests.

Of course, the Treasury cannot simply exercise these new powers under sections 3(1) or 4(2) without providing compensation to the original holders of these securities, who would be deprived of their property and associated rights. Section 5 provides that the Treasury must pay compensation following the transfer of securities under section 3 and following the extinguishing of any of the associated rights under section 4. The compensation that should be made must be determined taking into consideration the fact that the bank was about to fail. It would be unreasonable to compensate the original holders on the basis that the bank was a sound financial institution. Compensation will be determined in accordance with section 5(4), which provides:

> '5 – (4) In determining the amount of any compensation payable by the Treasury by virtue of any provision in an order under this section, it must be assumed—
>
> (a) that all financial assistance provided by the Bank of England or the Treasury to the deposit-taker in question has been withdrawn

> (whether by the making of a demand for repayment or otherwise), and
>
> (b) that no financial assistance would in future be provided by the Bank of England or the Treasury to the deposit-taker in question (apart from ordinary market assistance offered by the Bank of England subject to its usual terms).'

The value and rights must be assessed based on the strength of the, perhaps hypothetical, unsupported bank. In reality, this provision is likely to make the value and rights almost worthless because, given that the powers are exercised, the bank would be bankrupt without the specified assistance.

Under section 6 the Treasury is granted power similar to that under section 3 but relating to the transfer property, rights and liabilities.

> '6 – (1) The Treasury may by order make provision for or in connection with, or in consequence of, the transfer of property, rights and liabilities of an authorised UK deposit-taker to either (or each) of the following—
>
> (a) a company wholly owned by the Bank of England or the Treasury;
>
> (b) a body corporate not within paragraph (a).'

As with the transfer of securities, the Treasury must make arrangements for compensation as set out in section 7 of the Act. The amount payable is subject to similar conditions in section 7(3) as were defined for securities in section 5(4).

The powers described above are related to "authorised UK deposit-takers". These are defined in section 1(1) as a 'UK undertaking that under Part 4 of FSMA 2000 has permission to accept deposits'. The Act also makes provisions for building societies. Section 11 makes amendments to the Building Societies Act 1986 under which the Treasury may facilitate financial assistance for the purpose of maintaining stability in the UK financial system.

### b. Limitations on the Powers granted under the Act

It will be clear that the provisions discussed above grant the Treasury great power over the individuals because they allow the Treasury to take away property and associated rights from individuals. These powers cannot be granted without appropriate checks and balances in place to protect the individual. Besides the ordinary constitutional checks and balances, which are discussed further on, the Act itself provides that the exercise of these powers is subject to specific conditions and procedures. Most importantly, the Treasury can only make an order to transfer securities, property, rights and liabilities of an

authorised deposit-taker if and only if either or both of the section 2(2) purposes are satisfied.

> '2 – (2) The purposes are—
>
> > (a) maintaining the stability of the UK financial system in circumstances where the Treasury consider that there would be a serious threat to its stability if the order were not made;
> >
> > (b) protecting the public interest in circumstances where financial assistance has been provided by the Treasury to the deposit-taker for the purpose of maintaining the stability of the UK financial system.'

The power to intervene is thus limited as it may only be exercised in a situation where the financial stability of the entire UK financial system is under threat. Naturally, there can be no doubt that at the time of the global financial crisis this condition was satisfied. Even if it could be argued that a failure of a small deposit taker would in itself not constitute a great threat to stability, then the potential panic, uncertainty and contagion that would follow such a failure certainly would represent such a threat.

The powers are further limited because the Treasury can only exercise its power within one year of passing the Act, as per section 2(8). This means that a new Banking Act needed to be introduced within a year. Its replacement is the Banking Act 2009, discussed later. Parliament would need to approve any orders made under the Act, with some variations for the specific types of order available. This reflects the exceptional circumstances in which such an order is made and the huge consequences: it is not a common occurrence for the Treasury to intervene in the normal operation of businesses in the UK. The Act would even allow for orders to be made retrospectively, with some constraint on what is deemed an appropriate time.

The exercise of the powers granted by the Act is subject to the ordinary constitutional checks and balances. The first check on the power given is that the Treasury Ministers and the Chancellor, whilst acting on advice of the FSA and the Bank of England as per the Memorandum of Understanding, are accountable to Parliament.[1] Thus Parliament as well as the relevant parliamentary committees can scrutinise decisions to exercise the powers. Second, the exercise of the powers granted can be the subject of a judicial review. In these cases, the courts review the lawfulness of the decision made by a public body, in this case the Treasury. It is a well-established principle of common law that judicial reviews may

[1] HC 19 February 2008, vol 472, col 254

only challenge the way in which the decision is made, not whether the decision is the right one.

The Icelandic bank Kaupthing Bank HF applied for judicial review of the Treasury's decision to make the order to transfer deposits held by its subsidiary.[2] The Treasury had used the powers under section 6 of the Act to make this order after the FSA had judged the subsidiary to be in serious financial difficulty. The order was made because of the perceived threat to the stability of the UK financial system as per the purpose set out in section 2(2)(a). The two grounds of the challenge were, firstly, that the purpose of the Treasury was not to maintain the financial stability but to protect the depositors and, secondly, that HM Treasury had failed to identify the actual threat to financial stability in the UK posed by the financial difficulties of the subsidiary. The application was refused. In the first ground it was held that the objective was the financial stability, whilst the second ground was deemed artificial and unreal. It is the first ground which is most interesting as it demonstrates the difficulties under which the Treasury has to operate.[3] On one hand, HM Treasury needs to formulate its reasons for exercising its powers in precise terms for when it is scrutinised by courts and lawyers. If it does not do so, it risks acting ultra vires. On the other hand, there are market forces which in time of a crisis can show a shock reaction to anything said by the Treasury. Therefore, the Treasury cannot say outright that the financial stability of the UK is at significant risk, choosing instead to lean towards the argument of safeguarding depositors. Clearly this is a very difficult balancing act.

In another example of a challenge by way of judicial review, the applicants, former shareholders of Northern Rock, argued that the compensation payable to them following nationalisation was unfair and incompatible with their rights under the ECHR Protocol 1 Article 1.[4] In this case, it was held that the assumptions that the independent valuer had to make for the Northern Rock shares were not contrary to the shareholders' right of possession pursuant the Human Rights Act 1998. The claims by SRM for a judicial review were dismissed. In particular, the court held that three principles, as established by the case-law of the European Court of Human Rights, were all in place: the need for a fair balance to be struck between public interests and private rights, the principle of

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[2] *R. (on the application of Kaupthing Bank HF) v HM Treasury* [2009] EWHC 2542 (Admin)

[3] Joanna Gray, 'Case Comment: High Court considers Icelandic bank's challenge to HM Treasury's use of emergency powers during 2008' (2010) JFR&C 18(2) 178

[4] *R. (on the application of SRM Global Master Fund LP) v Treasury Commissioner* [2009] EWCA Civ 788, on appeal from *R. (on the application of SRM Global Master Fund LP) v Treasury Commissioner* [2009] EWHC 227 (Admin)

proportionality and the doctrine of the margin of appreciation. Another important conclusion was that the compensation scheme only required putting shareholders in the same situation as if the intervention had not taken place. In practice, this implies that that they would receive very little. It was noted that the regulators did not owe a duty to shareholders. On appeal to the European Court of Human Rights, the Court found that the applicants' complaint under Article 1 of Protocol 1 was 'manifestly ill-founded and therefore inadmissible'.[5]

### c. Compensation under the Act

The compensation arrangements for the transfer of securities under section 3 are set out under section 5. Compensation is to be decided by an independent valuer. The then Chancellor, Mr Alistair Darling, said of the compensation, that

> 'the valuer must assume that financial support provided by the Bank of England and the Treasury has been withdrawn and that no further public financial support will be given, apart from the ordinary market support provided by the Bank of England'.[6]

The argument for this principle is that the bank would go bankrupt without government support. If it would be valued under the assumption that government support would continue, it would be valued much higher. This would be an unfair result as it is effectively the tax payer who is paying for the compensation arrangements.

There have been various challenges brought in respect of the compensation measures. An application to this extent was brought in relation to Bradford & Bingley before the Upper Tribunal (Tax and Chancery). It was refused on the grounds that the tribunal did not have the authority to question the manner in which the valuer was appointed nor the rules governing his approach to the valuation of the compensation.[7] An earlier case before the same tribunal was heard, concerning the valuation of Northern Rock on nationalisation and in particular the reading of 'has been withdrawn' in section 5(4).[8] The point the claimants made was that financial support never was withdrawn or, in the alternative, it was withdrawn over a longer period and in any event not as intended under section 5(4). The result would have been that share prices and thus compensation would have been higher. This argument was rejected by the court, a decision upheld by a majority in the Court of

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[5] *Grainger v United Kingdom* (2012) 55 EHHR SE13
[6] HC 19 February 2008, vol 472, col 178
[7] *Bradford & Bingley Applicants v Clokey* (UKUT (TCC), 19 July 2012)
[8] *Northern Rock Applicants v Caldwell* [2011] UKUT 408 (TCC)

Appeal.[9] It was held that section 5(4) must be read in conjunction with section 15(1), which describes financial assistance. The main point made is that on valuation date all financial assistance must be withdrawn, which was the case here.

## 3. The Banking Act 2009

### a. An Overview of the Original Act

The Banking Act 2009 replaced the Banking (Special Provisions) Act 2008. This was necessary as the 2008 Act contained a provision that limited the power to the Treasury to only one year after passing of the Act. It was not introduced with the same urgency as the previous Banking Act and went through the normal consultation process. As a result, this new Banking Act is much larger and more complex than Banking Act 2008. The main objective of the act is to establish a framework for handling the insolvency of a bank in the UK through the use of a Special Resolution Regime. The passing of the Act was accompanied by two statutory instruments coming into force. The first is the Banking Act 2009 (Restriction of Partial Transfers) Order. This statutory instrument gives a bank protection from interference when it is placed in the Special Resolution Regime. The other is the Banking Act 2009 (Third Parties Compensation) Regulations, which makes provisions for compensation of third parties left behind in a failing bank. The Bank Insolvency part provides for the orderly windup of a failing bank and facilitates rapid payments from the Financial Services Compensation Scheme ("FSCS") or a transfer of relevant accounts to another financial institution. This part of the FSCS largely replaces previous arrangements under FSMA (Part 15), which have been in place since 2001. Note that, technically, this is not an insolvency provision used to dealing with the actual failing of the bank. Instead, they provide an insurance mechanism in case of failure.

As with the Banking (Special Provisions) Act 2009, the new Banking Act 2009 can be said to recognise the importance of the public at large as an external stakeholder. As with its predecessor, the new Act contains provisions to arrange what is effectively a rescue or an orderly wind-down of an authorised deposit holder. The main beneficiary of this, as before, is the general public. The extension to the FSCS is a further clear benefit for the general public as an external stakeholder. The safety of their money and savings goes a long way to ensuring financial stability and avoiding a sudden panic.

[9] *Harbinger Capital Partners v Caldwell* [2013] EWCA Civ 492

The Act contains three tools for intervention: private sector purchase, a construction with a bridge bank and temporary public ownership. In a private sector purchase, the authorities can arrange the transfer of all or parts of the failing bank. Using a bridge bank, the authorities can transfer some or the entire failing bank to a temporary vehicle. If there is no other option, the Treasury can temporarily take a failing bank into public ownership. Whenever the authorities use the powers under the Special Resolution Regime, i.e. the stabilisation powers, the bank insolvency procedure or the bank administration procedure, then the authorities must have regard to the five Special Resolution Objectives. These objectives are (1) to protect and enhance the stability of the financial systems of the UK, (2) to protect and enhance public confidence in the stability of the banking systems of the UK, (3) to protect depositors, (4) to protect public funds and (5) to avoid interfering with property rights in contravention of the Human Rights Act 1998. Note that this list has, under new legislation, been expanded and this is discussed in more detail in the next section. The Treasury must also issue a Code of Practice, which is discussed in the next paragraph, for the use of each of the three powers under the Special Resolution Regime.

The second part of the Act provides the framework for bank insolvency. The main features of bank insolvency are that a bank enters the process by court order. The order appoints a liquidator, who aims for the depositor's accounts to be transferred or for compensation to be made from the FSCS. The liquidator will then wind up the bank. An application for bank insolvency under the original Act may only be made to the court by the Bank of England, the (then) FSA or the Secretary of State. Each of these may only apply on certain grounds (section 95, 96): the Bank of England and the FSA may only apply for bank insolvency if the bank is unable, or likely to become unable, to pay its debts or if the winding up of the bank would be fair. If the FSA applies, then the Bank of England must consent and vice versa. The Secretary of State may only apply on the ground that winding up the bank would be in the public interest. If an insolvency order is made, then the liquidator has two objectives: the first being the safeguarding of deposits and the second to achieve the best result possible for the bank's creditors. The first objective takes precedence over the second pursuant section 99.

The third part of the Act provides the framework for bank administration. Bank administration is used when part of the bank is sold to a commercial purchaser or transferred to a bridge bank as outlined in sections 11, 12 of Part 1. The court will appoint an administrator on application of the Bank of England, who will ensure that the non-sold

or non-transferred part of the bank provides services required for the purchaser or bridge bank to operate effectively. In other aspects the procedures are the same as for insolvency. The administrator has two objectives (section 137): firstly, to support the commercial purchaser or the bridge bank, which takes precedence over the second objective of normal administration. This first objective ceases only when the Bank of England gives notice that the connection is no longer required (section 139).

The fourth part makes amendments to the FSCS as defined in the FSMA. The fifth part places the oversight of the systems of payments between financial institutions with the Bank of England. The Treasury can make a recognition order for a payments system to be supervised by the Bank of England. The Bank of England in turn may require operators of a payment system to establish rules for operation and it can give directions to such operators. However, the FSA must be consulted before the Bank of England may take action under this part of the Act. Finally, the sixth part of the Act tidies up the legislation concerning the permission of issuing bank notes in Northern Ireland and Scotland.

## b. The Special Resolution Regime – Current State

### *i. The Objectives and the Code of Practice*

The Banking Act 2009 ss5,6 require HM Treasury to set out a Code of Practice. This Code of Practice must contain the guidelines the authorities will use the powers under the Special Resolution Regime[10] and is regularly updated to include changes to the Banking Act 2009 and related legislation.[11] The Code of Practice covers the three stabilisation options, the bank insolvency procedure and the bank administration procedure. The relevant authorities are legally obliged to have regard for the Code under section 5(4). Some of its main points include how the special resolution regime's objectives are to be understood and achieved, the choice between different resolution options, compensation, and how the Bank of England will determine the public interest test for the use of the bridge bank and private purchaser stabilisation options is satisfied.[12]

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[10] HM Treasury, 'Banking Act 2009 Special Resolution Regime: Code of Practice' (November 2010) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209933/bankingact2009_code_of_practice.pdf> accessed 14 November 2015

[11] HM Treasury, 'Banking Act 2009 Special Resolution Regime: Code of Practice' (March 2015) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/411563/banking_act_2009_code_of_practice_web.pdf> accessed 14 November 2015

[12] ibid 7

The regime's objectives listed under section 4 are phrased in general terms without further explanation. Originally, there were 5 objectives but two have been added since. They are, in summary,

(1) To ensure the continuity of banking services in the UK and critical functions;
(2) To protect and enhance stability of the financial system within the UK, in particular with regard to preventing contagion and maintaining market discipline;
(3) To protect and enhance public confidence in the stability of the financial system in the UK;
(4) To protect public funds, in particular by minimising the reliance on extraordinary public financial support;
(5) To protect investors and depositors to the extent of the relevant schemes;
(6) To protect clients' assets (where relevant); and
(7) To avoid interfering with property rights in contravention of a Convention Right.

Chapter 3 of the Code provides the interpretation and further explanation. For example, the 'stability of the financial systems of the UK' is very broadly defined to include capital raising, risk-transfer, facilitation of domestic and international commerce, as well as the general continuity of the banking system and any systemic impact.[13] A similarly broad definition is given for 'public confidence in the stability of the banking system'. It includes the expectation that deposits will be repaid, that normal banking services will continue to be available, that (perceived) problems in one institution will not extend to another, and that if an institution fails, a system exists to protect the interests of depositors.[14] All other objectives of the regime are equally broadly defined. The point is that it is difficult to foresee any future circumstances in which these definitions may need to be relied upon, hence a broad catch-all approach is used. Finally, the last objective is important as it ensures that any interference is proportionate and in the public interest. It is a reflection of the legal challenges brought in relation to compensation in earlier nationalisation under the Banking Act 2008, as discussed previously.

[13] ibid 9
[14] ibid 10

### *ii. The Main Powers*

The Special Resolution Regime, the first part of the Act, is now the UK's statutory toolkit for resolving failing banks and building societies. At the time when the Act came into force, the three authorities, namely the FSA, the Bank of England and the Treasury, could exercise the powers granted. First, the FSA determined whether a bank had met the relevant conditions to be placed under the Special Resolution Regime. Thereafter, either the Bank of England would take over implementing and running the Special Resolution Regime. Only in the case of transfer to temporary public ownership would the Special Resolution Regime be run by the Treasury. The three authorities were naturally required to cooperate closely in all scenarios.

The current situation is slightly different as, following the Financial Services Act 2012, which is discussed in chapter five, the FSA was replaced as the main financial services regulator. In its place came the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA"). The provisions have therefore become more complicated. In total, there are four conditions under section 7 that need to be satisfied before a bank is to be placed in the Special Resolution Regime. The first condition is that the PRA needs to be satisfied that the bank is failing or is likely to fail. Additionally, the Bank of England needs to be satisfied of three further conditions. The first is that, having regard to timing and other relevant circumstances, it is not reasonably likely action will be taken by or in respect of the bank that will result in the PRA's condition ceasing to be met. The second condition is that the exercise of the power is necessary having regard to the public interest in the advancement of one or more of the special resolution objectives. Finally, the third condition is that one or more of the special resolution objectives would not be met to the same extent by the winding up of the bank. There are further provisions under section 7 which apply to these conditions. For example, although one of the regulators must determine whether a condition is met, the others are to be consulted. The Special Resolution Objectives are relevant to the Bank of England's second and third conditions. Finally, it is worth noting that provisions are included on the relation between failure and financial support.

When the Banking Act 2009 came into force, there were three options available for resolving a failing institution. The Bank of England had the power to sell all or part of a failing bank to a commercial purchaser. This was the private sector purchase option and could be executed by share or property transfer instruments. In the second option, the Bank of England can transfer all or part of the failing bank to a bridge bank. The third

option is a transfer by the Treasury of the institution into public ownership. This has changed substantially since January 1, 2015, when the Bank Recovery and Resolution Order 2014/3329 came into force. This was one of several Statutory Instruments that form the transposition of the Bank Recovery and Resolution Directive[15] ("BRRD") into UK law. Although this Statutory Instrument should be categorised as a longer term solution, therefore might also be discussed in the next chapter, it is discussed here instead because relates directly to the emergency measures available to the Treasury and the regulators. There are now five options available instead of three. These options are:

> (1) 'Transfer by the Bank of England of some or all of the business of the failed firm to a private sector purchaser;
> (2) Transfer by the Bank of England of some or all of its business to a bridge institution;
> (3) Transfer by the Bank of England assets, rights or liabilities of an institution or bridge institution to one or more asset management vehicles;
> (4) cancellation, reduction or conversion by the Bank of England of certain liabilities of the institution to the extent necessary to absorb losses and recapitalise the institution or the successor entity to as level necessary to restore market confidence (the bail-in stabilisation option); and
> (5) Transfer by the Treasury of the institution into temporary public ownership. This option applies to a holding company of a bank, but not to other banking group companies'.[16]

All of these can be achieved by using the stabilisation powers, such as the transfer of assets, shares and other property. The Bank of England and the PRA can further apply to the courts for insolvency, in order to ensure swift payment through the relevant compensation schemes. The FCA can do so where the institution holds clients' assets.

#### *iii. Limitations*

In the following circumstances, an institution is deemed to fail or likely to fail

> (1) 'if the banking institution is failing, or is likely to fail to satisfy the threshold conditions in circumstances where that failure would justify the variation or cancellation by the PRA or FCA of the banking institution's permission to carry on one or more regulated activities;
> (2) the value of the assets of the banking institution are or are likely soon to be less than the value of its liabilities;

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[15] Council Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 [2014] OJ L173/190, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN> accessed 14 November 2015

[16] HM Treasury (n 11) 19

(3) the banking institution is unable or likely to become unable to pay its debts as they fall due; or
(4) extraordinary public financial support is required except when, in order to remedy a serious disturbance to the economy and preserve financial stability, it takes the form of either a State guarantee to back liquidity facilities provided by the central bank according to the central bank's conditions, a State guarantee of newly issued liabilities, or an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage on the institution'.[17]

Only when one or more of these conditions are satisfied can the regulators use their powers under the Special Resolution Regime. However, each of the different tools within the resolution regime has different additional conditions attached that need to be satisfied.[18] These additional conditions reflect the severity and impact of each tool. For example, temporary public ownership has conditions relating to a serious threat to the stability of the financial system in the UK. On the other hand, conditions for transfer of specific assets to an asset management vehicle include the conditions on maximising the proceeds of its liquidation.

#### *iv. Compensation*

Provisions for compensation are made under sections 49 to 62. There are three types of compensation orders: compensation scheme orders, resolution fund orders and third party compensation orders.[19] Their object is to comply with Article 1 Protocol 1 of the European Convention on Human Rights, i.e. the right to peaceful enjoyment of ones' own property. In case of a transfer of shares or business by the Bank of England to a private sector purchaser under section 11(2), the Treasury must make a compensation scheme order under section 50(2). In case of a transfer of shares or business to a bridge bank or assets to an asset management vehicle, the Treasury must make a resolution fund order under section 52(2). Finally, where the Treasury has placed a failing bank into public ownership, it must make either a compensation scheme order or a resolution fund order under section 51(2). Where any of the stability options have been used, the Treasury holds discretionary powers to make third party compensation orders.

The different orders are a reflection of the severity of the situation and of what the receivers are likely to get in monetary terms. For example, a compensation scheme order requires an independent valuation of the transferred assets, to be arranged by the Bank of England. A resolution fund order on the other hand will be based on any contingent

[17] ibid 21
[18] ibid 24-29
[19] ibid 69

economic interest in the proceeds of the resolution, captured in the resolution fund. The third party compensation orders can become quite complex. Generally, it will involve an independent valuer assessing the damage of those whose property rights were affected. It becomes complex when there is a bail-in, which in summary means that a failing bank will cancel, dilute or transfer the interests of existing shareholders and write-down sufficiently the claims of unsecured creditors. In a bail-in, the rule is that creditors must be in a position in which they are not worse off than when the bank had become insolvent. If creditors are worse off, then a compensation order must be made.[20] In this case, an independent valuer needs to be appointed to assess the difference between the creditors' position in a bail-in and in insolvency.

### c. Depositor Protection

The Financial Services Compensation Scheme ("FSCS") was introduced through the Banking Act 2009 Part 4, sections 169 to 180. This is an important part of the Act for retail customers as it changes the usual insolvency hierarchy and gives preference to depositors.[21] FSCS covered deposits now rank equally with other preferential debts, whilst those not covered are preferred over ordinary unsecured debt but rank below other preferential debts. This reduces the likelihood that the FSCS will need to contribute to the resolution. However, there are some special cases. Worth noting is the case of a bail-in, where the FSCS is required to contribute up to the amount it would have had to pay out in the alternative of an insolvency.

In case of an actual insolvency, the bank liquidator is required to work together with the FSCS to facilitate prompt pay outs to eligible depositors or to facilitate the transfer of deposits as a whole to another institution. This is important considering the usually lengthy procedures involved in the liquidation of a bank. It would be unrealistic to expect customers to wait for months if not years to get their deposits back. It would completely defeat the purpose of the scheme as, with such a long waiting time, deposit holders would still try to withdraw their money when a bank gets into financial difficulty. In other words, the FSCS must pay out promptly if it is to prevent a run on a UK bank.

### d. Critical Analysis of the Banking Acts

The Banking (Special Provisions) Act 2008 and the nationalisation of Northern Rock are now widely praised as perhaps the first appropriate measures taken by any country to deal with

[20] ibid 72
[21] ibid 66

a bank failure during the crisis. Even if this is exaggerated, it must be accepted that the handling of Northern Rock provided a blueprint for handling the subsequent smaller failures and, more importantly, for the much larger failures of RBS and Lloyds HBoS. But the main lesson is that the focus of policymakers should not only be on trying to prevent a crisis, but also on actually managing a crisis when one arrives. Herein lies a problem. If risk-takers are, through this crisis management, protected from the negative outcomes of the risks undertaken, then they may in future engage in even greater risk.[22] There is, however, great pressure on policy makers to take immediate action, as inaction will lead to disastrous outcomes. But once action has been taken and support has been provided, it is very difficult to take it away again when the crisis is over. The best safeguard against this form of moral hazard is, in this case, to have a resolution system in place for large and complex financial institutions.[23] A badly run bank should be allowed to fail rather than relying on the availability of a lender of last resort, a deposit guarantee scheme or even a bailout by the government.

The Banking Acts are necessary steps towards such a resolution system in the UK. It may, however, not be enough. Although it may be adequate for smaller national institutions, the large financial institutions that are deemed to be systemically important have often adopted a very complex corporate structure. This makes the application of such Acts difficult in practice; the suggestion is made that systemically important financial institutions should be required to write and update a winding-down plan together with their business continuity plans.[24] If this winding-down plan is deemed to be inadequate, then supervisors should be given the power to force through changes in the corporate structure of the systemically important institution. Although the requirement to draft these plans has now made its way into law via the BRRD, and although the plans form the basis of important conversations between the regulator and the banks, it remains an untested tool for systemically important institutions.

The main reason why insolvency laws for financial institutions are different from those for other companies is because of the wider social and economic implications a bank failure has. The damage to customers, especially those who are deemed less able to fend for themselves, such as most deposit holders, as well damage to society as a whole, needs to

[22] Richard J Herring, 'The Known, the Unknown and the Unknowable in Financial Policy: An Application to the Subprime Crisis' (2009) 26 Yale J on Reg 391, 401
[23] ibid 403
[24] ibid 404

be limited. The Banking Act 2009 and the BRRD reflect this in the objectives set to the liquidator in the Special Resolution Objectives discussed previously: the priority goes to safeguarding deposits. It is further reflected in the associated Third Parties Compensation Regulation, which makes provisions for third parties left behind in case of a failure, as well as the FSCS specifically designed to protect deposit holders. The predecessor of the 2009 Act, namely the Banking (Special Resolutions) Act 2008, has been used and demonstrated that the safeguarding of wider public interests and of depositors does not please all parties involved. It is, for example, difficult to balance the right of shareholders with such a form of prudential regulation.[25] Shareholders enjoy their possession of shares as defined and protected by the ECHR. This does not sit well with the requirement for regulators or the government to intervene through the Special Resolution Regime in the Banking Act 2009 or with the arrangements in the preceding Act. In fact, the issue is recognised within the Special Resolution Regime as it seeks to avoid interference with the property rights in the Human Rights Act 1998. It also defines an extensive mechanism for compensation as and when deemed appropriate.

## 4. UK Financial Investments Ltd

### a. Introduction

The previous chapter contained several case studies of UK bank failures during the financial crisis. These failures included mortgage lender Northern Rock and RBS, a large, globally operating, bank which had just pulled off the spectacular but disastrous takeover of Dutch lender ABN Amro. These failing banks were (part-) nationalised using emergency legislation, such as the Banking (Special Provisions) Act 2008, as previously described in this chapter. The nationalisations raise questions about how the UK government should manage its investments in these banks. UK Financial Investments ("UKFI") was created for this purpose: to manage the government's investments at arm's length. Firstly, the creation and the operating framework of UKFI are explained. The formal rules and guidelines under which UKFI should be run are critically analysed. Thereafter, the impact of state-ownership on competition and the impact of the EU rules on state-aid are examined.

The objective of this analysis is to examine the impact of state-ownership of UK financial institutions on their corporate governance. The question is whether the political pressures and potential government intervention can be merged with running a commercial

[25] Kern Alexander, 'Bank Resolution Regimes: Balancing Prudential Regulation and Shareholder Rights' (2009) 9 J Corp L Stud 61

organisation that is at the same time trying to adapt to a swiftly changing regulatory environment. It might be that this gives rise to conflicting interests between the various actors in corporate governance at these banks. In particular, there is a danger that the political objectives of the owners may conflict with the ordinary commercial objectives. In the next chapter follows a discussion on the long term solutions proposed for the financial sector. It is important to realise that a substantial part of the financial sector is still in government ownership. This could have an impact on the proposed solutions.

### b. The Creation of UKFI

The creation of UKFI in November 2008 was an immediate result of the financial crisis that had now reached the UK institutions. In January 2008, as described previously in more detail, Northern Rock was fully nationalised. On the morning of 8 October 2008, the Chancellor of the Exchequer, Alistair Darling, announced proposals to restore confidence in the banking system and to put banks on a stronger footing, including an immediate £25 billion capital injection via a recapitalisation fund and another £25 billion available if needed.[26] These measures left the UK government with a substantial stake in various UK banks that would need to be managed. On 3 November 2008, the Chancellor of the Exchequer, Alistair Darling, announced the creation of UKFI for

> 'managing of the Government's shareholding in banks subscribing to its recapitalisation fund …'[27]

This announcement contained a summary of the relationship between the government and the objectives and targets for UKFI.

> 'The Government's investments will be managed on a commercial basis by a new arm's-length company. … Its overarching objectives will be to protect and create value for the taxpayer as shareholder, with due regard to financial stability and acting in a way that promotes competition'.[28]

From this summary statement it would appear that the government does not want to actively manage its investments but leave the company at arm's-length. It would thus be shielded from political influence and decisions that may be politically convenient but not commercially sound. This is further supported by the fact that it seeks to maximise value

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[26] HM Treasury, 'Statement by the Chancellor on financial stability' (8 October 2008) <http://webarchive.nationalarchives.gov.uk/20100407010852/http:/www.hm-treasury.gov.uk/statement_chx_081008.htm> accessed 14 November 2015

[27] HM Treasury, 'New Company to Manage Government's Shareholdings in Banks' (3 November 2008) http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/press_114_08.htm accessed 14 November 2015

[28] ibid

for the taxpayer as shareholder. There are other ways in which it could have maximised value for taxpayers, for example by cheap lending. The point is that as a shareholder the taxpayer's interest means that the investments must be run on a commercially sound basis with the aim of generating a healthy return. The additional constraint of having to regard financial stability seems only natural, given that the capital injections were made for the purpose of maintaining financial stability in the first place. And the constraint relating to competition would appear to arise naturally from national and EU law on state-aid.

The statement continued that the UK government would seek to influence the remuneration policy

> 'UKFI will work to ensure management incentives for banks in which it has shareholdings are based on maximising long-term value and restricting the potential for rewarding failure'.[29]

At this stage, it becomes less obvious that the government actually intends to have its investments managed at arm's length or even on a commercial basis. Of course, the idea that management's rewards should be directly linked with the performance of the bank over a longer period is in itself entirely reasonable and even desirable. The potential problem lies with the context in which remark is made as well as some of the wording.

The announcement further made it clear that the UK government wanted to ensure that the banks would continue to lend and stimulate the UK economy.

> 'It will also oversee the conditions of the recapitalisation fund, including maintaining, over the next three years, the availability and active marketing of competitively-priced lending to home owners and small businesses at 2007 levels'.[30]

It is at this point that the statement becomes inconsistent at best. First, the government is here actively engaged in prescribing the lending objectives for the banks in which it holds investments. It clearly defines the levels at which it expects this lending to occur. Second, the levels that it prescribes do not make commercial sense nor are they desirable in the context of creating financial stability. It is obvious that the situation before the crisis was not sustainable and that it would not be desirable to return to such a position. The objective of providing emergency funding should be to allow banks to survive and clean up their balance sheets. It is understandable why such a lending objective is being prescribed. The taxpayer is not only a shareholder, interested in a return on its investment and

[29] ibid
[30] ibid

potentially selling its stake at a profit. The taxpayer also has a great interest in economic growth. To allow for economic prosperity, banks must be willing to lend to households and businesses. Although growth in the longer term is still achievable when banks decrease their lending in the short term, any economic growth in the short term will be non-existent. And it is here that a major problem can arise if taxpayers and politicians are not willing to accept a major correction in banks' lending practices which lead to a deep recession in the short term.

### c. The Operating Framework of UKFI

Two documents set out the rules for the interaction between HM Treasury and UKFI: the Shareholder Relationship Framework Document[31] ("SRFD") and the Investment Mandate[32] ("IM"). These are occasionally updated to reflect new responsibilities as banks fail (such as B&B). The latest versions are from October 2014, updating those of October 2010. Additionally, UKFI has subscribed to the UK Stewardship Code and it expects its investees to comply with the Corporate Governance Code on a "comply or explain" basis.[33] UKFI has also issued the UKFI Sustainability Policy.[34]

#### *i. Shareholder Relationship Framework Document*

The SRFD, which manages the shareholder relationship, establishes the objectives for UKFI and sets out how it will pursue them. The main objective as set out in section 3.1 is to

> 'develop and execute an investment strategy for disposing of the Investments (or, in the case of UKAR, the underlying investments in NRAM and B&B) in an orderly and active way through sale, redemption, buy-back or other means within the context of protecting and creating value for the taxpayer as shareholder and, where applicable, as provider of financial support, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition.'

There are further points that are included in this objective. As per section 3.1(A), UKFI is not to be a permanent investor in its investments. Instead, UKFI must maximise sustainable

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[31] UK Financial Investments Ltd, 'UKFI Framework Document October 2014' (2014) <http://www.ukfi.co.uk/releases/UKFI%20Framework%20Document-Revised%20October%202014.pdf> accessed 14 November 2015

[32] UK Financial Investments Ltd, 'UKFI Investment Mandate October 2014' (2014) <http://www.ukfi.co.uk/releases/UKFI%20Investment%20Mandate%20-%20Revised%20October%202014.pdf> accessed 14 November 2015

[33] UK Financial Investments Ltd, 'UK Stewardship Code' (2010) http://www.ukfi.co.uk/images/dynamicImages/UK%20Stewardship%20code%2020101203.pdf accessed 14 November 2015

[34] UK Financial Investments Ltd, 'UKFI Sustainability Policy' (2010) http://www.ukfi.co.uk/images/dynamicImages/UKFI_Sustainability_policy_010210(1).pdf accessed 14 November 2015

value for the tax payer. UKFI must also take the overall UK financial stability into consideration in value-realisation transactions, disposal or restructuring of its investees, as per section 3.1(B). Finally, as outlined in section 3.1(C), UKFI must promote competition, both ensuring that the UK financial services industry looks after the consumers and that it respects commercial decisions of the institutions.

Section 6 of the SRFD gives the framework for interaction between UKFI and the boards of the investees. UKFI will seek to strengthen the boards of directors with the appointment of appropriately qualified non-executive directors. If the investee is wholly government-owned, then UKFI will exercise the associated rights originally conferred on the Treasury. With all of its investees, UKFI will engage in matters of board composition within the principles set out in section 7 relating to preservation of the independence of the investees. This section 7 is crucial as it should ensure that the government does not the investee companies for political purposes. This is best exemplified in section 7.1, where it states that UKFI

> 'will manage the Investments on a commercial basis and will not intervene in day-to-day management decisions of the Investee Companies (including with respect to individual lending or remuneration decisions save, in the case of the Wholly-Owned Investee Companies, to the extent provided in the applicable Investee Company Framework Document).'

The engagement with the investees will be proportionate to the percentage of government ownership. Hence, for a wholly-owned investee, its board would report directly and only to UKFI. For investees that are listed, section 7.2(B) provides that UKFI

> 'will engage actively with the Investee Company in accordance with best institutional shareholder practice. … the Listed Investee Companies will continue to be separate economic units with independent powers of decision and, in particular, will continue to have their own independent boards and management teams, determining their own strategies and commercial policies (including business plans and budgets)'.

The question is whether these parts of the SRFD are adhered to in practice. There are numerous areas where the government's interests may conflict with the commercial objectives of the institutions. For example, the institutions may want to reduce the size of their balance sheet whilst at the same time the government wants to increase lending. Another example is the desire of the institution to attract, reward and retain its talented staff, whilst the government wants to avoid headlines of large bonuses at bailed-out banks.

Other parts of section 7 make it clear that HM Treasury wants to prevent any distortions or impede competition in the banking sector. It also states that UKFI must adopt procedures to manage any conflicts and insider information. These are aimed to ensure that the investees are managed within the European and national competition regulation. The function of monitoring, reporting and securing compliance with competition regulation lies with UKFI as per section 8. However, section 9 makes it clear that the Treasury has a large say over what happens at UKFI.

### *ii. Investment Mandate*

The IM complements the SRFD. It contains important provisions on how UKFI is to manage the investments it holds. The overarching approach to managing these investments is captured in section 3.

> 'In managing the Investments, UKFI will (on behalf of HM Treasury) follow best institutional shareholder practice. This includes compliance with the Institutional Shareholders' Committee's Statement of Principles together with any developments to best institutional shareholder practice arising from recommendations or guidance contained in the Walker Review or elsewhere'.

This makes it clear that UKFI is to act as a normal shareholder following the relevant best practices. This implies that it is not to seek to implement government policies which would be contrary to those best practices. In fact, it re-emphasises the independent nature that UKFI should have, not influenced by the Treasury, in managing its investments. However, UKFI must work together with the Treasury in regard of the actual disposal, sale or restructuring of any of its investments. Section 4 provides a wide framework in which this must take place.

As UKFI has started to sell off part of its investments, it is now holds more investments in listed companies. This is treated separately in the IM. Special attention is given to the exercising the voting rights attached to investments. This covers topics such as remuneration, where section 7 provides that UKFI will seek to ensure that the remuneration policy will be in line with best practices as set out by the G20, the Walker Review and the FCA. UKFI should also seek to ensure that the costs of dismissing a director are reasonable and fair. Finally, as a counterbalance, UKFI should also seek to ensure that remuneration is such that the investee can attract the staff needed to maximise shareholder (and thus taxpayer) value.

### d. UKFI Today

On 20 May 2015 it was announced that UKFI is to become a subsidiary of UK Government Investments, a new company wholly owned by HM Treasury.[35] The Shareholder Executive, a division within the Department for Business, Innovation & Skills, will become a division in this new company. The Shareholder Executive is involved in a wide variety of government initiatives.[36] These include 23 state-owned businesses, ranging from the Nuclear Decommissioning Authority to Working Links, from the Met Office to Royal Mail, and from Companies House to the Green Investment Bank.[37] It will also be instrumental in setting up the British Business Bank.

Since its creation, UKFI has not only looked after the government's investments in the rescued banks, it has also successfully sold off parts of these investments. On 17 November, 2011, Northern Rock was sold to Virgin Money.[38] On 17 December 2013, a six percent stake in Lloyds was sold.[39] Further sales, including a sale of Lloyds' shares to the general public, are being planned. Although one can argue over the timeframe, this would evidence a clear determination by HM Treasury to sell off its stake in the nationalised institutions. It would also allow the government to get at least part of the money back that it has put into the failed banks. The reality is that privatisation carries political risks. If the share price subsequently increases, the critique will be that it was sold at too low a price. It also means that the government has less direct control over the former investees.

## 5. Rules on Competition and State-Aid

### a. Competition Rules within the UK

In the UK, the Office of Fair Trading ("OFT"), established by the Enterprise Act 2002 s1, was responsible at the time of the financial crisis for safeguarding competition rules. The OFT derives its power from various statutes, including for example the Competition Act 1988

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[35] UK Financial Investments Ltd, 'Press Release: UKFI becomes a subsidiary of new government-owned company, UK Government Investments' (20 May 2015) <http://www.ukfi.co.uk/press-releases/> accessed 12 November 2015

[36] The Shareholder Executive, 'About us' (2015) <https://www.gov.uk/government/organisations/the-shareholder-executive/about> accessed 14 November 2015

[37] The Shareholder Executive, 'Annual Review 2013-2014' (October 2014) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/368125/bis-14-405-shareholder-executive-annual-review-2013-14.pdf> accessed 14 November 2015, 25

[38] BBC, 'Northern Rock sold to Virgin Money' (17 November 2011) <http://www.bbc.co.uk/news/business-15769886> accessed 14 November 2015

[39] UK Financial Investment Ltd, 'Press Release' (2013) <http://www.ukfi.co.uk/index.php?URL_link=press-releases&Year=2013> accessed 14 November 2015

and the Enterprise Act 2002. The Competition Act 1988 prohibits anti-competitive behaviour. Firstly, it prohibits anti-competitive agreements per Chapter 1 of the Act and Article 101 of the EC Treaty. Secondly, it prohibits abuse of a dominant position per Chapter 2 of the Act and Article 102 of the EC Treaty. For example, the OFT can refer mergers to the Competition Commission for investigation if it leads to a substantial decrease in competition. With this authority, the OFT but also the Competition Commission played an important role in safeguarding competition within the UK during the period in which several UK banks had to be rescued. Often the solutions taken had the potential to reduce the competition in the UK banking sector. It must be noted that the OFT has been replaced on 1 April 2014 by the Competition and Markets Authority ("CMA"), established by the Enterprise and Regulatory Reform Act 2013.

The rescue of HBoS by Lloyds, which was announced on 18 September 2008, had the potential to create a dominant player in the UK retail banking market.[40] On that same day, the Secretary of State, using his powers under the Enterprise Act 2002 s42(2), asked the OFT to look into the effects of this merger and to report on it in accordance with s44 of the same Act.[41] The OFT concluded that the merger would result in a substantial reduction of the competition without relevant benefits to the customers affected. There was a large overlap between the activities of Lloyds and HBoS, in particular in the areas of personal banking, such as savings, loans, credit cards and mortgages, in corporate banking, such as banking services to SMEs, and in insurance, such as PPI.[42] Furthermore, HBoS was seen as a major driver of competition whilst Lloyds was the market leader. A merger could therefore significantly strengthen the position of Lloyds. The OFT thus concluded that the conditions for referral to the Competition Commission were met.

On the 24 October 2008, the day that the OFT published its report, the Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008 (SI 2008/2645) came into force. The OFT and the Competition Commission have a duty under s57 to bring to the attention of the Secretary of State if any of the considerations specified in s58 are met. These conditions are, for example, matters of national security as per s58(1). The Business

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[40] House of Commons Treasury Committee, 'Banking Crisis: Dealing with the Failure of UK Banks' (21 April 2009) <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/416/416.pdf> accessed 14 November 2015, 103

[41] Office of Fair Trading, 'Anticipated Acquisition by Lloyds TSB plc of HBOS plc' (24 October 2008) <http://www.oft.gov.uk/shared_oft/press_release_attachments/LLloydstsb.pdf> accessed 20 March 2014

[42] ibid 26

and Enterprise Secretary of State under s58(3) has the power to modify or add to these conditions. The order passed added the following condition.

> (2D) The interest of maintaining the stability of the UK financial system is specified in this section (other than for the purposes of sections 67 and 68 or references made, or deemed to be made, by the European Commission to the OFT under article 4(4) or 9 of the EC Merger Regulation).

On 31 October 2008 the Business and Enterprise Secretary of State thus exercised his powers to allow the merger between Lloyds and HBoS despite concerns over competition on the grounds of maintaining financial stability in the UK. This resulted in mixed responses.[43] Those in favour argued that the government had to take decisive action to ensure financial stability and that competition was a secondary concern in this. The other side argues that different solutions might have been possible and that in the longer term problems with competition would need to be addressed. In any event, the merger of Lloyds and HBoS clearly demonstrates that the government was willing to override national competition rules in securing financial stability.

### b. The EU Rules on Competition and State-Aid

The national rules on competition are not the only ones relevant. In fact, the national rules are based largely on an implementation of the EU competitions rules. The EU rules come into play when several Member States are involved. Furthermore, the EU has rules relating to state-aid, something which was provided by many Member States to banks during the global financial crisis.[44] Furthermore, it would be far less likely that these rules and regulations could be brushed aside as easily as the national rules previously discussed. The European Commission has been especially concerned about state-aid provided to financial institutions and has engaged with the relevant institutions to ensure that in the longer term competition would be restored. The Commission has taken a longer term view in this, thereby acknowledging that removing the threat to financial stability was more important in the short term.

The principles and consequences of EU rules on state-aid are examined. The Treaties of the European Union set out the EU's constitutional basis. The two main treaties are the Treaty

[43] House of Commons Treasury Committee (n 40) 104

[44] Michael Reynolds, Sarah Macrory and Michelle Chowdhury, 'EU Competition Policy in the Financial Crisis: Extraordinary Measures' [2010] 33 Fordham Int'l L J 1670

on European Union,[45] originally the Maastricht Treaty,[46] and the Treaty of the Functioning of the European Union,[47] originally the Treaty of Rome[48] to which the UK was not a signatory. These treaties have been amended on several occasions, most recently in the Treaty of Lisbon.[49] In the timeline of the global financial crisis and the aid provided to ailing banks, it is necessary to go back to the consolidated versions of these treaties in 2006[50] and in 2008.[51] Within these treaties, there are limitations set out on the aid that governments can give to their national enterprises. These fall under the Treaty on the Functioning of the European Union, Title VII Common Rules on Competition, Taxation and Approximation of Laws. The background concept behind this part of the treaty is to create a single internal market without trade barriers or unfair competition.

As mentioned previously in the discussion on competition at a national level, the main articles on competition are 101 and 102. The 2008 Treaty on the Functioning of the European Union, Title VII Section 1, Article 101, states that

> 'The following shall be prohibited as incompatible with the internal market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the internal market, in particular … (d) apply dissimilar conditions to equivalent transactions with other parties, thereby placing them at a competitive disadvantage …'

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[45] Consolidated Version of the Treaty on European Union [2012] OJ C326/13, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:326:FULL:EN:PDF accessed 14 November 2015

[46] Treaty of the European Union, signed in Maastricht on 7 February 1992 [1992] OJ C191/4, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:1992:191:FULL:EN:PDF accessed 14 November 2015

[47] Consolidated Version of the Treaty on the Functioning of the European Union [2012] OJ C326/47, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:326:FULL:EN:PDF accessed 14 November 2015

[48] Verdrag tot oprichting van de Europese Economische Gemeenschap en bijbehorende documenten [ … ] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:11957E/TXT:NL:PDF accessed 14 November 2015

[49] Amendments to the Treaty on European Union and the Treaty establishing the European Community [2007] OJ C306/10, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2007:306:FULL:EN:PDF accessed 14 November 2015

[50] Consolidated Versions of the Treaty on European Union and the Treaty on Establishing the European Community [2006] OJ C321/1, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:321E:0001:0331:EN:PDF accessed 14 November 2015

[51] Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union [2008] OJ C115/1, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:115:FULL:EN:PDF accessed 14 November 2015

The 2008 Treaty on the Functioning of the European Union, Article 102, states that

> 'Any abuse by one or more undertakings of a dominant position within the internal market or in a substantial part of it shall be prohibited as incompatible with the internal market in so far as it may affect trade between Member States. …'

There are two articles very similar to the two branches of rules on competition in the Competition Act 1988, enforced by the OFT. Especially Article 102 was relevant to the merger between Lloyds and HBoS discussed previously.

The rules on state-aid are set out in Section 2 "Aids Granted by States". Article 107 at 1 says that

> 'Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.'

It continues at 3 to provide exceptions under which state-aid may be granted.

> 'The following may be considered to be compatible with the internal market: … (b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State'.

If state aid has been provided, then the Commission will keep it under close scrutiny in Article 108(1).

> 'The Commission shall, in corporation with the Member States, keep under constant review all systems of state aid existing in those States. It shall propose to the latter any appropriate measures required by the progressive development or functioning of the internal market'.

If the Commission does not approve of the state-aid granted, then it will inform the State to change the situation using its power granted under Article 108(2). If the State does not comply it will be referred to the Court of Justice of the European Union.

> 'If, after giving notice to the parties concerned to submit their comments, the Commission finds that aid granted by a State or through State resources is not compatible with the internal market having regard to Article 107, or that such aid is being misused, it shall decide that the State concerned shall abolish or alter such aid within a period of time determined by the Commission'.

The Commission would also like to be informed of changes in 108(3).

> 'The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid. If it considers that any such plan is not compatible with the internal market having regard to article 107, it shall without delay initiate the procedure provided for in paragraph 2. The Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision'.[52]

These EU Treaty Articles set out the rules on competition and state-aid. The focus for the European Commission was mainly on the latter.

### c. Application of EU rules on State-Aid

The discussion on allowing the government of Member States to provide aid to the financial institutions in their country centred around Article 107 3(b) as quoted earlier. The question arises whether, in light of the ongoing global financial crisis, a failure of a bank would constitute a serious disturbance in the economy. If so, providing state-aid may be allowed. The Commission started to issue guidelines early on in the financial crisis when it became obvious that various governments had already or were about to intervene in their national banks. In the end, a series of guidelines[53] were issued keeping pace with the developments during the crisis and events in individual Member States.[54]

The first communication, referred to as the Banking Communication,[55] sets out guidelines to be used when assessing aid given by Member States to their banks. The three underlying principles[56] to be applied are set out in s15. First, that the serious disturbance must be remedied. Thus the aided banks must be made viable in the long term without continued aid. This would include an analysis of alternative options and of a long term business plan. Second, the aid provided must be proportionate. The state-aid should not be used, for example, to finance acquisitions or other investments. Third, measures must be taken that will minimise any distortions to competition in the European Single Market. In particular,

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[52] ibid 92

[53] European Commission, 'State aid temporary rules established in response to the economic and financial crisis' (31 July 2013) <http://ec.europa.eu/competition/state_aid/legislation/temporary.html> accessed 14 November 2015

[54] European Commission, 'State aid: Overview of decisions and on-going in-depth investigations in the context of the financial crisis' (3 September 2013) <http://europa.eu/rapid/press-release_MEMO-13-762_en.htm> accessed 14 November 2015

[55] Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis [2008] OJ C270/8 available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008XC1025(01)&from=EN> accessed 14 November 2015

[56] Slaughter and May, 'Commission publishes guidelines on restructuring aid to banks' (14-20 August 2009) <http://slaughterandmay.com/media/847977/eu_competition_newsletter_14_aug_20_aug_2009.pdf> accessed 14 November 2015

this may include divestments and sale of parts of the bank to favour entry of competitors or cross border activity. State-aid must certainly not be used to the detriment of competitors. For example, state-aid may not be used to offer terms that competitors cannot match to obtain better interest rates, lower collateral costs or similar.

The second communication, the Recapitalisation Communication,[57] builds on this. It sets out three common objectives of recapitalisation: restoring financial stability, ensuring lending to the real economy and dealing with the systemic risk of a possible insolvency. With these objectives in mind, there are three concerns for competition: banks recapitalised by one Member State should not have an unfair advantage over banks in another Member State, recapitalisation schemes should differentiate in accordance with risk profiles so as not to give any undue advantage, and public recapitalisation should not put those banks that not have recourse to public funding in a less competitive position. The communication further contains comments from the European Central Bank and provisions on the type of capitalisation and the minimum price.

The third communication is the Impaired Assets Communication.[58] By this time, governments of Member States had started to devise schemes to help banks with their assets on which they were likely to incur losses. These include, for example, the securities related to US sub-prime mortgages. Schemes devised include purchase through the creation of a bad bank containing the impaired assets as well as insurance schemes against losses from impaired assets. By setting out the guidelines for state-aid relating to impaired assets, the European Commission tried to increase the disclosure of potential future losses and improve transparency of financial markets, thus restoring some of the confidence between banks.[59] The guidelines introduced include the requirement of full disclosure of the impairments prior to government intervention. The relevant assets should be valued by independent experts, certified by bank supervisors and validated by the Commission. Other guidelines similar to those on recapitalisation apply as well. Together with the guidelines on

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[57] Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition [2009] OJ C10/2 available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:010:0002:0010:EN:PDF> accessed 14 November 2015

[58] Communication from the Commission on the treatment of impaired assets in the Community Banking Sector [2009] OJ C72/1 available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009XC0326(01)&from=EN> accessed 14 November 2015

[59] European Commission, 'State aid: Commission provides guidance for the treatment of impaired assets in the EU banking sector' (25 February 2009) <http://europa.eu/rapid/press-release_IP-09-322_en.htm?locale=en> accessed 14 November 2015

recapitalisation, the guidelines on impaired assets cover the majority of state-aid provided by Member States and thus ensure a level-playing field in the European market.

When the financial crisis had passed its peak, the focus shifted from ensuring stability to restructuring the aided banks with the aim to remove government support. The fourth communication, Restructuring Communication,[60] contains three principles which the Commission will apply. These are simply that the bank must be made viable for the long term, that restructuring costs are shared fairly with the owners and that distortion of competition is minimal. One of the main points made by the Commission is that, in order to ensure stability, banks will have to stress-test their business.[61] The communication on restructuring is the logical next step taken by the Commission following the timeline of events, as it now seeks to ensure that the emergency measures start to unwind, removing state-aid and bringing the European Market back to a normal state.

The next communications by the Commission, the fifth,[62] the sixth[63] and the last,[64] prolong the crisis framework as previously established. They do, however, gradually apply stricter rules. Most notably, in the final prolongation, the Commission seeks to create a more effective restructuring process by requiring a full restructuring plan, including a capital raising plan, to be in place before any state-aid may be granted to recapitalise the bank.[65] Furthermore, any shortfall in capital must first be to detriment of the shareholders and junior debt holders before any state-aid can be provided in the form of recapitalisation or

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[60] Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules [2009] OJ C195/9 available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:195:0009:0020:EN:PDF> accessed 14 November 2015

[61] European Commission, 'State Aid: Commission presents guidelines on restructuring aid to banks' (23 July 2009) <http://europa.eu/rapid/press-release_IP-09-1180_en.htm?locale=en> accessed 14 November 2015

[62] Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis [2010] OJ C329/7 available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52010XC1207(04)&from=EN> accessed 14 November 2015

[63] Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis [2011] OJ C356/7 available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011XC1206(02)&from=EN> accessed 14 November 2015

[64] Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis [2013] OJ C216/1 available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013XC0730(01)&from=EN> accessed 14 November 2015

[65] European Commission, 'State aid: Commission adapts crisis rules for banks' (10 July 2013) <http://europa.eu/rapid/press-release_IP-13-672_en.htm> accessed 14 November 2015

asset protection schemes. It also arranges for a cap on remuneration and other strict remuneration policies for failed banks.

### d. The European Commission and State-Aid in the UK

The measures taken by the European Commission discussed so far are of a general nature. They apply within the whole of the EU and intend to give guidance and create a level playing field. Besides these general measures, the European Commission has also looked at individual cases of state-aid granted by Member States to failed banks. It should be noted that the Commission, and in particular its then Commissioner for Internal Markets and Competition, Neelie Kroes, took a rather pragmatic approach.[66] In the UK, the European Commission has been involved in aid which was granted to individual banks and building societies as well as the stabilisation plan and the asset protection scheme. The first approval given by the Commission was for the rescue of Bradford & Bingley.[67] The Commission approved the sale of the retail deposit book and branches to Abbey National and the nationalisation and winding-down of the rest of the bank. The Commission noted in particular that no aid was given to the purchaser of the branches, Abbey National, and that the UK government had committed to presenting a restructuring plan within six months.

The next three issues the Commission dealt with were the UK stabilisation plan, the lending to business plan and the asset-backed securities guarantee scheme. The UK stabilisation plan, launched on 11 October 2008, included the recapitalisation of the UK banks and building societies in exchange for shares, a guarantee scheme for short term and medium term debt for those unable to access funding, and an extension of the short term liquidity scheme by the Bank of England. The Commission swiftly approved this package and prolonged it on several occasions, noting that the measures were aimed at restoring confidence, were non-discriminatory and time-limited.[68] The Commission also swiftly approved the lending scheme to businesses, under which the UK government guarantees

[66] Andrea Gomes da Silva, James Aitken, Alison Jones and Michele Hearty, 'Neelie Kroes: A Review of the Former EU Competition Commissioner's Term of Office' (2010) 24 Antitrust 57

[67] European Commission, 'State aid: Commission approves UK rescue aid package for Bradford & Bingley' (1 October 2008) <http://europa.eu/rapid/press-release_IP-08-1437_en.htm?locale=en> accessed 14 November 2015

[68] European Commission, 'State aid: Commission approves UK support scheme for financial institutions' (13 October 2008) <http://europa.eu/rapid/press-release_IP-08-1496_en.htm?locale=en> accessed 14 November 2015

lending to SMEs.[69] Again, the Commission noted its non-discriminatory nature, its time limit and that it was an appropriate, necessary and proportionate way to support the real economy. The Commission gave the same arguments to approve the Asset-Backed Securities Guarantee scheme, which was designed to aid the mortgage backed securities market.[70]

Thereafter, the Commission looked at state-aid to individual banks. The first was Northern Rock.[71] This was not a straight forward affair as the Commission first launched an in-depth investigation[72] about a year earlier. It was extended after the plans were amended to create a good bank and a bad bank.[73] This amended plan was approved, with the Commission noting that the aid was kept to a minimum, the good bank had long term viability without state support and that normal competition would be restored by winding down the bad bank. This last argument was based on the observation that Northern Rock's aggressive yet unviable growth model in itself was a distortion and that bringing it back to a viable size would benefit competition.

The Commission applied the earlier approvals for the UK stabilisation plan and the EU-wide guidelines for restructuring to approve the state-aid of recapitalisation given to Lloyds to the extent of 17 billion pounds.[74] The plan approved contains a significant divestment package in Lloyds' core business area of UK retail. The objective of this divestment was to ensure competition was not distorted by the aid granted. Similarly, the Commission applied earlier EU wide guidelines on impaired asset relief and on restructuring aid for banks to

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[69] European Commission, 'State aid: Commission authorises UK scheme to support lending to businesses' (24 March 2009) <http://europa.eu/rapid/press-release_IP-09-471_en.htm?locale=en> accessed 14 November 2015

[70] European Commission, 'State aid: Commission authorises UK Asset-Backed Securities Guarantee Scheme' (21 April 2009) <http://europa.eu/rapid/press-release_IP-09-613_en.htm?locale=en> accessed 14 November 2015

[71] European Commission, 'State aid: Commission approves restructuring package for Northern Rock' (28 October 2009) <http://europa.eu/rapid/press-release_IP-09-1600_en.htm?locale=en> accessed 14 November 2015

[72] European Commission, 'State aid: Commission launches in-depth investigation into UK restructuring aid package for Northern Rock' (2 April 2008) <http://europa.eu/rapid/press-release_IP-08-489_en.htm?locale=en> accessed 14 November 2015

[73] European Commission, 'State aid: Commission extends in-depth investigation into UK restructuring aid package for Northern Rock' (7 May 2009) <http://europa.eu/rapid/press-release_IP-09-713_en.htm?locale=en> accessed 14 November 2015

[74] European Commission, 'State aid: Commission approves restructuring plan of Lloyds Banking Group' (18 November 2009) <http://europa.eu/rapid/press-release_IP-09-1728_en.htm?locale=en/1728> accessed 14 November 2015

approve the impaired asset relief and restructuring for RBS.[75] The Commission notes in particular the long term viability of the bank without state support and the required reduction in size of the bank.

## 6. Conclusions

The second research question asked what the effect is of new legislation and other initiatives on corporate governance at UK banks. This chapter contained a close examination of the legislation enacted in the wake of the crisis to deal with the banking failures. This constituted mainly the two Banking Acts, which defined the main powers as well as the limitations ordained to HM Treasury and the financial regulators to deal with a failure of a bank. This chapter also contained a study of what happened with the rescued banks, in particular their management within UKFI and the relevant rules on state-aid and competition. The conclusion must be that none of the emergency legislation nor any of the establishment of UKFI was set up with the direct purpose of improving corporate governance at UK banks. However, that does not mean they do not have an effect on it, as the research question rightly asks. The main effect can be found in the recognition of customer, deposit holders and even the general public at large as important stakeholders. The third research question asked what specifically the effect of state-ownership is on corporate governance at UK banks. The answer to this question can be found in comparing the described setup of UKFI with everyday reality.

### a. Stakeholders

The Banking Act 2009, together with the BRRD and its transposition into UK law, establish the framework for dealing with the failure of a UK bank. The main beneficiary of an orderly failure, whether through a bail-in, a private purchaser, a bridge institution or any of the options available, has to be the general public. There are several obvious reasons for this. Unlike with the failures of Northern Rock or RBS, the tax payer should not need to provide enormous public funds to bail out the failing bank. In contrast to the global financial crisis, this would mean that there is no large increase in government debt or other severe pressure on the public finances. It would thus also prevent the trigger into a recession which followed the financial crisis. This means the overall economic impact of the failure of a bank would be limited. From a corporate governance perspective, it means that these measures implicitly recognise the importance of the general public as a stakeholder in the

[75] European Commission, 'State aid: Commission approves impaired asset relief measure and restructuring plan of Royal Bank of Scotland' (14 December 2009) <http://europa.eu/rapid/press-release_IP-09-1915_en.htm?locale=en> accessed 14 November 2015

banks. The interest of the wider environment in which the bank operates is taken into account by protecting public funds and the UK economy from its failure.

More specifically than the general public at large, the depositors with the bank are better protected. They see their deposits, or at least up to a reasonable amount, protected via the FSCS. In practice this means that they rank highest in case of a failure and that a prompt repayment of their deposits by the liquidator can be expected. This is another implicit recognition of the importance of one of the stakeholders of a bank. Here, the depositors are recognised as important stakeholders. The other purpose of the FSCS is to prevent a run on a bank that is perceived to fail. This in turn makes a bank safer which, as per the argument above, would be in the interest of the public at large.

The protection of these stakeholders is not done without proper safeguards. The limitations seek to ensure that there can only be an intervention when it is absolutely necessary. However, these conditions, especially for extra-ordinary public financial support, are phrased in the context of the stability of the financial system within the UK and a serious disturbance to the wider economy. Again, in these conditions one can find the recognition of the general public as a stakeholder in the bank. There are also safeguards in terms of compensation payable. As and when required, these actions may lead to the situation that various parties involved need to be compensated for actions taken by HM Treasury and regulators. This would typically be the case where the solution includes a transfer of assets or parts of the business. This recognises the property rights of the shareholders, who play a crucial role in the corporate governance process.

### b. The Role of the Government and Commercial Objectives

The third research question asked what the effect is of state-ownership on the corporate governance at UK banks. The core element in answering this question is whether the government would or not act like an ordinary shareholder. If it is the former, then state-ownership would make little difference. If it is the latter, then it clearly would. The framework documents that were issued by UKFI would suggest that the government's intention is to keep their investments at arm's-length. It suggests that there is no interest in interfering with the institutions beyond that what might be expected from the ideal shareholder, who abides by all the relevant codes of practice. There is good reason to do so. By running these nationalised banks on a sound commercial basis, it would allow their management to maximise the value for shareholders. This is in the clear interest of

taxpayers, who would be best served if the investments are sold off at the highest price. It would ensure that they see the majority of their money returned.

This is not how it worked out in practice. As discussed, the government, through UKFI, sought to influence the remuneration and other management incentives. In principle there is nothing wrong with that. It makes perfect sense to align remuneration to the long-term value and the well-being of the bank. It also makes perfect sense to restrict potential rewards for failure. In fact, any ordinary shareholder may seek to do this. The problem is twofold. First, every year in the lead up to the annual bonus round, the media would be full of speculation about remuneration at the failed banks. It placed enormous pressure on the government to reduce the overall variable payments to a level at which the nationalised banks would arguably no longer remain competitive. The second part of the problem is that, as a consequence of the first, the perception is created, rightly or not, that the nationalised banks are a 'political football'. Highly skilled staff, who have a choice of which bank they work for, would not be attracted by the idea of working for such a bank. As a consequence, the nationalised banks struggle to attract the best staff they need to return them to public ownership.

Another area the government sought to influence was the lending policy. The nationalised banks were in a position where they needed to strengthen their capital position whilst at the same time reducing their balance sheet size. So the last thing these banks would want to do is to extend lending in the UK. This would weaken their capital position and increase their balance sheets, contrary to the banks' objectives. It was also directly contrary the objectives of the regulators, which sought to stabilise the banks and the UK financial system. In order to comply with the government's wishes, internationally active banks such as RBS were forced to sell a substantial part of their international operations. In doing so, the bank would reduce its balance sheet enough to allow it to increase domestic lending. In the case of Lloyds HBoS, the question is whether it was desirable in the first place to extend domestic lending, considering that the bank was already forced by the European Commission to sell part of its UK branches due to competition concerns. In the case of Northern Rock, its domestic growth had been so aggressive that its main objective was to return its lending practices to a manageable size. In other words, the government's desire to stimulate the UK economy by increasing lending by state-owned banks was often directly at odds with the banks' objectives and with the regulators' objectives.

Finally, it has to be noted that state-ownership has the potential to reduce competition. The absence of competition in the UK banking market is discussed in more detail in the next chapter. The conclusion therefore has to be, firstly, that the government did not manage its investments at arm's-length as it set out to do, and secondly, that the government's objectives for the banks was often detrimental to the banks' commercial and regulatory objectives. That said, it has to be pointed out that the government sought to address two points which are recurring themes in the research. The first is that, by interfering with pay at the nationalised banks, it sought to address the shortcomings in the banking culture, in its ethics. The second is that, by trying to stimulate the UK economy, it recognised the importance of banks to the general economy. It recognised the importance as the general public as a stakeholder in the banks. By way of its actions, the government was addressing some of the fundamental weakness of corporate governance at UK banks.

# Chapter 5 – Structural and Long Term Solutions

## 1. Introduction

The objective is to be able to formulate, at the end of this chapter, a substantial part of the answer to the second research question: what is the effect of new legislation and other initiatives on corporate governance at UK banks? Combining this analysis with that of the previous chapter, which analysed the emergency measures designed to deal with the failure of a UK bank, it is possible to draw some conclusions on how effective these combined new measures will be.

The failures of UK banks revealed weaknesses in their corporate governance. In chapter three, in which a number of case studies were examined, these weaknesses were identified: there were problems with culture, value and ethics; the boards were largely ineffective; and controls and risk management were ineffective. It was further demonstrated that the framework to deal with the failure of a bank was inadequate. Finally, it was noted that over the last decade, largely due to financial innovation and the growth in size of the banks, the minimum standard of what constitutes good corporate governance had gone up. In the previous chapter, the short term measures were examined. Because these measures focussed mainly on dealing with the failing banks and how to keep them operating, the other weaknesses were not addressed by them.

The structural and long term reforms should therefore seek to remedy the identified weaknesses in corporate governance of UK banks. The reforms are organised within the context of the weakness that they seek to address. However, before doing so, there is a short overview of the framework set out by international and EU responses. The international recommendations are a persuasive model of reform for the UK. There has been a large amount of reports by international groups analysing what had gone wrong and suggesting improvements, including those written by the Senior Supervisors Group,[1] the International Monetary Fund[2] and the Basel Committee.[3] The EU responses, in the form of regulations or directives, either apply directly in the UK or need to be transposed.

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[1] Senior Supervisors Group, 'Risk Management Lessons from the Global Banking Crisis of 2008' (21 October 2009) <http://www.financialstabilityboard.org/publications/r_0910a.pdf> accessed 14 November 2015

[2] International Monetary Fund, 'Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System' (April 2010) <http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf> accessed 14 November 2015

Recommendations by the reports from international organisations found their way in to the UK national reports. There were two important reports commissioned in the UK: the Walker Review[4] and the report by the Independent Commission on Banking.[5] This in itself is a problem of comparative law, as the legal transpositions of harmonised principles[6] may not address the weaknesses in the UK, reducing their effectiveness.[7] The second issue of comparative analysis in this chapter is that of direct comparative analysis, or how to compare different aspects of different legal systems.[8] Considering a wider context can help to overcome these issues.[9]

## 2. International Framework

### a. Response from the G20

The initial reports focussed broadly on two things: default prevention, in particular through the reduction of systemic risk, and the handling of an actual default. The reduction of systemic risk can be achieved in several ways. An important step has been to create more transparency in the derivatives market through the introduction of clearinghouses. Another important step, and more relevant to this research, has been the design of measures to improve the stability of systemically important financial institutions. With all these new measures, it is important to keep in mind that the risk one tries to reduce can be known, unknown or unknowable.[10] Note that, for example, Basel's economic capital and its minimum requirement is largely based upon known risks only.[11] This categorisation of risks will influence all answers to questions as: how safe should a financial institution be, or would it restrict financial intermediation and investment? How far should new regulation

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[3] Basel Committee on Banking Supervision, 'The Basel Committee's Response to the Financial Crisis: Report to the G20' (October 2010) <http://www.bis.org/publ/bcbs179.pdf> accessed 14 November 2015

[4] Sir David Walker, 'A Review of Corporate Governance in UK banks and other financial industry entities – Final Recommendations' (26 November 2009) <http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf> accessed 14 November 2015

[5] Independent Commission on Banking, 'Final Report – Recommendations' (September 2011) <http://www.ecgi.org/documents/icb_final_report_12sep2011.pdf> accessed 14 November 2015

[6] Loukas A. Mistelis, 'Regulatory Aspects: Globalization, Harmonization, Legal Transplants, and Law Reform – Some Fundamental Observations' (2000) 34 Int'l L 1055, 1056-1057

[7] Gunther Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergence' (1998) 61 Mod L Rev 11, 12; or Nicholas H.D. Foster, 'The Journal of Comparative Law: A New Scholarly Resource' (2006) 1 JCL 1, 8

[8] Nicholas H.D. Foster (n 7) 7

[9] Pierre Legrand, 'How to Compare Now' (1996) 16 Legal Stud 232, 236

[10] Richard J Herring, 'The Known, the Unknown, and the Unknowable in Financial Policy: An Application to the Subprime Crisis' (2009) 26 Yale J on Reg 391

[11] ibid 397

go in preventing a new crisis? And, ultimately, how can risk management and good corporate governance take into account the different types of risk, in particular the unknown risks?

Starting with the international responses, one of the first global responses came from the G20 leaders. It was very clear where the G20 thought the responsibility for the crisis lies:

> 'Major failures of regulation and supervision, plus reckless and irresponsible risk taking by banks and other financial institutions, created dangerous financial fragilities that contributed significantly to the current crisis'. [12]

Failures of corporate governance and risk management at the banks as well as failures with the regulators, acting as gatekeepers, have led to this crisis.

### b. Responses from the Senior Supervisors Group

The Senior Supervisors Group first published a report in March 2008 on the events of 2007,[13] which was later followed by a second report in October 2009 as a consequence of the continuing and deepening of the crisis.[14] The Senior Supervisors Group, which is composed of the financial regulators of Canada, France, Germany, Japan, Switzerland, the UK and the US, combines the opinion and expertise of some of the most powerful and most experienced financial supervisors worldwide. Their first report examines how different banks were responding to the financial crisis and what distinguishes those that are successful from those that are not. The Group identifies four key areas in which firm-wide risk management practices made a key difference to a bank's performance.[15] First, the successful banks had an effective firm-wide risk management system in place that could share valuable information throughout every level of the organisation, including the board and the Chief Risk Officer. Second, firms that had rigorous and independent valuation practices were better prepared to revalue and write down the complex credit structures that they had on their books. Third, the banks that did well had aligned their capital management, liquidity management and balance sheet management, thereby controlling their balance sheet rather than providing incentives to balloon it. Fourth, and last, banks

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[12] G20 Leaders, 'Leaders' Statement: The Pittsburgh Summit' (24-25 September 2009) <https://g20.org/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf> accessed 14 November 2015

[13] Senior Supervisors Group, 'Observations on Risk Management Practices during the Market Turbulence' (6 March 2008) <https://www.sec.gov/news/press/2008/report030608.pdf> accessed 14 November 2015

[14] Senior Supervisors Group (n 1)

[15] Senior Supervisors Group (n 13) 3

that did well overall had much better risk information systems, allowing management to critically assess their risk positions and change underlying assumptions. Better systems were often able to integrate their market risk, i.e. the risk of changing share prices, interest rates and exchange rates, with their counterparty risk, i.e. the risk of default of the counterparty. The differences between banks in these four key areas of risk management had most impact in three lines of business: in CDO structuring, warehousing and trading, in syndication of leveraged financing loans and in conduit and SIV business.[16] Engagement of senior management played an important role in how the bank fared so far. Banks where senior management was able to implement its balance between risk appetite and its desire to do business, where it could identify, understand and act upon risks and finally where there was a good flow of information throughout the structure aided by cross-disciplinary communication – these banks were much better able to withstand the crisis to date.[17]

The second report by the Senior Supervisors Group[18] adds to this by adding ten areas of continued improvement. One of these is that most boards are being adjusted to increase their strength and engagement in risk management.[19] This goes together with improving risk reporting to the board and integrating risk management throughout the bank. Having said that, the Senior Supervisors Group notes that it is generally unhappy with the board's monitoring of adherence to the bank's risk appetite. In fact, the risk appetite of the bank is often not well stated nor defined. Especially the remuneration policy was generally not aligned with the defined risk appetite, but often driven by a desire to attract and retain talented individuals.[20] Many of the other points refer to the inflexibility of the banks' IT systems and infrastructure. These have been found to be lacking the flexibility to adapt to an increase or change in demand for new types of risk to be measured, including stress-testing and counterparty risk measures.

### c. The Basel Committee

#### *i. Response to the G20*

The Basel Committee wrote the leading Basel II report, which advocated the structure of three pillars: minimum capital requirements, supervisory review process and market discipline, as was discussed in more detail in chapter two. Not surprisingly, in the aftermath of the crisis, the Committee drew up a program of reform of the banking sector addressing

[16] ibid 5
[17] ibid 7
[18] Senior Supervisors Group (n 1)
[19] ibid 22
[20] ibid 24

the issues raised by the G20. The Committee describes the objective for reform following the crisis as 'to better protect consumers, depositors and investors'.[21] In its report to the G20 the Committee outlined key elements to improve the resilience of the banks and the global banking system.[22] These elements can be divided into micro-level or firm-level improvements and macro-level or global improvements.

On a firm-level, the committee looked at capital, liquidity, risk management and market discipline.[23] This segmented approach corresponds closely with the three pillar approach of Basel II. Several different improvements to capital were suggested. Firstly, the definition of tier 1 and tier 2 capital, which represents the different quality levels of capital that a bank can hold, was improved. A greater emphasis was placed on common equity, which is regarded as the highest quality of capital. Secondly, the risk that this capital needs to cover was extended to include those risks that were not appropriately covered previously. For example, during the crisis no capital had to be held for complex derivative transactions that the trading arm of the bank was engaged in. As a result, capital requirements for the trading book are introduced, including measures to cover the risk that a counterparty in such a complex transaction would fail. Furthermore, the overall level of capital required was increased by raising the minimum percentage levels of capital that a bank must hold. Lastly, measures were proposed to restrain the leverage one could take based on capital. Apart from new restrictions on capital, controls on the liquidity of the banks was introduced. During the crisis it was not merely capital that was inadequate but, with funding drying up, liquidity proved a major problem for banks as well. The committee proposed a liquidity ratio, which can be used to measure the bank's resilience to a temporary disruption in the funding market.

In relation to the second pillar of the three pillar approach, namely supervisory review, the Committee conducted a review in the following areas to address any weaknesses revealed in the banks' risk management systems:

- 'Firm-wide governance and risk management,
- Capturing the risk of off-balance sheet exposures and securitisation activities,
- Managing risk concentrations,
- Providing incentives for banks to better manage risk and returns over the long term, and

[21] Basel Committee on Banking Supervision (n 3)
[22] ibid
[23] ibid 4

- Sound compensation practices'.[24]

This resulted in several separate reports, such as the report on sound compensation practice[25] and the report on enhancing corporate governance of banks.[26] The points listed here represent a recurring theme throughout most of the reports that were written by other organisations.

In relation to the third of the three pillars, market discipline, the Committee concluded that the disclosure provided by the banks, both of the risk and of the capital base, was inadequate. Due to the extensive use of off-balance sheet instruments and securitisation, the reporting on risk and capital was insufficient and inadequate; the committee has proposed new guidelines to cover these aspects. Furthermore, an increased disclosure of remuneration practice, already mentioned as part of the second pillar, has been proposed. The question here is whose remuneration to disclose and to whom; remuneration will be discussed in more detail later on.

On a macro-level, the two main concerns raised by the committee are procyclicality, or the increase in risk as the economy grows, and systemic risk, or the risk arising from interconnectedness of markets and its participants. Procyclicality is countered by restraining the leverage in a situation where credit is cheap via the leverage ratio. At the same time, the capital ratios will be strengthened during a good period to provide a buffer during subsequent bad years. A special countercyclical capital buffer is introduced for this purpose.[27] Finally, as not to overstate the profit on loans during good times, which later have to be adjusted to a loss in a downturn, additional loan loss provisions are proposed. These measures are aimed at the procyclical amplification of shocks over time. At the same time, it is necessary to recognise the systemic risk in system, namely that through the interconnectedness of the banks such a shock would rapidly spread and affect many banks at the same time. To reduce systemic risk, the Committee proposed an overhaul of the over-the-counter derivative markets, extra capital requirements for inter-financial exposure and limitations to overreliance on short-term interbank funding.[28] Dealing with the actual default of a bank remains a difficult problem. One suggestion is to have

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[24] ibid 6
[25] Basel Committee on Banking Supervision, 'Pillar 3 Disclosure Requirements for Remuneration' (July 2011) <http://www.bis.org/publ/bcbs197.pdf> accessed 14 November 2015
[26] Basel Committee on Banking Supervision, 'Principles for Enhancing Corporate Governance' (October 2010) <http://www.bis.org/publ/bcbs176.pdf> accessed 14 November 2015
[27] Basel Committee on Banking Supervision (n 3) 9
[28] ibid 10

contingent capital, which allows capital instruments to be written off or converted to common shares.[29] Further difficulties that remain unresolved arise in the failure of a cross-border bank, highlighted by the differences in intervention tools for an orderly resolution during the recent crisis.

### *ii. Basel III*

If you ask a bank employee, he or she may say that the Basel III report is the single most important report produced in the wake of the crisis. Although that statement certainly holds true from a regulatory perspective and indeed it may present the banks with a great amount of work in the coming years to implement it in full – it may not necessarily be the most important report from a corporate governance perspective. Especially if one regards corporate governance as merely 'a system by which companies are directed and controlled'.[30] However, the proposals will have an impact on shareholders as the amount of capital that is required to undertake the same banking activities will be higher. This can only have a negative effect on the return on equity; hopefully the risks will be lower as well.

Basel III consists of two documents, the first discussing the framework to manage liquidity risk[31] and the second to outline a global regulatory framework.[32] Many of the proposals contain further detailed implementations of the initial response made to the G20 discussed previously.[33] The emphasis is on strengthening capital and liquidity requirements to improve the resilience in the banking sector. Basel III requires banks to improve the quality of capital; in particular tier 1 capital, the highest quality of capital, as well as to increase the risk that capital needs to cover and to increase the capital requirement ratio itself. Increasing capital ratios includes increasing the level tier 1 capital hold against risk weighted assets ("RWAs") to 4.5% and the building up of both a conservation buffer and a countercyclical buffer. These capital ratios are complemented by a new leverage ratio. To

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[29] Ibid 10

[30] Sir Adrian Cadbury, *Report on the Committee on the Financial Aspects of Corporate Governance* (London, Gee&Co, 1992) <http://www.icaew.com/~/media/corporate/files/library/subjects/corporate%20governance/financial%20aspects%20of%20corporate%20governance.ashx> accessed 14 November 2015, at paragraph 2.5

[31] Basel Committee on Banking Supervision, 'Basel III: International Framework for Liquidity Risk Management, Standards and Monitoring' (Dec 2011) <http://www.bis.org/publ/bcbs188.pdf> accessed 14 November 2015

[32] Basel Committee on Banking Supervision, 'Basel III: A Global Regulatory Framework for More Resilient Banks and Banking System' (June 2011) <http://www.bis.org/publ/bcbs189.pdf> accessed 14 November 2015

[33] ibid

protect liquidity, something that proved disastrous during the crisis, two new ratios are introduced: the liquidity coverage ratio and the net stable funding ratio. A timeline has been drawn up for the introduction of these new or amended ratios. As stated before, most of these proposals are a more detailed implementation of the previously discussed recommendations to the G20. The amount of work that these new measures bring for banks is enormous as they require coordination between very different parts of the organisation, infrastructure, process and technology.

All these combined individual measures show an underlying trend towards a much stronger and more integrated form of risk management. The bringing together of the different parts of the organisation is crucial in forming this newly integrated risk management. Compared with Basel II, the conclusion can be that, at the very least, the level of risk management that is required is significantly raised. The integration, or further integration, of a stronger risk management into the 'system by which companies are directed and controlled' can be identified as a unifying objective of all the measures outlined in Basel III and as its biggest influence on corporate governance of banks. This in itself should not be surprising, as risk management is often seen as such a specific element of corporate governance for banks,[34] as discussed in chapter two. The fact that risk management is an element of corporate governance for any company is amongst others acknowledged through the UK Corporate Governance Code[35] and by the Financial Reporting Council,[36] as discussed in chapter two.

### *iii. Corporate Governance of Banks*

The Committee has previously published reports specifically on corporate governance of banks, both in 1999[37] and a short period before the crisis in 2006.[38] Both reports appeared shortly after the OECD had published their updated reports on corporate governance, also

[34] Gottfried Wohlmannstetter, 'Corporate Governance von Banken', in Klaus J Hopt and Gottfried Wohlmannstetter (eds), *Handbuch Corporate Governance von Banken* (Verlag 2011) 67-69

[35] Financial Reporting Council, 'Internal Control: Revised Guidance for Directors on the Combined Code' (2005) <https://www.frc.org.uk/getattachment/5e4d12e4-a94f-4186-9d6f-19e17aeb5351/Turnbull-guidance-October-2005.aspx> accessed 14 November 2015, 7

[36] Financial Reporting Council, 'Boards and Risk: a Summary of Discussions with Companies, Investors and Advisers' (2011) <https://www.frc.org.uk/FRC-Documents/FRC/Boards-and-Risk-A-Summary-of-Discussions-with-Comp.aspx> accessed 14 November 2015, 2

[37] The Basel Committee on Banking Supervision, 'Enhancing Corporate Governance for Banking Organisations' (September 1999) <http://www.bis.org/publ/bcbs56.pdf> accessed 14 November 2015

[38] The Basel Committee on Banking Supervision, 'Enhancing Corporate Governance for Banking Organisations' (February 2006) <http://www.bis.org/publ/bcbs122.pdf> accessed 14 November 2015

in 1999[39] and 2004.[40] Following the crisis, and taking into account various other reports that have been published since, including those by the Senior Supervisors Group on risk management during[41] and after the crisis,[42] discussed previously, and by the OECD,[43] the committee has updated its report on corporate governance of banks in October 2010[44] and again in July 2015.[45] For this research, the October 2010 version is the most relevant as it contains the direct responses to the financial crisis. Given the importance of the committee, this report is a very significant aid in answering the research questions. Among some of the failures of corporate governance of banks, the Committee mentions explicitly and upfront

> 'insufficient board oversight of senior management, inadequate risk management and unduly complex or opaque organisational structures and activities'.[46]

The committee highlighted six areas in which it believes the greatest focus for improvement must be:

1. 'Board Practices,
2. Senior Management,
3. Risk Management and Internal Controls,
4. Compensation,
5. Complex or Opaque Structures, and
6. Disclosure and Transparency'.[47]

The committee identifies fourteen basic principles that together represent important elements of an effective corporate governance development process for banks. These principles address the areas listed above where the Committee believes the focus for improvement should be. Note that in the latest version of July 2015, the first eleven principles are at some points slightly reworded but remain in essence very much the same.

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[39] OECD, 'OECD Principles on Corporate Governance' (April 1999) <http://www.ecgi.org/codes/code.php?code_id=89> accessed 14 November 2015
[40] OECD, 'OECD Principles on Corporate Governance' (April 2004) <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf> accessed 14 November 2015
[41] Senior Supervisors Group (n 13)
[42] Senior Supervisors Group (n 1)
[43] OECD, 'Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles' (February 2010) <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/44679170.pdf> accessed 14 November 2015
[44] The Basel Committee on Banking Supervision (n 26)
[45] Basel Committee on Banking Supervision, 'Guidelines: Corporate Governance Principles for Banks' (July 2015) <http://www.bis.org/bcbs/publ/d328.pdf> accessed 14 November 2015
[46] The Basel Committee on Banking Supervision (n 26) 2
[47] ibid 2-4

Because the Committee is one of the most influential organisations worldwide shaping financial regulation, it is worth going through each of the fourteen principles in some detail: they are likely to shape the debate on corporate governance of banks for the coming years. Rather than discussing each principle in turn here, they are discussed in the following sections where they are placed in the context of the weaknesses they seek to address. Some of them relate to board effectiveness, whilst others relate to culture and remuneration. Each principle is thus matched, as best as possible, to the corresponding weaknesses in corporate governance at UK banks.

### *iv. The Role of the Financial Regulator in Corporate Governance*

There is one principle, however, which merits separate discussion. The July 2015 version of the principles of corporate governance adds a new principle, Principle 13 in its new counting system, which includes the role of supervisors in corporate governance at banks.

> 'Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors'.[48]

This is quite a novel point. It means that, although the board and senior management are primarily responsible for the governance of the bank, the supervisors should assess their performance in this context. Some of the details include that

> 'Supervisors should evaluate whether the board and senior management have processes in place for the oversight of the bank's strategic objectives, including risk appetite, financial performance, capital adequacy, capital planning, liquidity, risk profile and risk culture, controls, compensation practices, and the selection and evaluation of management. Supervisors should focus particular attention on the oversight of the risk management, compliance and internal audit functions'.[49]

This greatly expands the role of the supervisor. No longer should the supervisor focus only on the capital and liquidity position of the bank. Under these guidelines, the supervisor becomes responsible for supervising the entire internal processes at the bank as well as areas such as culture and compensation. The supervisor should also get increased powers over the composition of the board and senior management:

> 'Supervisors should evaluate the processes and criteria used by banks in the selection of board members and senior management and, as they

[48] Basel Committee on Banking Supervision (n 45) 38
[49] ibid 38

> judge necessary, obtain information about the expertise and character of board members and senior management. … The individual and collective suitability of board members and senior management should be subject to ongoing attention by supervisors'.[50]

It is not merely the suitability and expertise that the supervisor should look at. The supervisor should also have regard for the culture that is emanated from the top throughout the bank.

> 'As part of their evaluation of the overall corporate governance in a bank, supervisors should also endeavour to assess the governance effectiveness of the board and senior management, especially with respect to the risk culture of the bank'.[51]

Overall, the implication of this last principle is that the supervisor, in other words the regulator, should become the guardian of all elements of good corporate governance at the banks.

### d. Other Jurisdictions

In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act 2009, or the Dodd-Frank Act in short, was the most comprehensive piece of legislation to be passed as a direct response to the financial crisis. It covers, amongst others: the supervision of financial institutions; a new resolution procedure for large financial companies; more stringent rules on banking capital; the creation of a new agency for enforcing consumer financial laws; the Volcker rule; regulation of over-the-counter derivatives; and so on. It is beyond the scope of this research project to examine this lengthy act in full. Instead, the say-on-pay provisions are examined as they are the main provisions described relating directly to corporate governance. Companies will be required to ask their shareholders to approve, albeit in a non-binding vote, the compensation package for their executive officers. This may include, under circumstances such as a merger, a say on any golden parachutes. The compensation committee must meet enhanced independent standards as already apply for the audit committee. A greater disclosure will be required on executive pay, in particular in relation to the financial performance of the company.

The EU has implemented a range of regulations and directives in response to the crisis.[52] Some of this, such as the BRRD for recovery and resolution and the FSCS have been

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[50] ibid 38
[51] ibid 39
[52] Paulina Dejmek, 'The EU Internal Market for Financial Services – a Look at the First Regulatory Responses to the Financial Crisis and a View to the Future' (2009) 15 Colum J Eur L 456

discussed in chapter four. The Credit Requirement Directive IV[53] ("CRD IV"), which goes together with the Credit Requirements Regulation[54] ("CRR"), are the implementation into EU legislation of Basel III. These include the new major prudential requirements in relation to the capital that institutions are required to hold. Where the CRR is directly applicable, CRD IV has been transposed by the PRA and the FCA into their respective handbooks for their respective firms. For the Eurozone countries, the main responsibility lies with the European Central Bank ("ECB"). The European Supervisory Bodies, such as the European Banking Authority ("EBA"), are under certain articles tasked with drafting delegated legislation. This often involves drafting the relevant technical standards to support some of the articles. CRD IV and the CRR came into force on 1 January, 2014, although full compliance with Basel III is not a requirement until 1 January, 2019. The difference between CRD IV and the CRR is that the CRR focusses on the prudential requirements for capital, liquidity and leverage. On the other hand, CRD IV looks at deposit taking activities, but also at topics such as remuneration, board composition and transparency.

Apart from technical differences and more detailed specifications of the capital requirements, the main difference between CRD IV and Basel III is that CRD IV sets restrictions on the remuneration. There will be a basic ratio of fixed and variable pay of one on one. Subject to shareholder approval, this can be increased to one on two. Those within scope would include senior management, risk takers, staff engaged in control functions or anyone else whose remuneration is of such a level that they should be in those categories. There are some more technical requirements around it, however, it is fair to say that anyone who has worked in an investment bank in London for over five years is likely to be caught under this definition. Any of the variable remuneration is further subject to a clawback. Of the variable remuneration, at least fifty percent must consist of shares or equivalent ownership interests, whilst at least forty percent of the payment must be deferred. These are requirements that go well beyond what was agreed within Basel III. They are a reflection of the public opinion within the wider EU on bankers pay during the

[53] Council Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC OJ L 176/338, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:EN:PDF> accessed 14 November 2015

[54] Council Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 OJ L176/1 available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF> accessed 14 November 2015

crisis. Arguably, they have the potential of affecting London, which has by far the largest financial centre in Europe, the most.

## 3. Changing the Culture

### a. Background

One of the major weaknesses in corporate governance at UK banks is the culture within the banks. In particular, there is an emphasis on growth and profit over risk management and the interests of external stakeholders. This is evidenced in chapter three by a large number of scandals, such as the LIBOR manipulation and the PPI mis-selling, as well as the problems at Barclays and the Co-operative Bank. This section contains an overview of the recommendations made to address these and of the actual measures taken. These include: restrictions on remuneration; increase in competition; restructuring the financial regulator to increase focus on conduct; and specific measures to address the manipulation of benchmarks such as LIBOR.

### b. Basel Committee on Corporate Governance

The Basel Committee defined, as discussed previously, various principles of good corporate governance. Two are related to culture as they seek to provide guidance on the remuneration practices and their alignment with the bank's risk appetite.

> 'Principle 10: The board should actively oversee the compensation system's design and operation, and should monitor and review the compensation system to ensure that it operates as intended'.[55]
>
> 'Principle 11: An employee's compensation should be effectively aligned with prudent risk taking: compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment'.[56]

The Senior Supervisors Group named remuneration as a prime example of an area where the risk appetite of an organisation determined by the board was largely ignored in practice.[57] Remuneration in banks is an area of much controversy and media attention. In a separate report, the commission argues for more transparency and disclosure on

[55] Basel Committee on Banking Supervision (n 45) 25
[56] ibid 26
[57] Senior Supervisors Group (n 1) 24

remuneration practices.[58] It can also be traced back to principles of fairness and integrity within an organisation as outlined by Cadbury. The point here is that bringing in staff from another organisation with the agreement of a large guaranteed bonus may not only be contrary the risk appetite of the organisation, it may also cause grievance with existing members of staff.

It should be recognised that some of these points are not new. The FSA had previously made an effort to improve the connection between risk and rewards. It had done so via its handbook, in particular by way of SYSC 19. The aim was to try and make the remuneration risk neutral. This part of the handbook has now been updated following the implementation of EU legislation.[59] It should further be noted that the UK government in fact resisted the EU regulation on bankers' remuneration: it sought to challenge it through the court only to abandon it when the adviser to the European Court of Justice rejected its arguments.[60]

### c. The Walker Review

#### *i. Background, Mandate and Scope*

The Walker Review took place in the UK immediately after the financial crisis, ordered by the then Labour government. It contains some recommendations as regards remuneration, which are discussed here. The terms of reference for the review were

> 'To examine corporate governance in the UK banking industry and make recommendations, including the following areas: the effectiveness of risk management at board level, … the balance of skills, experience and independence required on the boards of UK banking institutions; the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees; the role of institutional shareholders in engaging effectively with the companies and monitoring the boards; and whether the UK approach is consistent with international practice and how national and international practice can be promulgated'.[61]

It is a mandate covering the basic elements of corporate governance for banks. The final report makes various recommendations in various areas: the role and constitution of the board, the board composition and education, the role of shareholders, risk management,

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[58] Basel Committee on Banking Supervision, 'Pillar 3 Disclosure Requirements for Remuneration' (July 2011) <http://www.bis.org/publ/bcbs197.pdf> accessed 14 November 2015
[59] Financial Conduct Authority 'IFPRU Remuneration Code (SYSC 19A)' (2016) <https://www.the-fca.org.uk/firms/remuneration/ifpru-remuneration-code-sysc-19a> accessed 4 July 2016
[60] BBC, 'Osborne abandons challenge to EU cap on bankers' bonuses' (20 Nov 2014) <http://www.bbc.co.uk/news/business-30125780> accessed 4 July 2016
[61] Sir David Walker (n 4) 5

and finally remuneration. Perhaps not surprisingly, the Review is on several points in line with the previously discussed report on improvements to corporate governance by the Basel Committee[62] but applied specifically to the UK situation.

### *ii. Remuneration*

Remuneration has already been discussed in the context of principles 10 and 11 of the Basel Committee[63] and in relation to the discrepancy between remuneration and banks' risk appetite observed by the Senior Supervisors Group.[64] The Walker Review takes a slightly different approach and bases its assessment of remuneration largely on a report by the Financial Services Authority called the Remuneration Code 2009.[65] The Financial Services Authority has updated the Remuneration Code[66] to reflect the Capital Requirements Directive EU CRD3, the Financial Services Act 2010 and the Walker Review itself. The objectives of the Remuneration Code 2009 are to

> '… sustain market confidence and promote financial stability through removing the incentives for inappropriate risk taking by firms, and thereby to protect consumers'.[67]

Although the Remuneration Code recognises that remuneration practices were not the dominant factor in the crisis, it states that it has certainly contributed. It is hoped that the proposed changes will not just help to avoid future crisis, it is especially hoped, despite recognising that it will not change the 'bonus culture' overnight, that it will bring about a change in attitude and behaviour with employees and management. It is noted as especially important, if not immediately obvious already, that the remuneration policy and practice is consistent with and promotes effective risk management; this was highlighted in previous recommendations concerning remuneration. It is perhaps a shortcoming of the Walker Review that it does not consider culture in light broader than remuneration. As will be discussed in the following sections, there are other elements of culture than are important to protect consumers. Some of these include acting with due care and integrity, creating accountability, promoting competition, and treating customers fairly. It could be

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[62] Basel Committee on Banking Supervision (n 45)
[63] ibid
[64] Senior Supervisors Group (n 1)
[65] Financial Services Authority, 'Reforming Remuneration Practices in Financial Services: Feedback on CP09/1 and Final Rules' (August 2010) <http://hb.betterregulation.com/external/fs09_05.pdf> accessed 14 November 2015
[66] Financial Services Authority, 'Revising the Remuneration Code: Feedback on CP10/19 and the Final Rules' (December 2010) <http://www.fsa.gov.uk/pubs/policy/ps10_20.pdf> accessed 14 November 2015
[67] Financial Services Authority (n 63) 6

said that this would go beyond the scope defined in its terms of reference, however, when considering that customers are an important stakeholder in the banks, it does not.

#### *iii. Amending Legislation*

The review points out that much of the governance of remuneration is already arranged through the Companies Act 2006, for example, s420-422 provide reporting details on directors' pay and s215-217 provide details on severance packages for directors. There is a category of what is called "high end" employees within financial institutions, perhaps more prominent than in any other industry, who earn more than the median of the board, often have a function of significant influence and who could materially impact on the risk profile of the entire bank.[68] The Board Remuneration Committee should also have oversight over the remuneration policy for these "high end" employees. It should look at their performance objectives as well as any risk adjustments. Some form of disclosure on pay of these employees should also be required, without necessarily identifying them.

The most important risk adjustment that can be made to align risk and reward is to defer pay until a later date. The review, in line with the remuneration code, recommends the deferral of a significant amount of pay for three or even up to five years.[69] It should also be possible to claw back these rewards in case of, for example, misstatement or misconduct. Note that the Walker Review, as a UK report, can actually recommend how regulation concerning remuneration should be implemented as it advises within a national framework of legislation and regulation and within a national culture and context; the international reports could merely observe that a change was needed.

### d. Independent Commission on Banking

The Independent Commission on Banking, which was established by the UK government in June 2010 and was chaired by Sir John Vickers, wrote a report to consider

> '… structural and related non-structural reforms to the UK banking sector to promote financial stability and competition'.[70]

The recommendations have three aims: to reduce the probability and impact of systemic financial crises in the future; to maintain the efficient flow of credit to the real economy; and to preserve the functioning of the payment system and guaranteed capital certainty for

[68] Sir David Walker (n 4) 109
[69] ibid 117
[70] Independent Commission on Banking (n 5) 19

small savers and small businesses.[71] The report is broadly divided in two parts: the first part concerns financial stability whilst the second part concerns competition. This section on culture considers the latter part, because increased competition would strengthen the position of the external stakeholders. It would ensure that banks focus on providing value for money, reducing the chance of mis-selling.

The ICB thus sets out its recommendations to improve the competition issues in the UK retail market. A few large banks dominate this market. Suggestions are made to make it easier to switch account and to ensure that some of the large banks make divestments. It examines how entry barriers can be responsibly lowered for new market entrants. The question here is whether improved competition and an easier process to switch banks will actually lead to more people switching banks. Even if this process becomes more straightforward, it may still be perceived to be difficult. It may also be that there is little appetite to switch banks as the perception is that there is little difference between products and services. The recommendations made by the report may make the process easier, but do not appear to address the underlying causes of the inertia, of the reluctance of people to change accounts. Perhaps such causes should be sought more in the field of behavioural economics. Of course, these arguments should not stop banks from being more competitive or offering better products.

### e. Reforming the Financial Regulator

As some of the responsibility of the crisis is attributed to the gatekeepers, regulatory reform is taking place. On a global level, there is the creation of the Financial Stability Board to facilitate cooperation and to oversee global financial stability.[72] Although this is not a regulator in itself, it does report regularly on worldwide improvement and reform on transparency, remuneration and related issues. Various institutes have been set up at EU level to facilitate regulation with the EU, such as the European Systemic Risk Board.

The Financial Services Act 2010 contains provisions on the following: new objectives of the FSA in ss1-3; the remuneration of executives and of authorised persons in ss4-6; recovery and resolution plans in s7; short-selling in s8; the FSA's disciplinary powers in ss9-13; measures to protect consumers in ss14, 15; the Financial Services Compensation Scheme in ss16, 17; powers to require information in ss18, 19; and a few other smaller items in the

[71] ibid 20

[72] Financial Stability Forum, 'Press Release – Financial Stability Forum Re-established as the Financial Stability Board' (2009) <http://www.financialstabilityboard.org/wp-content/uploads/pr_091107.pdf> accessed 14 November 2015

remaining ss20-27. The main purpose of the Act was to strengthen the position and powers of the FSA to act in response to weaknesses revealed by the global financial crisis. As an example, sections 1 and 2 extend the objectives of the FSA to include financial stability and enhancing public education on the working of financial markets. Under sections 9 to 13, the FSA is granted new disciplinary powers, including increased powers of suspension and fining authorised persons. Section 7 further provides that authorised persons must make a so called living will, meaning a plan for what to do when they are suddenly no longer there. Finally, under section 8, the FSA can prohibit or require disclosure of short-selling.

The working of the Financial Services Authority has initially been reviewed in the Turner Review.[73] However, shortly after publication of this report a government, which had campaigned to return regulatory powers to the Bank of England, was installed.[74] This agenda has been pursued and, through an amendment of the Financial Services and Markets Act 2000, three new institutions are established under the Bank of England.[75] Hence where the Financial Services Act 2010 provided some change in powers of the financial regulator, the FSA, the Financial Services Act 2012 completely change the regulatory landscape in the UK. The three new entities are: the Financial Policy Committee with responsibility for macro-prudential regulation; the Prudential Regulation Authority with responsibility for firm-specific regulation; and thirdly the Financial Conduct Authority, which will put consumer interest at the centre of regulation.

The Bank of England holds the overall responsibility for financial stability. The PRA is a subsidiary of the Bank of England tasked with the prudential regulation of deposit takes, insurers and major investment firms. As the name suggests, the FCA is regulates conduct but is also responsible for the prudential regulation of those organisations not covered by the PRA. The naming of the PRA and FCA is therefore confusing, as the FCA is only a conduct regulator for dual-regulated firms, and both conduct and prudential supervisor for solo-regulated firms. The question for our research is whether the formation of these new gatekeepers will improve banking corporate governance. The most likely candidate to

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[73] Financial Services Authority, 'The Turner Review: A Regulatory Response to the Global Financial Crisis' (March 2009) <http://www.fsa.gov.uk/pubs/other/turner_review.pdf> accessed 14 November 2015

[74] Conservative Party, 'Invitation to Join the Government of Britain: The Conservative Manifesto 2010' (2010) <https://www.conservatives.com/~/media/files/activist%20centre/press%20and%20policy/manifestos/manifesto2010> accessed 14 November 2015

[75] HM Treasury,' A New Approach To Financial Regulation: Building a Stronger System' (February 2011) <http://www.hm-treasury.gov.uk/d/consult_newfinancial_regulation170211.pdf> accessed 14 November 2015

stimulate improvements is the Financial Conduct Authority, which could aid strengthening the position of consumers as stakeholders – although the Financial Services Authority already made a point of improving awareness of its existence amongst consumers.[76]

With the reform of the regulators also comes the updating of the handbooks. These changes contain the implementation of ethical standards. In particular, within the FCA handbook, are the Principles for Businesses (PRIN).[77] These principles state, amongst others, that a regulated firm must conduct its business with integrity and with due skill, care and diligence. It also states that it must have regard for customers and treat them fairly. Similar principles are defined for approved persons in the corresponding section (APER).[78] The section on Senior management arrangements, Systems and Controls (SYSC) was discussed earlier as it contains the arrangements for remunerations (SYSC 19).[79] The PRA has a set of fundamental principles, which are slightly different from the FCA's principles, although they both feature integrity and due skill, care and diligence.[80] All of these additions or updates to the regulatory handbook give in particular the FCA some ways of enforcing ethical standards. It should be noted that, separately, the Banking Standards Board, an industry body without statutory powers, was set up with the aim to issue ethical guidance and standards. However, given the difficulty of doing so, it had not issued any nine months after coming into existence.[81] The first annual review instead looks at themes, explaining that 'good' and 'bad' cultures are hard to define and that no single template exists.[82]

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[76] Financial Services Authority, 'Consumer Awareness of the FSA and Financial Regulation – 2010 Report' (2010) <http://www.fsa.gov.uk/pubs/consumer-research/crpr83.pdf> accessed 14 November 2015

[77] Financial Conduct Authority, 'Principles for Businesses' (2016) <https://www.handbook.fca.org.uk/handbook/PRIN.pdf> accessed 4 July 2016

[78] Financial Conduct Authority, 'Statements of Principle and Code of Practice for Approved Persons' (June 2016) <https://www.handbook.fca.org.uk/handbook/APER.pdf> accessed 4 July 2016

[79] Financial Conduct Authority, 'Senior management arrangements, Systems and Controls' (June 2016) <https://www.handbook.fca.org.uk/handbook/SYSC.pdf> accessed 4 July 2016

[80] Prudential Regulation Authority, 'Fundamental Rules and Principles for Businesses' (Jan 2016) <http://www.bankofengland.co.uk/pra/Documents/authorisations/newfirmauths/fundamentalrulesprinciples.pdf> accessed 4 July 2016

[81] Jill Treanor, 'Banking Standards Board yet to outline any banking standards' (18 January 2016) <https://www.theguardian.com/business/2016/jan/18/banking-standards-boards-fails-outline-standards> accessed 4 July 2016

[82] Banking Standards Board, 'Annual Review 2015/2016' (2016) <http://www.bankingstandardsboard.org.uk/wp-content/uploads/2016/03/BSB-Annual-Review-20152016.pdf> accessed 4 July 2016

### f. Benchmarks

In the wake of the LIBOR scandals, the Financial Services Act 2012 contains provisions on misleading statements, misleading provisions and specifically misleading statements etc. in relation to benchmarks. Section 91(1) provides

> 'A person ("A") who makes to another person ("B") a false or misleading statement commits an offence if—
>
> (a) A makes the statement in the course of arrangements for the setting of a relevant benchmark,
>
> (b) A intends that the statement should be used by B for the purpose of the setting of a relevant benchmark, and
>
> (c) A knows that the statement is false or misleading or is reckless as to whether it is.'

This follows the findings that traders frequently promised all sorts of things to their colleagues that were tasked with the actual LIBOR rate submission. Likewise, traders who deceived their rate setting colleagues by amending their own prices of assets would now fall under section 91(2)

> A person ("C") who does any act or engages in any course of conduct which creates a false or misleading impression as to the price or value of any investment or as to the interest rate appropriate to any transaction commits an offence if—
>
> (a) C intends to create the impression,
>
> (b) the impression may affect the setting of a relevant benchmark,
>
> (c) C knows that the impression is false or misleading or is reckless as to whether it is, and
>
> (d) C knows that the impression may affect the setting of a relevant benchmark.

It is important to note that section 91(3) provides a justification for such actions as it may occur in a future financial crisis

> In proceedings for an offence under subsection (1), it is a defence for the person charged ("D") to show that the statement was made in conformity with—
>
> (a) price stabilising rules,
>
> (b) control of information rules, or
>
> (c) the relevant provisions of Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European

> Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments.

The purpose of these provisions is both to give the regulators the most convenient tools for these situations as well as an attempt to clean up and re-establish public trust in the banking sector.

## 4. Increasing Board Effectiveness

### a. Background

The failures examined in chapter three have demonstrated clear weakness at board level. In the cases of RBS and Barclays, the board did not and could not challenge a dominant CEO sufficiently. The rapid expansion at Northern Rock and at HBoS was not challenged by the board. Generally, the boards lacked experience in banking and could thus not provide adequate oversight and challenge. It further allowed a culture to be established within the banks placing growth and profit before anything else. Especially the case study of the Co-operate Bank provided a persuasive argument for increasing board effectiveness. This sections sets out the most important responses and measures taken to address these weaknesses.

### b. Basel Committee on Corporate Governance

The majority of the principles on corporate governance set out by the Basel Committee relate to board effectiveness. It starts with the first principle, which is almost an overriding general objective of what the board's responsibility is.

> 'Principle 1: The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The board is also responsible for providing oversight of senior management'.[83]

This goes back to Cadbury who states that the 'Boards of directors are responsible for the governance of their companies',[84] as discussed in chapter two. The risk management function at board level has again been highlighted as important. The oversight of senior management is explicitly mentioned here, presumably as a consequence of the failure of board members to challenge senior executives at several banks.

> 'Principle 2: Board members should be and remain qualified, including through training, for their positions. They should have a clear

[83] ibid 7
[84] Sir Adrian Cadbury (n 30) 2.5

> understanding of their role in corporate governance and be able to exercise sound and objective judgement about the affairs of the bank'.[85]

This point highlights the importance of the education of the directors. Directors above all should be knowledgeable on banking and finance: general commercial skills and experience may be sufficient in other organisations, but banks require specialist knowledge. As with the first principle, this conclusion has presumably been drawn by lessons from failed banks. The Senior Supervisors Group noted that boards are already trying to expand their knowledge base and financial expertise as a response to the crisis.[86]

> 'Principle 3: The board should define appropriate governance practices for its own work and have in place the means to ensure that such practices are followed and periodically reviewed for ongoing improvement'.[87]

> 'Principle 4: In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risk of the group and its entities'.[88]

These go back to principles discussed in chapter two. The two principles specifically go back to Cadbury: elements of a successful system of corporate governance include openness, integrity and accountability. Integrity and accountability are aided by the internal information and control systems as set out in the Turnbull Guidance and internationally by the IMF and OECD. Both the quality and the integrity of the information are crucial for transparency and accountability.

> 'Principle 5: Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board'.[89]

This principle may sound obvious but it is not by any means. The Senior Supervisors Group expressed its dissatisfaction with the lack of consistency between the risk appetite defined by the board and that implemented at lower levels.[90] The fact that the board may agree on a risk appetite and strategy may be one thing, but overseeing that this is implemented and adhered to throughout the entire bank is an entirely different matter. It requires clear lines of communication and information both from the board into the business but also the

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[85] ibid 10
[86] Senior Supervisors Group (n 1) 22
[87] ibid 11
[88] ibid 15
[89] ibid 16
[90] Senior Supervisors Group (n 1) 24

other way; this is outlined in the next principles. But it also requires that other important issues, such as remuneration, adequately reflect the risk appetite that the board is willing to take; this is outlined in later principles.

> 'Principle 6: Banks should have an effective internal controls system and a risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board'.[91]
>
> 'Principle 7: Risks should be identified and monitored on an ongoing firm-wide and individual entity basis, and the sophistication of the bank's risk management and internal control infrastructures should keep pace with any changes to the bank's risk profile (including its growth), and to the external landscape'.[92]
>
> 'Principle 8: Effective risk management requires robust internal communication within the bank about risk, both across the organisation and through reporting to the board and senior management'.[93]
>
> 'Principle 9: The board and senior management should effectively utilise the work conducted by internal audit functions, external auditors and internal control functions'.[94]

Principles 6, 7, 8 and 9 build upon principles 3 and 4 providing further detail on the internal controls and systems. In these principles, it is emphasised that especially the information on the bank's risks must be accurate and of high integrity. But these systems need to be flexible so that in a time of rapidly changing markets they can quickly be adapted to the new situation. Keeping these large information structures flexible within a bank is no simple task. However, as per the first and fourth point noted by the Senior Supervisors Group,[95] banks with a very good and adaptable risk management system in place that shared information at every level of the organisation, including the board, found it easier to stay on top of things during the financial crisis.

> 'Principle 12: The board and senior management should know and understand the bank's operational structure and the risks that it poses (i.e. "know-your-structure")'.[96]
>
> 'Principle 13: Where a bank operates through special-purpose or related structures or in jurisdictions that impede transparency or do not meet international banking standards, its board and senior management should understand the purpose, structure and unique risks of these operations.

[91] ibid 17
[92] ibid 19
[93] ibid 22
[94] ibid 23
[95] Senior Supervisors Group (n 13) 3
[96] ibid 26

> They should also seek to mitigate the risks identified (i.e. "know-your-structure")'.[97]

These in essence come back to the earlier discussed key principle of transparency but also to the educational requirement of the board. Note that Principles 12 and 13 have been dropped in the July 2015 version of the report. Instead, it lists the next Principle 14 as the new Principle 12.

> 'Principle 14: The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants'.[98]

It is quite remarkable that only in the last of its fourteen principles the Committee finally mentions shareholders and stakeholders. It mentions these in the context of the third pillar of Basel II, disclosure. The most important thing is that it does not just mention shareholders, but the Committee acknowledges that there is a whole range of stakeholders, including depositors and other market participants, who need to be involved and informed. It uses an enlarged group of actors in the system of corporate governance, as was previously done by the OECD[99] globally and the Winter report[100] within the EU, as well as in earlier reports by the Committee.[101] Several reasons can be put forward as to why it is mentioned only in the last principle. It could be because the inclusion of stakeholders would make the report less palatable in the UK and US. The report is after all a compromise between all the views of participating nations.

### c. The Walker Review

#### *i. The Board*

The Walker Review notes that some boards were far more effective than others at creating solutions and implementing these at the time of the crisis than others, despite the fact that they had the same obligations to their shareholders.[102] This difference was also noted by

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[97] ibid 27
[98] ibid 2
[99] OECD, *OECD Principles of Corporate Governance* (Paris, OECD Publication Service 2004) <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf> accessed 14 November 2015, 12, 43
[100] Jaap Winter, 'Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe' (Brussels, 4 November 2002) 59 <http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf> accessed 14 November 2015, 105
[101] Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* (Bank for International Settlements, 2006)
[102] Sir David Walker (n 4) 33

the Senior Supervisors Group[103] and allows for some comparison between good and bad practices. The Walker Review seeks to investigate this difference by answering several questions, most notably by questioning whether to extend the statutory responsibility of the board to include depositors or even society as a whole and by examining the role of non-executive directors. Although the review considered extending the responsibilities beyond those to shareholders to include employees, depositors and taxpayers, as well as the creation of a non-executive director for public interest, it recommends focussing on the existing core accountabilities rather than expanding on these.[104] The main argument presented in support of not expanding the responsibilities is that the Companies Act 2006 s172-174, which describes the duties of the director, is sufficient: damaging public confidence and not meeting obligations to depositors is not the long-term interests of the company.[105] It is further argued that giving more consideration to, for example, employees may cause conflicts with shareholders during a restructuring or take-over, leading to the dilution of existing shareholder power towards other stakeholders and thereby risking to fundamentally change the way that the UK markets operate.[106] As discussed in chapter two, these specific sections in the Company Act 2006 have been called 'enlightened shareholder value' as it goes somewhat further than plain shareholder value.[107] The question remains whether this part of the act is sufficient to promote stakeholder value in this specific situation.

Instead of amending the existing statutes, the review concludes that a great deal can be achieved even within this existing framework.[108] The requirement of specialist knowledge concerning the financial industry for the non-executive directors is greater than in other sectors. It requires a specialised set of skills and knowledge as the impact of the lack of it on society as a whole is far greater than in other industries. This observation corresponds with principle 2 of the Basel Committee[109] as well as observations made by the Senior Supervisors Group on how board members are selected.[110] It presents, however, the problem of independence of non-executive directors as the best place to build this knowledge is from within the industry itself. This would ask for extra scrutiny to be placed

[103] Senior Supervisors Group (n 13)
[104] Sir David Walker (n 4) 34
[105] ibid 136
[106] ibid 134
[107] Peter Muchlinski, 'Implementing the New UN Corporate Human Rights Framework: Implications for Corporate Law, Governance and Regulation' (2012) 22 Business Ethics Quarterly 147, 160
[108] Sir David Walker (n 4) 40
[109] The Basel Committee on Banking Supervision (n 26) 10
[110] Senior Supervisors Group (n 1) 22

on the selection process.[111] But the knowledge and understanding of the financial sector as well as further training is essential for the optimal functioning of each non-executive director.[112] Because of this specialist aspect, the time commitment of a non-executive director will be far greater than in other industry sectors.[113] It would require additional supervision by the FSA on whether not only the non-executive directors are sufficiently knowledgeable and commit enough time, but also whether they engage proactively in the board discussions and act in line with the risk strategy.[114]

Therefore, instead of arguing for a prescribed specific or specialised duty for board members of a bank, set out in statute, the answer would be provided by more intense supervision of the directors by the regulator. The FCA as custodian of corporate governance at UK banks would thus negate the necessity for such a duty. Avoiding such prescribed specialised duties is arguably desirable as it creates a potential problem in which other industry sectors would justify additional duties beyond the core accountabilities already defined. The Walker Review takes the correct approach in this instance.

The FCA would thus ensure that the directors are knowledgeable and engaged, which is essential for the proper functioning of the board. The executive needs to be challenged and tested on the proposals that he puts forward.[115] The non-executive directors need to be especially satisfied that the risk assessment is done properly and that the outcome is in line with the overall risk strategy. For the chairman, it is possibly even more important that he is extremely knowledgeable on the financial sector and that he can commit at least two thirds of his time to this role. It is also very important that he possesses the leadership skills necessary to ensure that he can facilitate and encourage informed and critical contributions from the directors, in particular on matters such as strategy and risk.[116] Altogether, the board should regularly undertake a critical evaluation of its performance and governance as well as that of the separate committees. Part of this evaluation should focus on whether the board has a sufficient skillset and understanding to address the challenges of risk and decisions it has to take.[117]

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[111] Sir David Walker (n 4) 45
[112] ibid 46
[113] ibid 49
[114] ibid 50
[115] ibid 56
[116] ibid 60
[117] ibid 66

### *ii. Shareholders and the Stewardship Code*

The review notes that there are two types of shareholders, distinguished by the time horizon of their investment. Some fund managers may hold the stock only for a short period, deciding to sell it again if they do not like the direction the company is going. On the other side, there are the investors who intend to hold on to the stock for a long period of time. This group of investors may seek to influence the decisions of the board if they do not like the direction that the company is going in.[118] The two groups themselves may operate under different pressures: the fund managers may seek short-term targets on a few selected investments whilst the other group may consider a longer term view on a large and diversified portfolio of investments. The review takes the position that influence of major shareholders executed principally through buying and selling is highly unsatisfactory as an ownership model. The suggestion is that, as a counterpart to the obligation of the board to its shareholders, the investors should have a

> '… reciprocal obligation involving attentiveness to the performance of investee companies over a long as well as a short-term horizon. On this view, those who have significant rights of ownership and enjoy the very material advantage of limited liability should see these as complemented by a duty of stewardship'.[119]

Although some fund managers may be hesitant to subscribe to such a code, the least that can reasonably be expected in the governance process is that they are involved in the selection of the board and in holding it to account on their performance.

The Institutional Shareholders' Committee, renamed the Institutional Investor Committee on the 18th of May 2011, published the Code on the Responsibilities of Institutional Investors.[120] The Code has the following aim:

> '… to enhance the quality of the dialogue of the institutional investors with companies to help improve long-term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, and help with the efficient exercise of governance responsibilities'.[121]

The code is made up of seven principles. It requires investors to develop and publish a policy on how they will discharge their stewardship responsibilities and how they will deal

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[118] ibid 69
[119] ibid 70
[120] Institutional Shareholders' Committee, 'Code on the Responsibilities of Institutional Investors' (16 November 2009) <http://www.uss.co.uk/Documents/ISC%20Code%20Responsibilities%20of%20Institutional%20Investors.pdf> accessed 14 November 2015
[121] ibid 1

with a conflict of interest between this policy and acting in the interests of their clients. The investors will need to monitor their investee companies. In particular, they need to satisfy themselves that the board and its commissions are effective. They need to maintain an audit trail of the monitoring activities. Investors may, either collectively or individually, escalate their activities of required but should do so in line with guidelines that they have clearly set out themselves. Finally, investors should have a clear policy on voting and report on their stewardship and voting activities.

The Financial Reporting Council is currently responsible for the UK Corporate Governance Code, formerly called the Combined Code.[122] All companies with a Premium Listing in the UK are required under the Listing Rules to report on how they have applied the UK Corporate Governance Code. The Walker Review suggests that it should be placed within the remit of the Financial Reporting Council to design principles of best practice in stewardship by institutional investors and fund managers.[123] In practice, this would mean that the Code on the Responsibilities of Institutional Investors is ratified by the Financial Reporting Council as some form Code of Stewardship. As with the Combined Code, it should be done on a 'comply or explain' basis. The Financial Reporting Council would be responsible, in consultation with relevant parties, for updating the Code of Stewardship. The Review suggests that investors and fund managers regulated by the Financial Services Authority must make public whether they subscribe to the Code of Stewardship or not. Unfortunately, this initiative is only UK based. Although demands can be placed on UK investors, it may be difficult to engage foreign institutional investors, including for example sovereign wealth funds or foreign public sector pension funds, to subscribe to such a Code of Stewardship.

The ownership structure and the behaviour of shareholders have not featured in the international reports discussed so far. These international reports, whether written by a small group such as the Senior Supervisors Group, or a very large group, such as the Basel Committee, contain compromises between the different backgrounds and customs of the individual members. It underlines the different views on share ownership in different countries. In particular, the case study of Japan in chapter six will present an approach based on relationships between different companies. The governance structure relies

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[122] Financial Reporting Council, 'The UK Corporate Governance Code' (June 2010) <http://www.frc.org.uk/getattachment/b0832de2-5c94-48c0-b771-ebb249fe1fec/The-UK-Corporate-Governance-Code.aspx> accessed 14 November 2015

[123] Sir David Walker (n 4) 83

heavily on these relationships, providing a very different model than discussed for the UK. In order to achieve any result or agreement, these international reports are either both extremely vague and general, or they seek to agree on very specific points whilst avoiding any contentious aspects. Ownership, the role of the shareholders and, extrapolating, the role of stakeholders are examples where the different participating nations have different historical, cultural and legal notions. The Walker Review, being a UK report, is better placed to make recommendations on these issues. Ownership most certainly requires attention.

### *iii. Governance of Risk*

For any business, the management of financial risk as well as many other types of risk is important and subject to a set of constraints. For large financial institutions, however, it is part of their core strategic objectives.[124] They principally take on financial risk and often a much higher form of leverage than is normal in other types of industries. Moreover, the consequences of these risks are potentially much larger in terms of social costs, exceeding the downside risk to shareholders. Hence, regulatory requirements have been put in place to restrain these risks, including, for example, capital requirements. The board would need to make decisions on whether new complex structures or overseas operations would give sufficient return taking into account the regulatory costs rising from the associated risks. The Senior Supervisors Group[125] has emphasised the same point, by highlighting that banks with good and flexible risk management systems that reached up to board level were able to deal with the crisis much better; likewise, the Basel Committee has included this in, for example, principles 1 and 5 of its report on corporate governance.[126]

The Review is concerned mainly by how the governance of risk by the board can be made more effective alongside the regulation.[127] It summarises, that

> '… the obligation of the board in respect of risk should be to ensure that risks are promptly identified and assessed; that risks are effectively controlled; that strategy is informed by and aligned with the board's risk appetite; and that a supportive risk culture is appropriately embedded so that all employees are alert to the wider impact on the whole organisation of their actions and decisions'.[128]

[124] ibid 91
[125] SSG
[126] The Basel Committee on Banking Supervision (n 26)
[127] Sir David Walker (n 4) 91
[128] ibid 92

Note that this is again very much in line with what the Basel Committee has dictated, in this case in principles 4 to 8.[129] The new regulation that is being developed should aim to eliminate the risk of a crisis reoccurring, but the Review notes that it must not be the job of the regulator to sit on the board of the banks. The regulators must stand back to allow for new developments, products and inventions whilst satisfying itself in the capabilities and effectiveness of the board to discharge its obligations in relation to the associated risks.

Although one may wish to place the oversight of risk within the audit committee, the review argues against this. Not only is the audit committee already loaded with the demanding task of financial reporting and internal control, the task of risk management for a financial institution is so large that it may easily overload the audit committee. Instead, the review recommends establishing a separate board risk committee which should focus on 'the fundamental prudential risks of the institution'.[130] These risks include leverage, liquidity risk and market risks including interest rate and currency risk, credit risk and counterparty risk. These prudential risks present a demanding task in their own right for this Board Risk Committee, which should therefore not be distracted by other risks such as information technology or reputational risk. It should solely focus on a strategy for fundamental prudential risks, including a strategy for capital and liquidity management, taking into account any potential changes in the economic and financial environment.

The Board Risk Committee, which as any board committee should largely consist of non-executive directors, should be supported by a Chief Risk Officer (CRO). The requirement of a Chief Risk Officer within the bank emphasises a small but important part of principle 6 of the Basel Committee, where this important role is only briefly mentioned.[131] The Chief Risk Officer should operate at board level risk governance but be independent of any business unit.[132] Besides the usual daily tasks, the Board Risk Committee must be involved in any major strategic transactions, such as a potential acquisition, to ensure that proper due diligence has been conducted and to assess the consequences of the risk profile of the company after the transaction. It needs to take into account whether it falls within the risk tolerance and appetite as defined in the risk strategy. This is essentially principle 5 as defined by the Basel Committee.[133] Note that the risk strategy, tolerance and appetite

[129] The Basel Committee on Banking Supervision (n 26)
[130] Sir David Walker (n 4) 94
[131] The Basel Committee on Banking Supervision (n 26)
[132] Sir David Walker (n 4) 99
[133] The Basel Committee on Banking Supervision (n 26)

should be included in a risk report, which must form part of the annual report and accounting obligations.[134]

## 5. External Stakeholders

### a. Background

The financial crisis clearly showed the enormous impact of the (expected) failure of a bank. It has great consequences for the customers, deposit holders, the small business' ability to obtain loans, and the general economy as a whole. The previous chapter already contains an analysis of the specific resolution regimes that are setup to tackle the failure of a bank. This section looks in more detail at the interests of external stakeholders in a bank and how they can be protected best, especially considering the possibility of a future failure. There is thus a different emphasis. The interests of external stakeholders, such as retail clients and small businesses, could be served by the creation of a ring-fence or even a complete separate between retail and investment banking. Another possibility is to protect the taxpayer from bailing out a bank by making bond holders pay. Such measures are examined in this section.

### b. The Independent Commission on Banking

#### *i. Retail Ring-Fence*

The Independent Commission on Banking proposes to create a separation between retail and investment banking, or, in other words, to create a ring-fence within the bank. These proposals are later followed by the Liikanen report, a similar set of recommendations made at EU level.[135] At UK level, the Commission presents three arguments for creating some separation between retail banking and investment banking.[136] The first reason is that, if a bank would get into trouble, it will be easier to separate the investment bank from the retail bank, as much of this separation will have been done before the problems arise. This would make it easier to resolve the bad part of the bank whilst keeping the retail part running as usual, thereby minimising the impact on the economy as well as the potential losses for account holders. It would also ensure that taxpayers do not have to pay for bailing out parts of the failing bank. The second argument concerns the separation of balance sheets: by separating the balance sheet of the individuals and small businesses

[134] Sir David Walker (n 4) 105
[135] Erkki Liikanen et.al., 'High-level Expert Group on reforming the structure of the EU banking sector' (Oct 2012) <http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf> accessed 4 July 2016
[136] Independent Commission on Banking (n 5) 24, 25

from that of the global activities, it will prevent contagion in case of problems in the global economy or financial system. It would mean that the risks that fall beyond the control of UK authorities and regulators are separate in balance sheet terms from the domestic activities. The third argument is that it would remove the implicit government guarantee of a rescue in case of a failure. The parts that are required for normal functioning of the national economy are already safeguarded whilst the others can easily be resolved. These arguments link back to the public at large as an external stakeholder in the bank. All three arguments describe clear benefits to the general public: preventing or minimising losses to account holders, minimising the impact on the economy and reducing the need for a government rescue.

The proposal to create a retail ring-fence is a specific measure that would come to full effect in case of a banking insolvency. As discussed in chapter one on methodology, insolvency laws, or essentially the priority given to each creditor, are anchored in each country's history and culture. The choice that is made here is to put depositors and small businesses, which are deemed to be less able to fend for themselves, at the top of the hierarchy of creditors. This would also ensure that the government no longer needs to spend public money to bail out a failing bank, which benefits society as a whole. The commission notes that it received several objections to the proposals of ring-fencing. They fall into three broad categories.[137] This first category argues that the benefits from the universal banking model come from unfettered intermediation between savers and borrowers and the diversification of risks. This enables banks to hold lower capital and have access to cheaper funding. The second category of objections goes exactly the other way: rather than advocating the universal banking model, the proposal is a complete separation of retail and investment banking in a return to the situation under the Glass-Steagall Act. The argument is that in the universal banking model the retail bank is an undesirable subsidiser of the investment bank. By separating the two, the investment bank will lose its implicit government guarantee and overall financial stability will increase. The third category contains the practical objections: it will be difficult to create a workable implementation of ring-fencing.

Taking these objections into consideration, the commission has drawn up the following purpose and objectives for ring-fencing:

[137] ibid 25-27

> 'The purpose of the retail ring-fence is to isolate those banking activities where continuous provision of service is vital to the economy and to a bank's customers in order to ensure, first, that this provision is not threatened as a result of activities which are incidental to it and, second, that such a provision can be maintained in the event of the bank's failure without government solvency support. A retail ring-fence should be designed to achieve the following objectives at the lowest possible cost to the economy:
>
> - Make it easier to sort out both ring-fenced banks and non-ring-fenced banks which get into trouble, without the provision of taxpayer-funded solvency support;
> - Insulate vital banking services on which households and SMEs depend from problems elsewhere in the financial system; and
> - Curtail government guarantees, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place'.[138]

This contains several interesting points. The very first sentence recognises that the bank has a very clear obligation to the smooth functioning of economy and to customers. By doing so, the commission states very clearly that stakeholders are not only very important but they are a very large group namely society as a whole. It is a clear recognition of the importance of the general public as an external stakeholder. It further states clearly that even in case of a failure, these stakeholders are still the bank's responsibility and not the government's. Here the Commission's recommendation differs completely from the Walker Review: although the Walker Review recognised that banks had these obligations to stakeholder and society, it recommended to deal with these obligations within the existing legislation[139] instead of creating new legislation to reflect these obligations. It is possible that the Walker Review came to this conclusion after examining more specifically the duties of directors rather than the organisational structure of the bank; nonetheless, it decided that stakeholder protection was sufficiently covered by the Company Act 2006 s172 and that an extension might conflict with shareholders' interests.

### *ii. Ring-Fencing Principles*

As with a normal everyday fence, this fence has two main measures: where to put it and how high it should be? For both the location and the height, the Commission has developed a set of five principles. The first ring-fence principle "Mandated Services" states that 'only ring-fenced banks should be granted permission by the UK regulator to provide mandated services'.[140] Mandated services are defined as banking services whose

[138] ibid 35
[139] Sir David Walker (n 4) 137, 138
[140] Independent Commission on Banking (n 5) 38

interruption would come at significant economic costs and where customers are generally not capable of planning for such an interruption. Examples of mandated services include taking deposits and providing overdrafts.

The first principle sets out what should be included within the fence; the second principle sets out what must not be included. Here, the commission has made a trade-off between financial costs and improving financial stability. The US has introduced something similar in the Volcker Rule, which restricts certain activities for banks to engage in.[141] Under the Volcker rule, US banks are not allowed to engage in proprietary trading activities and are limited in their exposure to hedge funds and private equity firms. The Commission argues that this rule is not sufficient to define prohibited activities within the ring-fenced part of the bank.[142] The Commission specifies many criteria that would make services prohibited: any banking services that meet any of the following requirements

- 'make it significantly harder and/or costlier to resolve the ring-fenced bank;
- directly increase the exposure of the ring-fenced bank to global financial markets;
- involve the ring-fenced bank taking risk and are not integral to the provision of payment services to customers, or the direct intermediation of funds between savers and borrowers within the non-financial sector; or
- in any other way threaten the objective of the ring-fence'.[143]

Some examples that the Commission has included are services which would result in a trading book asset, services which would result in a requirement to hold regulatory capital against market risk and the purchase or origination of derivatives or other contracts which would result in a requirement to hold regulatory capital against counterparty credit risk.

The third ring-fence principle is that of "Ancillary services." 'The only activities which a ring-fenced bank should be permitted to engage in are: the provision of services which are not prohibited; and those ancillary activities necessary for the efficient provision of such services'.[144] Ancillary activities that commission provides as example include employing staff and owning or procuring the necessary operational infrastructure. In particular, a ring-fenced bank should be permitted to conduct financial activities beyond the provision of non-prohibited services to the extent that these are strictly required for the purposes of its

[141] The Volcker Rule is a specific section of the Dodd-Frank Act, Title VI Improvements to Regulation.
[142] Independent Commission on Banking (n 5) 45
[143] ibid
[144] ibid 62

treasury function – i.e. for risk management, liquidity management, or in order to raise funding for the provision of non-prohibited services. This is an important concession.

The fourth ring-fence principle "Legal and operational links" is

> 'Where a ring-fenced bank is part of a wider corporate group, the authorities should have confidence that they can isolate it from the rest of the group in a matter of days and continue the provision of its services without providing solvency support.[145]

The fifth ring-fence principle "Economic links" is

> 'Where a ring-fenced bank is part of a wider corporate group, its relationships with entities in that group should be conducted on a third party basis and it should not be dependent for its solvency or liquidity on the continued financial health of the rest of the corporate group. This should be ensured through both regulation and sufficiently independent governance.

The measures described sound relatively simple, but their implementation is not necessarily easy. Consider the third and fourth principle: the technological infrastructure, the bank's IT systems, as well as any other operational links, will be shared between the entities inside and outside the fence prior to the creation of this fence. The question must be answered to which part of the bank which operational element belongs in case of insolvency. It will be not only difficult to sort this out but also costly, with the potential to require duplicated infrastructure within the bank.

#### *iii. Absorbing Future Losses*

The under-capitalisation of banks during the financial crisis threatened them with insolvency. If a systemically important bank did become insolvent, the government bailed it out with mixed consequences for those involved. Equity holders were largely wiped out whilst creditors and bank employees were largely unaffected. This raises questions of fairness as well as whether the current setup is in fact a destabilising one. Furthermore, the approaching insolvency forces a bank to reduce its risk, which may in itself be damaging to the economy. Altogether, the commission sees a clear need to improve the capacity of banks to absorb future losses.

The commission distinguished between the capacity to absorb losses before and after the bank is put into resolution.[146] In either case, only equity is used to absorb losses. This equity, following Basel III, is made up by the hard minimum requirement of 4.5% of the risk

[145] ibid 67
[146] ibid 87

weighted assets ("RWAs") and the additional capital conservation buffer ("CCB").[147] Under Basel III, this minimum requirement has gone up from 2% under Basel II,[148] but the commission suggests that it could be further increased to 7%. The Commission proposes to do just that: ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more should be required to have an equity-to-RWA ratio of at least 10%; if this ratio of RWAs to UK GDP is between 1-3% then the equity-to-RWA ratio should be between 7-10%.[149] The Commission does so whilst acknowledging several points against increasing the capital ratio even further.[150] It recognises that banks are likely to deleverage to reach the minimum ratio rather than increasing equity. This deleveraging process may have a profoundly negative impact on the UK economy as all the large UK banks will deleverage at the same time. Another problem is the potential establishment in the UK of a so-called EEA-branch by another EU bank, which is primarily regulated in its home country. This bank could operate under less stringent capital requirement, thereby competing under different terms with UK banks. It may even serve to drive some activities out of the regulated banking world into the shadow-banking world as costs are too high.

Apart from practical problems that may arise from adopting the higher capital ratios proposed by the commission, there is a legal issue concerning EU legislation. The EU's Capital Requirement Directive IV,[151] which seeks to implement most of the Basel III report,[152] seeks to harmonize the capital requirements imposed across all the EU members. It does not aim to specify a minimum requirement to which individual member states can add their own increases and it certainly does not aim at allowing member states to set a lower minimum. The clear aim is to harmonise. The commission recognises this legal obstacle, however, it argues that it is of great international benefit were the UK to adopt the higher requirements it proposes.[153] The commission points at the fact that the composition of the banking sector within each EU Member State is very different, making it undesirable to set one standard for all. The UK has several large and internationally active banks, which requires them to set higher standards. Additionally, the insolvency regimes differ across EU Member States, which means that a banking failure is dealt with differently and consequently has a different impact. Consequently, some Member States may attach

[147] Basel Committee on Banking Supervision (n 32)
[148] Basel 2
[149] Independent Commission on Banking (n 5) 93
[150] ibid 89-91
[151] EU as before in that section
[152] Basel Committee on Banking Supervision (n 32)
[153] Independent Commission on Banking (n 5) 97

more value to a safer banking system with higher standards than others. It is a clear example of a harmonised report not working as a transplant in a country's specific situation.

Although the commission accepts that RWAs are part of the primary method for measure capital, it also recognises that the use of RWAs leads to the potential manipulation of the weightings.[154] Hence another method based on non-weighted assets should be used in support. An appropriate minimum of equity to non-weighted assets could act in support: if the risk weights are manipulated and too low, this additional minimum requirement would catch it. Basel III proposes to use precisely this ratio with a minimum of 3%[155] but the commission proposes to increase this in line with their proposed increase on the RWAs based ratio to 4.06% instead.[156]

So far, only equity has been discussed as potentially absorbing losses. The commission sees advantages in exposing liabilities to losses as well. At present, debt would only be exposed to losses if a bank went into insolvency. Hence, when the banks that approached insolvency during the crisis received bailouts, the debt holders would not take any losses. By forcing these debt holders to shoulder some of the losses, market discipline would be sharpened and thereby it could reduce excessive risk taking.[157] This type of bail-in scheme is now, by way of the BRRD, part of the Special Resolution Scheme in the Banking Act 2009, as discussed in chapter four. Another safeguard for depositors is the FSCS. The Commission notes two issues[158] with this: firstly, the depositors are not able to apply the same market discipline as other creditors can. Secondly, well-run banks may have to pay for the insolvent bank through higher contributions to the FSCS. The solution proposed by the commission is to move depositors up in the hierarchy above other creditors. This has now been implemented as discussed in chapter four.

### c. Financial Services (Banking Reform) Act 2013

The Financial Services (Banking Reform) Act 2013 ("FS(BR)A") implements a variety of different measures that are important for corporate governance at banks and thus for this research. The first part of the FS(BR)A, sections 2 to 12, implement the ring-fencing scheme as proposed by the ICB. The banks must ring-fence their retail and small- and medium-sized

[154] ibid 98
[155] Basel Committee on Banking Supervision (n 32)
[156] Independent Commission on Banking (n 5) 99
[157] ibid 100
[158] ibid 105

enterprise and deposit taking activities in legal entities that are clearly separate from those that are considered risky. These would include the wholesale and investment banking activities. The exact details of the ring-fencing rules will be set out in secondary legislation and in the PRA rulebook. On top of this, the capital requirements for banks are further increased by introducing a so-called Primary Loss Absorbing Capacity ("PLAC"). Again, most of the technical details will be set out in separate secondary legislation. The point of introducing PLAC is that losses will be absorbed by the shareholders and unsecured creditors, rather than the tax payer.

Some of the tools available in the case of the failure of a bank, which have already been discussed in chapter four, are introduced by the FS(BR)A. The bail-in option in case of a failure, as discussed in chapter four, which emanated from the BRRD, is introduced. The FSCS is amended to include the ranking as preferential debts in case of insolvency. The FSCS is required to ensure prompt pay-outs, as well as other new statutory duties to ensure smooth operations. The FS(BR)A also implements several of the recommendations made by the Parliamentary Commission on Banking Standards. This includes the Senior Management Regime, which covers persons within a designated senior management position. The most important aspect is that these persons will be criminally liable if they take, or agree to take, a decision that causes a financial institution to fail. For this, they must have displayed conduct that falls far below what could reasonably be expected of a person in their position. Clearly this rule is a major change. Although whether anyone would ever be convicted under this rule is questionable, the fact that this is now possible increases the accountability of those in such a position.

The FCA and PRA set out the detailed rules in this respect.[159] In particular, the Senior Management Regime sets out that key individuals must allocate and map out their responsibilities. Those key individuals will continue to fall under an approved person regime, where the regulator needs to give approval. The Senior Management Regime works in conjunction with the Certification Regime, which covers staff that would pose a risk of significant harm to the firm or any of its customers. Although the staff itself does not need to be approved by the regulator, the procedures for fitness and propriety a firm must have place around them does need to be approved.

[159] Financial Conduct Authority, 'FCA publishes final rules to make those in banking sector more accountable' (7 July 2015) <https://www.fca.org.uk/news/fca-publishes-final-rules-to-make-those-in-the-banking-sector-more-accountable> accessed 4 July 2016

## 6. Conclusions

### a. The Increased Complexity

If anything should be clear from this chapter and the previous one, then it is that the amount of regulation in the banking sector as well as its complexity has grown dramatically. Of course, this comes on top of the fact that managing a bank in itself has become far more complex, given the scale of the institutions and the swift developments in financial markets. In terms of regulation, especially the rules around capital and liquidity requirements have become incredibly lengthy and technical. The rules around recovery and resolution, bail-in and ring-fencing are of equal complexity. This is not necessarily a bad thing in itself, and it is not the purpose of this research to assess this. However, what inherently does follow, is that the role of senior management and of the board at a UK bank has become far more difficult. Aside from the usual strategy planning and other common agenda items, a significant amount of time will have to be spent on the programs to implement and comply with this new regulation. It would seem almost impossible to do this if senior management and the board do not have the required knowledge and skills to do this. This now comes back to the point made at the end of previous chapters: the standard of what comprises good corporate governance at UK banks keeps rising.

This means all elements of corporate governance must be of a higher standard. The information that reaches senior management must be of a higher standard. This means that the internal information flows and control processes must be of a higher standard. The complexity and technical level of the information that must flow through the organisation to monitor, for example, the ring-fencing, or the latest capital requirements, is far higher than what it was even only ten years ago. The same applies to the risk management function. There are far more detailed requirements on, for example, the calculation of counterparty risk or the treatment of non-centrally cleared derivatives. The entire risk management function must step up a level. Furthermore, many of the requirements cut directly across the departmental silos that exist within a bank. Many trading operations within a bank are organised across asset classes, each with their different systems and risk management. This makes aggregation of risks as well as a coherent implementation of new regulation incredibly difficult. The problem becomes even more complex when considering different entities within the banking group. It increases the need for transparency and cooperation. It may also require a reduction in organisational complexity. In summary, it is

a direct consequence of the increased complexity of the regulatory landscape that the overall standard of what constitutes good corporate governance is rising.

### b. The Culture with the Bank

Although much of the new regulation is of a prudential nature, aiming to reduce the chance of a failure by increasing the minimum requirements, there are other important changes that aim to improve the culture within the banks. The major thrust of these regulations seek to address the remuneration structure within the banks. In its initial response to the G20, the Basel Committee already noted that incentives at banks should be better aligned to manage the risk and returns over the longer term. It also noted in this context the importance of sound compensation practices. The Basel Committee implemented this in its principles of corporate governance. In particular, Principles 10 and 11 require the board to design a compensation system that is effectively aligned with prudent risk taking. The compensation should be adjusted for the related risks taken and compensation payout schedules should be sensitive to the time horizon of risks. Furthermore, the payment should take the form of a mix of cash, equity and other forms of compensation, again aligned with the risks taken.

Within the UK, the Walker Review makes similar recommendations on remuneration. In the US, the Dodd-Frank Act specifies remuneration requirements. Although these do not go nearly as far as those in the EU, the point is that remuneration is becoming more transparent and must be put before the shareholders. In the EU, the Basel III implementation in CRD IV is extended to include strict requirements on pay within the relevant financial institutions. Limitations are placed on the proportion of variable pay as well as the form in which the pay-out must be made. Finally, a clawback is implemented on variable pay. The fact that pay in banks has come under scrutiny worldwide, and that restrictions of different severity have been imposed worldwide, tells the undeniable story that there is something fundamentally wrong with the culture within the banks. It is clear that personal gain and greed have been a major motivation for some of those working in the industry. Under the reward structure before the crisis it was possible to take substantial risks with possibly unlimited upside and almost no downside. This is now changing as deferred rewards can be cancelled and there is even the threat of a clawback. The incentives are moving towards aligning the risks taken by individuals with the way they are paid, which will hopefully improve the culture within banks and move it beyond a focus on short-term financial targets.

### c. Board Effectiveness

The first three principles of corporate governance as set out by the Basel Committee defined the role of the board. Of particular importance is the second principle, which includes that board members should be and remain qualified, including through training, for their positions. Furthermore, they should have a clear understanding of their role in supporting good corporate governance and be able to exercise sound and objective judgement about the affairs of the bank. The Senior Supervisors Group confirmed that those banks with more experienced, knowledgeable and effective boards got through the crisis in better shape. This has been echoed by the Walker Review, which concluded that the requirement on knowledge of the financial industry for the non-executive directors is greater than in other sectors. In particular, it requires a specialised set of skills and knowledge which is unique to the finance industry. It also reflects the potential impact any failure at a bank would have on society at large. But these points come back to the first conclusion made previously: the overall standard of what constitutes good corporate governance at a UK bank is going up. And, by implication, the standard of what is required of a board member will go up. The knowledge required to challenge and oversee senior management is substantial, especially considering the new regulation discussed in this and the previous chapter. In practice, it may well be that it is becoming increasingly difficult to find such highly skilled individuals.

A new weapon in the arsenal of the UK regulators to ensure board effectives is the FS(BR)A senior management regime. Those individuals that now fall below the standard and cause a bank to fail face the prospect of criminal prosecution. Although some of the exact details, especially those in relation to the burden of proof, are currently undergoing change, the regime is likely to stay in place. It means that, if RBS had failed whilst this regime was in place, it may well have been possible to prosecute Fred Goodwin. It is clear that this was the central thought behind the introduction of this regime. Whether it actually works in practice remains to be seen. For the moment, at the very least it will focus the minds of people in relevant positions or of those considering to take up such a position. Although this new form of accountability is to be applauded, it does also raise questions. Would it, for example, deter any suitable candidates to take such a position? It is not unlikely that they will have a choice of similar positions, perhaps at non-banks, where they will not be subject to such a regime but receive comparable remuneration. In other words, there is the possibility that, indirectly, it could undermine board effectiveness as well.

### d. External Stakeholders

External stakeholders are explicitly recognised by the Basel Committee. In principle 14 of their code of corporate governance, it is mentioned that the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants. This is something, but not a great deal. Transparency is a first step, but it is difficult to see how this would go beyond providing accurate information for a current account or providing accurate profit and loss statements. It is disappointing that it does not go further in recognising the importance of external stakeholders especially in light of how detrimental the financial crisis was for them. However, it can be argued strongly that within EU and UK reports and legislation there is an implicit recognition of the importance of external stakeholders. This was done throughout this chapter, in particular with reference to the ring-fence proposed by the ICB, the FSCS and the BRRD. By placing a ring-fence around the retail banking activities and splitting them from the investment banking activities, there is an implicit recognition of the importance of the safety of retail banking. Customers, as an external stakeholder, need to be assured of a sound financial infrastructure and the safety of their deposits. This last point is further emphasised by the implementation of the FSCS. It can therefore be said that this scheme also implicitly recognises the importance of customers as external stakeholders. Finally, in the event of a bank failure, it is important that the impact to financial stability, the financial infrastructure, the economy and society in general is minimal. The BRRD seeks to achieve this by creating a framework for an orderly wind down, recovery or bail in of a failing bank. It could thus be said that the BRRD implicitly recognises the importance of a broad range of external stakeholders. The conclusion must therefore be that, although most of these proposals will remain untested until the next bank failure, it can be argued strongly that there is a growing recognition of external stakeholders and that the structural and long term solutions discussed in this and the previous chapter go some way to address their most important concerns.

Lastly, it is important to highlight the new principle 13 of the July 2015 guidelines for corporate governance at banks by the Basle Committee. It is important because it does not only recognise the regulators as an important stakeholder, it effectively makes the regulators the custodian of corporate governance at banks. It places the burden on the regulators to check whether all internal systems and controls are in place and whether they are adequate. It places the burden on the regulators to ensure that the board and senior management are capable and consists of the right people to do the job. They must check

the risk culture, compensation practices and so on. This is in contrast to what is proposed by, for example, the Walker Review, which places the burden with the shareholders. The review highlights the reciprocal obligation on investors involving attentiveness to the performance of investee companies over a long as well as a short-term horizon. It is suggested that those who have significant rights of ownership and enjoy the very material advantage of limited liability should see these as complemented by a duty of stewardship. It would appear that the Basel Committee has reached the conclusion that the investors can or will not do this, and that it is therefore up to the regulators instead to do it. This raises the difficult question how the regulators should do this. The FCA and PRA contain a diverse workforce ranging from industry experts to those who spent their lives at various regulators, from low to highly experienced professionals. Clearly, these should not prescribe how a regulated firm is run. However, the diverse nature and experience of the workforce should allow for an objective and measured approach to looking after corporate governance at UK banks.

A further consideration is the potential for political interference. This can take several forms, for example through public questions to the regulators in the Treasury Select Committee, or simply through statements in Parliament or to the media. The case for political pressure on the regulators may be even stronger when the bank is largely state-owned and the objectives are not aligned, for example, when handing out a large fine or when approving the appointment of a former politician to the board. In this light, it is important that the regulators are seen as independent from political interference, but not from accountability, and perhaps the appointment process of the most senior officials at the Bank of England and the FCA should be reviewed in this context. Regardless of the quality of the persons appointed at the regulator, this must be done by way of a transparent process and perhaps even an independent committee.

# Chapter 6 –Japan's Financial Crisis and Reforms

## 1. Introduction

The previous chapters presented the case of the UK in the wake of the global financial crisis. This chapter presents the case of Japan during and after the financial crisis that hit the country in the nineties. The objective is, in summary, to examine whether there are any parallel experiences from which conclusions may be drawn. Following the Second World War and the American occupation,[1] Japan experienced a period of rapid economic growth.[2] It saw the rise of large industrial groups, called the *keiretsu*, in which different companies worked together.[3] This period came to an end with the bursting of the asset price bubble in 1991. The Asian financial crisis in 1997 dealt a further blow to Japan's economy. Since the problems started in the early nineties, the Japanese government has taken various measures to revitalise the economy and to improve its financial system. It has tried to reform its financial markets through liberalisation and through the creation of an independent financial regulator. It has pushed Japanese financial institutions to resolve their non-performing loan problem, to reform their lending practices traditionally based upon relationships and, importantly, to reduce their dominant role in Japan's system of corporate governance. The government has further tried to improve Japan's informal corporate governance practices via changes to the Commercial Code, which in 2005 was largely replaced by the Company Law. Many of the changes replaced outdated laws based upon legislation imported from the US legal system during the post-war occupation or even from Germany during the Meiji period. Such changes include the option to choose a US-style board structure and the establishment of board committees and external directors.

Successive Japanese governments have gradually attempted to change corporate governance practice, which had been painfully exposed as inadequate in the nineties. The aim of the current chapter is to provide a detailed overview of the important facts and a historical outline of the crisis and of the piecemeal reforms introduced by the Japanese government. In further contains both an analysis of the impact of these measures and reforms in Japan as well as the comparative analysis with the current situation in the UK.

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[1] Andrew Gordon, *A Modern History of Japan: From Tokugawa Times to the Present* (OUP 2013); Marius B Jansen, *The Making of Modern* Japan (Harvard University Press 2002); John H Dower, *Embracing Defeat: Japan in the Wake of World War II* (W W Norton & Company 2000)

[2] David Flath, *The Japanese Economy* (3rd ed, OUP 2014)

[3] Kenichi Miyashita and David Russell, *Keiretsu, Inside the Hidden Japanese Conglomerates* (McGraw-Hill 1996)

There are clear parallels between the situation and responses in Japan and the current issues faced in the UK. As explained in chapter one, when discussing research methodology, a comparative analysis is justified and hopefully reveals valuable ways to improve the situation in the UK. To assist in answering the research questions, the comparative analysis must focus on the area of corporate governance and seek to draw out parallels between the failures and the responses in both countries. Of particular interest is the case study Long Term Credit Bank. This bank failed, was nationalised and later re-privatised. This case is compared with the failure and nationalisation of UK banks.

## 2. Corporate Alliances and Corporate Governance

### a. The Rise of the *Keiretsu*

Before the Second World War, during Japan's period of territorial expansion,[4] the *zaibatsu* were the large and dominating business conglomerates. The big four *zaibatsu* were Mitsui, Mitsubishi, Sumitomo and Yasuda. They consisted of a family owned holding company with many subsidiaries. The zaibatsu played an important part in the period of industrialisation following the *Meiji Ishin*. At the time, Japan was gradually increasing its empire, acquiring for example the RyuKyu Islands (Okinawa) and Taiwan. The *zaibatsu* played an important role in the colonisation of these territories. As a result, they held close links with the military and political leaders. After Japan had capitulated at the end of the Second World War, a long rebuilding process of the industrial sector began.[5] For the *zaibatsu*, the holding companies were dismantled during the American occupation. Although the holding companies were dismantled, the essence of the structure remained in place. The underlying factories, plants and sales networks, although in places severely damaged by the war, remained largely unchanged despite a change in ownership structure. In the early 1950s, these structures were once more allowed to strengthen their informal approach. In effect, what previously were the various business units of the *zaibatsu* now formed the *keiretsu* groups. The *zaibatsu* had hence been transformed from a single firm or single holding company with hierarchical control over its subsidiaries to a network of individual organisations working together.

The transformation and rise of the *keiretsu* relied heavily on the support of the industrial policy and the intervention by Japan's government to plan its economy and allocate the

[4] Ian Inkster, *Japanese Industrialisation, Historical and Cultural Perspectives* (Routledge, 2001)
[5] Hirohisa Kohama, *Industrial Development in Post-War Japan* (Routledge, 2007); Steven Tolliday (ed), *The Economic Development of Modern Japan, 1945-1995, From Occupation to the Bubble Economy* (Edward Elgar Pub 2002)

available resources. These policies have been developed and implemented by the Ministry of International Trade and Industry ("MITI"), renamed in 2001 to Ministry of Economy, Trade and Industry ("METI").[6] Japan's industrial policy was aimed at rebuilding the country's industry after the destruction of the war. MITI had enormous influence over subsidies, licenses, imports and exports and provided 'administrative guidance' to industries. It therefore formed a cooperative partnership with Japanese business, initially with the aim to rebuild Japan. The government, through MITI, formed an 'iron triangle' together with corporations and the banks (including the Bank of Japan). Corporations would provide political support for the government, which in turn provided a stable environment for the corporations to prosper. The corporations and banks formed part of the same *keiretsu* as main borrowers and main lenders respectively. The government and the banks provided for stable fiscal and monetary policy. These strong ties in the 'iron triangle' dominated Japan's business environment after the war.

### b. Alliance Capitalism

The *keiretsu* groups are the most important feature of Japan's post-war business environment. They are business networks without a legal structure sitting above individual companies and hold them together. Although these networks are not prescribed in a legal structure and are mostly created indirectly, they are nonetheless very strong. In the seminal work by Michael Gerlach, *keiretsu* are described to operate as a form of 'alliance capitalism'.[7] There are several characteristics of alliance capitalism. The groups of companies working together own large parts of each other through cross-shareholdings. This form of ownership serves as a symbolic commitment as companies of the same *keiretsu* take a direct interest in each other's welfare. This ownership structure also serves as a protection against any unwanted interference by potential owners that are not part of the *keiretsu*, such as institutional investors. Closely aligned with this form of ownership is the co-monitoring of performance by interlocking directorships. Many senior executives of a company inside the *keiretsu* will serve as a director on the board of another company within the *keiretsu*. Again, it also provides additional protection against any outside influence as no outsiders are allowed on the boards inside the *keiretsu*. The ties between the different boards are further strengthened by various informal organisations, such as

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[6] Chalmers Johnson, *MITI and the Japanese Miracle, The Growth of Industrial Policy, 1925-1975* (Stanford University Press, 1982); Scott Dalon, *MITI and the Breakdown of Japanese High-Tech Industrial Policy, 1975-1993* (Stanford University Press, 1995)

[7] Michael L Gerlach, *Alliance Capitalism: The Social Organisation of Japanese Business* (University of California Press 1992)

Presidents' Clubs. An example of such a club is the *SanKinKai*, a club within the Dai-Ichi group that meets every third Friday.

Co-operation is not restricted to ownership and boardroom membership. It extends to sharing complete business units between *keiretsu* members, in particular shared intelligence units. The market research of Japanese firms is highly rated and shared between *keiretsu* members. This underlines the description of a corporate alliance, as groups of companies work together to enter into new markets or to expand in existing ones. Co-operation extends to the priority which group members receive when it comes to business opportunities and finance. Contracts for the production of small parts or the provision of services are often made with other *keiretsu* members because of their linkage and not because they offer more competitive prices or superior service.

There are different organisational models among *keiretsu* groups. First, there is the horizontal or financial *keiretsu*. The group of companies has ties based on financial linkages. The group of companies itself can be quite dispersed, but they share a Main Bank in the middle of the network. The main horizontal *keiretsu* include Mitsui, Mitsubishi, Sumitomo, Sanwa, Dai-Ichi and Fuyo. Some of these are directly linked to the pre-war zaibatsu: Mitsui, Mitsubishi and Sumitomo are the remnants of their zaibatsu namesakes. They all consist of an enormous variety of companies clustered around their Main Bank. Mitsui consists of Sakura Bank and other companies such as Mitsui Bussan, Mitsukoshi, Suntory and Toyota. Mitsubishi consists of Bank of Tokyo-Mitsubishi as the Main Bank and, amongst other, Mitsubishi Corp, Mitsubishi Electric, Mitsubishi Motors, Nippon Oil, Nikon and Kirin breweries. Sumitomo follows the same pattern as it includes Sumitomo bank as Main Bank and counts Sumitomo Corp, Asahi Breweries and Mazda amongst its other companies. This short list of affiliated companies confirms that these *keiretsu* have a Main Bank as a spider in the middle of the network and a range of different companies around it, varying from carmakers to breweries. They are held together by the financial link and collaboration between the companies themselves. It is not surprising that employees of a particular *keiretsu* are expected to buy the drinks from their affiliated brewery.

The second form of the *keiretsu* organisational structures is the vertical or production *keiretsu*. As the name suggests, the ties between the companies are based upon the production process. The companies within the group are mainly assemblers and suppliers. These *keiretsu* structures are most dominant in automobile production, such as Nissan and Toyota, and in electronics, such as Hitatchi, Toshiba, Matsushita, Fujitsu and Canon. Some

of these vertical *keiretsu* are themselves part of a horizontal *keiretsu* as previously discussed. Toyota is part of Mitsui, for example. Production *keiretsu* do appear in other sectors as well, consider for example Nippon Steel. The common element of all these production *keiretsu* is that they are based around the supply chain. Pyramids of suppliers of parts and sub-parts are created, consisting not just of large corporations but also of small- and medium enterprises. Within these supply chains there is interlocking through both ownership and directorship, creating large strategic alliances.

The third group is the distribution *keiretsu*. The linked companies are the producers, the distributors, the wholesale and retail outlets. These go a step beyond the production *keiretsu* by also controlling the distribution and sales of their products. There are also *keiretsu* that do not fit easily within any of the categories as links appear tenuous. The basic structures, however, are the same and in this they are also different from their predecessors, the *zaibatsu*. The *zaibatsu* had a single holding company, which was owned by a family. The *keiretsu* on the other hand, or at least its larger components, are publicly traded companies. The control is different as well: where the single holding company formed the headquarters and main place of decision making for the *zaibatsu*, in the *keiretsu* such control is exercised by linked directorships. Furthermore, the *zaibatsu* were competing directly for profit, whilst *keiretsu* compete mainly for market share.

Although the large *keiretsu* are Japan's large corporate conglomerates that speak to the imagination and get most of the attention, it should be noted that the real engine behind these is formed by small- and medium enterprises. In fact, the majority of Japan's population does not work for a large company but for a small- or medium sized company. They do fit into the *keiretsu* structure, in particular the vertical or production *keiretsu*, where they are part of the supply chain, but often they are at the bottom of this chain and there is more competition. Subcontracting to smaller companies gives certain advantages, including the reduction of costs and thereby improving competitiveness. The large manufacturers avoid building enormous factory plants for parts. They operate at lower costs by extracting low prices from their suppliers and demand a high quality of the supplied goods. At the same time, the risk is shared with the group of suppliers. Furthermore, the small suppliers get the long-term contracts needed to invest and obtain technological advantages by sharing key personal with the large manufacturing companies. But this relationship is exclusive and works only within the *keiretsu*. It creates high prices for Japanese consumers and prevents foreign players from entering the Japanese market.

### c. Characteristics of Japanese Companies

Aoki developed the standard theory that contrasts Japanese companies with their Western counterparts, but in particular with US companies. [8] The contrast is made following the success of Japanese firms in the 1980s, when they presented an attractive alternative to the way US companies operated. The comparison is done from an economic perspective rather than a legal perspective. Nonetheless the theory has gained such weight and provides so much insight that it needs to be discussed in detail. Aoki coined the term J-Firm to describe the theoretical Japanese firm and the term A-Firm for the US firm. Perhaps the main merit of the theory is that, under these theoretical descriptions of the firms, it brings together many different elements that were previously studied in mere isolation. Some of these elements have already been mentioned in the context of alliance capitalism above, such as cross-shareholding, but also include elements from different fields such as human resources management. The main drawback of the model is that it is a theoretical concept that tries to model the average Japanese company and as such no actual company will operate exactly as the model describes. But again, the value of the model lies in the way it bundles the individual elements that make up the Japanese company.

One such element of the J-Firm is the way in which the information structure and coordination is set up. The A-Firm is said to have a vertical coordination and vertical information structure. That means that decisions are made at the top and send down the chain of command to the workforce. The J-Firm on the other hand is said to have a horizontal coordination and horizontal information structure. This means that the workforce on the ground is involved in the actual decision making and by doing so also influences the strategic decisions that are made at the top. This system is taken a step further at companies such as Toyota, where rotation on the factory floor form an important part of improving decision making and idea generation amongst the workforce.[9]

The elements of shareholders and stakeholders have already been raised to some extend when discussing alliance capitalism. In the A-Firm, the shareholders play the most important part. In the J-Firm, in sharp contrast, there are not only shareholders but also the employees and the enterprise unions. Part of this stems from the difference of what holding shares stands for in the different firms. Shares in the A-firm are freely traded and floating, they are highly liquid. Shares in the J-Firm on the other hand, whilst perhaps listed

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[8] Masahiko Aoki, 'Toward an Economic Model of the Japanese Firm (1990) 76:5 The American Economic Review

[9] Taiichi Ohno, *Toyota Production System, Beyond Large-Scale Production* (Productivity Press 1998)

on an exchange, are largely held by affiliated companies and therefore locked. The purpose of owning shares in a company is not seen as a capital investment but as an expression of a relationship. It implies that the reason for holding shares not merely relates to short-term potential capital gains but to a longer-term interest in the well-being of the company.

These different reasons for holding shares are reflected in the perceived ownership of the company, its management and employees. The ownership of the A-Firm rests simply with the shareholders. However, in the J-Firm, the ownership, if not the legal then at least the practical or perceived ownership, lies with the entire community of the company. The company can be regarded as a community of members with the company board presiding as a community council, which guides the company along. This community is protected by friendly cross-shareholdings in other firms, which both reduces the risk of a take-over and reduces any unwanted shareholder pressure or influence on the board. The board is therefore free to exercise its role as senior leaders of the community or perhaps as mediators between shareholders, employees and unions. In a paternalistic view, the board may even be regarded as benevolent guardians of the community.

The employees demonstrate the same level of commitment in the J-Firm as discussed for the shareholders and the board. It introduces the idea of the 'company man', ensuring the lifetime loyalty of the employee working as part of the collective, as a member of the community. This is reflected in the HR system, which is built around the lifetime employment system. During a lifetime of employment, an employee rotates around various places in the company, creating generalist knowledge rather than specialist knowledge. As well as rotating, the employee receives in-house training or is sent to affiliated *keiretsu* firms for short time periods to increase their skills and to share knowledge and expertise. In the A-Firm, employees become more specialised and, seeking to maximize their own careers instead of the collective, they work for different companies for shorter time periods. The incentive structure in the J-Firm is aligned with its HR system. Promotion and wage are both determined by age or seniority, as opposed to merit as in the A-Firm. Promotion is mainly determined by factors such as seniority, length of service and, to a lesser extent, skills. This type of hierarchy works in conjunction with the horizontal coordination structure outlined before. Finally, any movement in jobs by the employees and hence competition for skills comes from other areas within the same company. The A-Firm faces such competition mainly from outside the company, in other words from different companies.

The central idea behind labour in the J-Firm is 'commitment', whereas the central idea in the A-Firm is 'exit'. This idea of commitment in labour comes back in many production concepts, such as job rotation and problem solving on the work floor, quality control circles and consensus-building within the company. Any response to a downturn in a company's fortunes is also based upon this central idea. The A-Firm will reduce headcount and make employees redundant, thereby reducing costs and maintaining profitability. The J-Firm on the other hand will try to retain workers and maintain employment by reducing working hours, thus placing more weight on the duty to look after those within the company community.

It should be noted here that there is important academic writing that contests the existence of *keiretsu*.[10] With substantial evidence it is argued that, for example, cross-shareholdings do not exist and that lifetime-employment does not formerly exist in law. These arguments may have some force, but it simply goes too far to completely deny the existence of *keiretsu*, as the examples mentioned here so far already prove that they exist. Furthermore, this academic stream heavily criticizes the existence of something akin to the J-Frim. This appears to ignore the point that both the A-Firm and the J-Firm are economic models based on reality. They generalise the characteristics found within different Japanese companies and of course no specific Japanese company will completely satisfy them. Creating these models allows for some comparison and discussion, as long as the restrictions of the model are kept in mind.

### d. Corporate Governance

Another important question in the context of this research project is how corporate governance functions within the J-Firm and within the A-Firm? In the classical A-Firm, the shareholders are the owners of the company and monitor the performance of the company. In the J-Firm this monitoring role is performed from inside the *keiretsu* by the Main Bank.[11] The Main Bank performs such a central role that it is often referred to as the Main Bank System. The Main Bank holds both a substantial amount of companies' share in the pattern of cross-shareholding, but also provides credit and loans and often even provides advice on the development of the company. The immediate conclusion is that it is

[10] Yoshiro Miwa and Mark Ramseyer, *The Fable of the Keiretsu: Urban Legends of the Japanese Economy* (Chicago University Press 2006)

[11] M Aoki, H Patrick and P Sheard, 'The Japanese Main Bank System, An Introductory Overview' in M Aoki, P Patrick and P Sheard (eds), *The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies* (OUP 1994)

central to the corporate governance of the J-Firm and monitors the performance of all companies within its *keiretsu*, but is this a sufficient analysis?

With a way of organising companies that is so different from in particular the US, it is important to keep in mind that some of the basic theories of corporate governance were developed in a US context. Consider in particular the Berle-Means problem of monitoring associated with the separation of ownership and control. Answers have included outside directors, the market and institutional investors. When discussing corporate governance in the UK in chapter two, it was observed that the Cadbury report did not go far beyond shareholders appointing a board of directors and auditors whilst ensuring an appropriate governance structure was in place. Subsequent UK reports, resulting in the UK Corporate Governance Code, have not moved far beyond this. This creates the danger of studying Japan's corporate governance by trying to find equivalent elements of system in the UK or the US. [12] This type of comparative analysis in academic literature has resulted in a search for the solution to the monitoring and control problem in Japan. The Main Bank would usually hold a large amount of equity in cross-shareholdings, provide a large part of the loans and be intimately familiar with the company's plans and health. It is therefore understandable that the generally accepted solution is that the Main Bank performs this role. Although this may be partially true, it is not the complete answer.

The Main Bank would under normal circumstances not take on some of the tasks normally associated with monitoring and control. Firstly, it would remain passive unless the company would be near failure, rather than active. Secondly, and related, it would normally not remove underperforming board members. The point here is not to show that the Main Bank did not perform the role of control and monitoring properly, rather, the point is to question whether that was its role at all. An alternative model is offered by what has been coined "contractual governance".[13] The name refers to the "implicit contract" that exists between the different companies within a *keiretsu*. As discussed, the companies in *keiretsu* have strong relationships, for examples as supplier of components, assemblers and distributors. They usually also hold blocks of each other's shares. This means that each company within a *keiretsu* takes a direct interest in the other companies delivering good quality products or services at a competitive price whilst turning over a decent profit.

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[12] Ronald J Gilson and Mark J Roe, 'Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organisation' (1993) 102 Yale L J 4, 871, 874
[13] ibid 882

The point is thus that an investment in equity is not just an opportunistic short-term transaction aimed at obtaining a good return: it is a long-term investment that underlines the relationship between companies in the supply chain and removes opportunism.[14] For example, it greatly reduces the possibility that a manufacturer will suddenly go to a different supplier in order to get a better deal, allowing the original supplier to make long term plans and investments. Hence the situation of shareholders within a *keiretsu* is far more complicated than in the US or the UK, as shareholders are also either, in the case of companies, trading partners, or, in the case of the Main Bank, creditors. One question is why this system would not lead to companies within the *keiretsu* producing efficiently. The point is that competition outside the *keiretsu*, with other business groups, is very intense. This forces each part of the *keiretsu* to produce efficiently to ultimately produce competitive goods or services.[15] This analysis and understanding of the role of holding shares and of the Main Bank provides a much clearer picture of how corporate governance in Japan should be studied.

As discussed previously, the role of employees in Japanese companies is quite different from that in US or in the UK, with its own characteristics including lifetime employment, generalists over specialists and the seniority wage system. The board consists completely of employee insiders. As a result, employees have received a great amount of attention in the debate on Japan's corporate governance. The idea from the theory of the A-firm, that Japanese companies regard their employees as important stakeholders and as an important that requires investment, has been challenged.[16] Some critics argue that, in the absence of a competitive labour market, other explanations present itself to explain the importance given to employees. These explanations can be found in the political sphere, arising from a fear of socialist movements and their potential political success, as well as in the firm specific sphere, arising from a desire to curtail the power of the unions. This downplay of the importance of employees is further supported by the fact that employees are merely engaged with the company but not active in its process of governance.[17] Their input was often used to improve the production process[18] on the floor, but it did not extend beyond that. A counterargument to this is that Japanese companies generally focussed on the expansion of market share, rather than increase in profit: this is beneficial

[14] ibid 887
[15] ibid 893
[16] Ronald J Gilson and Mark J Roe, 'Lifetime employment: Labor Peace and the Evolution of Japanese Corporate Governance' (1999) 99 Col L R 2, 508
[17] Simon Learmount, *Corporate Governance: What can be learned from Japan?* (OUP 2002) 32-39
[18] Taiichi Ohno (n 9)

to the employees as it creates work. It is not advantageous to the shareholders if they are only looking for a return on their investment.

## 3. The Financial Crisis

### a. The Bursting of the Bubble Economy

The corporate landscape in Japan, as set out in the previous section, had developed since the end of the Second World War and made Japan one of the largest economies in the world by the end of the 1980s. This came to an abrupt end. In December 1989, the Nikkei index reached its peak at 38,916 points. It went below 30,000 in March 1990 and below 25,000 in November 1990. It dropped further and went below 20,000 in March 1992. On January 23, 1993, the Japanese prime minister finally conceded that the 'bubble economy' had collapsed, several years after the initial crash of house prices and the bust of the asset price bubble.[19] It was followed by the loss of power by the Liberal Democratic Party ("LDP") in the elections of August 1993, which signified a major political landslide in Japan as the LDP had been the ruling party since 1955. At the same time, every economic forecast since the bubble had burst said the bottom had now been reached. Slowly, there was a realisation that a growth rate of at best a few per cent per year would be the norm long-term. It raised questions about the sustainability of how Japan conducted its business: were lifetime employment and the enormous amount of corporate investment still sustainable or was a shift to return on capital becoming a reality? Manufacturers have started both to cut down on their domestic overproduction and to move production abroad to cheaper nearby countries, thereby 'hollowing out' Japan. It is without doubt that the financial crisis of the early 1990s would have a wide impact on Japan beyond its financial system and its economy.

The bursting of the bubble and the crashing of house prices may have been the direct trigger of the financial crisis, but the immediate underlying cause of the problems were the bad loans, in particular those relating to real estate.[20] How did Japan get to this point? Going back to the period from the late 1970s to the mid-1980s, Japan had started a program of financial deregulation. There was a variety of reasons for the start of this program, including a large issuance of government bonds which Japan's banks could no longer absorb and pressure from the US to open Japan's financial markets. The reduction in

[19] Christopher Wood, *The End of Japan, Inc.* (Simoan & Schuster 1994)
[20] Kazuo Ueda, 'Causes of Japan's Banking Problems in the 1990s' in Takeo Hoshi and High Patrick (eds), *Crisis and Change in the Japanese Financial System* (Kluwer Academic Publishers 2000)

tight control by the regulator was not replaced by an improved risk management practice at the banks themselves. From the 1980s onwards, Japanese banks started to lend aggressively, backed by continuously rising asset prices, though without the financial innovation that financial institutions outside Japan were developing. In the nineties, when the bubble burst and asset prices collapsed, the banks were ill prepared and the government slow to address the issues. In fact, the approach taken by the government and the regulator was one of forbearance, severely underestimating the impact of the bad loans on the general economy. By reducing the number of loans and by trying to increase their capital whilst share prices were falling, the banks were unable to support the Japanese economy by providing new loans to businesses. The government did not take serious action until 1997 when it introduced the so-called Big Bang reforms.

### b. The Role of the Main Bank

Despite efforts to deregulate Japan's financial markets slowly before the mid-1980s, Japan's capital markets were underdeveloped compared to, for example, their US counterparts. As a result, much of a company's financing would be done through loans with the banks, rather than through the capital markets. The Main Bank, as discussed previously, sits in the centre of the *keiretsu* structure.[21] It provides most of the financing to the other companies within the *keiretsu* through both loans and cross-shareholding. The close relationship between the Main Bank and the companies go beyond these financial and ownership interests. For example, a Main Bank would often initiate a support or rescue action if a company would come into financial difficulty. There is also the corporate alliance that is formed between the Main Bank and the various companies within the *keiretsu*, which includes for example the exchange of personnel and other group activities.

Due to this level of embeddedness, the Main Bank makes most of its decisions concerning financial support based upon the relationship with the clients rather than on any factors, as might happen in an open and critical capital market. The bank does not take a critical view on why the money is needed or what the borrower's position is, but instead takes a more paternalistic role as befits its role in the *keiretsu*. This creates a further problem when a company would lend from other banks as well, something that was not at all uncommon. The issue is that these other banks would rely on the Main Bank to do all the due diligence, monitoring and any necessary intervention. This type of behaviour is referred to as 'convoy behaviour'. It was actively encouraged by the Ministry of Finance, which went as far as to

[21] M Aoki, H Patrick and P Sheard (n 11)

protect Japan's banking sector from both internal and external competition and from competition from capital markets. Ironically, it did this to promote stability within the financial system. It would even force a merger with a stronger bank if a weak bank threatened to go into default.

The role of the Main Bank in the financial crisis has been heavily criticised and it has been suggested that the Main Bank and the *keiretsu* in itself have become outdated.[22] A large part of the critique on the Main Banks is based on their reluctance to deal with their non-performing loans. These loans were provided based on the relationship with the company instead of any financial merit and forcing companies to now default on these loans would therefore bring various difficulties. First, it would adversely affect and strain the relationship between the bank and the company. It would be a loss of face on both sides. Second, the bank is also likely to hold a substantial amount of equity of the company it is about to bankrupt, which means that the bank would lose twice. Overall, renewing bad loans was the easier option.

A further problem was posed by the *Jusen*, or non-bank financial institutions created by banks in the 1970s. Whilst banks at the time were mostly interested in corporate customers, these *Jusen* primarily entered into the home mortgage business, originally set up to facilitate the large move from people from rural Japan to the cities. When, at a later stage, the banks themselves moved into the mortgage business, the *Jusen* found it difficult to compete. As a result, the *Jusen* moved more and more into lending to real estate businesses, an area in which banks were still reluctant to lend. When the asset bubble burst, the *Jusen* had an enormous amount of nonperforming loans: an estimated 38% of all their loans were deemed to be nonperforming.[23] A series of rescue packages by the Japanese government was needed to rescue the *Jusen*. All of these were hopelessly inadequate and by 1995 the percentage of nonperforming loans had reach 75%, with as must as 60% completely unrecoverable. The enormous amount of bad loans residing with the *Jusen* and with the banks obviously caused great problems in Japan's financial system.

### c. 1997: Asian Crisis, Failing Financial Institutions and Big Bang

The Asian Crisis in 1997 changed the game. Many of the South East Asian nations saw their currencies devalue and stock markets collapse. The IMF had to intervene in several

[22] Thomas F Cargill, 'What caused Japan's Banking Crisis?' in Takeo Hoshi and Hugh Patrick (eds), *Crisis and Change in the Japanese Financial System* (Kluwer Academic Publishers 2000)
[23] M Aoki, H Patrick and P Sheard (n 11) 13

countries, including South Korea. It is often claimed that this intervention by the IMF was very beneficial to South Korea as it forced the country to introduce a swift series of drastic reforms to clear up the problem, in contrast with the much slower approach Japan was taking. Although Japan was not directly hit by the crisis, many of its nearby trading partners were hit, causing an economic slump in Japan itself. With exports to the region declining rapidly, many Japanese companies were in trouble or went out of business altogether. Several large Japanese financial institutions failed, including Sanyo Securities, Yamaichi Securities and Hokkaido Takushoku Bank. In particular, Yamaichi was active outside of Japan, making the financial malaise for the first time an international rather than a domestic problem. Japan's government finally had to act.

The government made ¥1.8 trillion available, which was distributed amongst banks in March 1998.[24] Unfortunately, this capital injection was not sufficient. The Financial Reconstruction Act was passed, which allowed for failed banks to be nationalised and reorganised or to be put under receivership and reorganised as a bridge bank. A bank could also apply for nationalisation before it failed. Both Long-Term Credit Bank and Nippon Credit Bank were nationalised under this Act. These two cases of nationalisation are discussed in more detail later. The Rapid Recapitalisation Act was also passed, allowing the injection of capital into undercapitalised banks and allowing healthy banks to apply for public funds. These two Acts together raised the government's commitment to ¥17 trillion for depositor protection, ¥18 trillion for the failed or nationalised banks and another ¥25 trillion for capital injection.[25] Independent institutions were created to aid in solving the crisis: the Financial Reconstruction Commission was created to make decisions under the Financial Reconstruction Act and in June 1998 the Financial Supervisory Agency was created as an independent financial regulator. The government also advocated the "Big Bang" Reformation Plan in November 1996. This is discussed later on this chapter.

### d. The Case of Long Term Credit Bank

One of the most significant banking failures during the crisis was that of Long Term Credit Bank ("LTCB"). The bank was created in 1952 with the aim of providing long term financing to the rebuilding Japanese industry.[26] LTCB also slowly started its overseas expansion,

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[24] Takeo Hoshi and Hugh Patrick, 'The Japanese Financial System: An Introductory Overview' in Takeo Hoshi and Hugh Patrick (eds), *Crisis and Change in the Japanese Financial System* (Kluwer Academic Publishers 2000) 17

[25] ibid 18

[26] Gillian Tett, *Saving the Sun, Shinsei and the Battle for Japan's Future* (Random House Business Books 2004)

which it stepped up shortly after the Oil Crisis, as this economic shock slowed down the economy. In 1989, nearly at the peak of the bubble, LTCB was at the height of its power and was the ninth largest corporation in the world measured by asset size. When the bubble burst, LTCB's decline started. In 1996, during an inspection by the Ministry of Finance, it was discovered that LTCB had around $40 billion non-performing loans on their books. These findings were covered up. Only when the Asian Financial Crisis intensified in the summer of 1998 did rumours surrounding LTCB cause its share price to collapse.

In autumn 1998, under pressure from the US to take action, Japan nationalised LTCB after it collapsed. Around the same time Nippon Credit Bank was nationalised. The drama intensified when a criminal investigation revealed illegal payment of dividends, which, once leaked, drove several managers involved to commit suicide. In winter 1998 the government appointed Goldman Sachs to find a buyer for LTCB. The creation of alliances between Western and Japanese companies now gathered speed. One of the most prolific alliances was the one between Renault and Nissan in 1999. In that same year, many of the smaller Japanese banks consolidated to create four megabanks. In spring 2000, Ripplewood, a US private equity firm, took control of LTCB and rename it to Shinsei. For the next few years, a struggle ensued between the government, the FSA and Shinsei concerning the cleaning up of the non-performing loans. Shinsei had a successful initial public offering in 2004.

There are three important observations to be made. The first is that LTCB grew into one of the largest financial conglomerates worldwide at the expense of conducting prudent risk management. This is evident by the large amount of non-performing loans they had. It would appear that, similar to the banks that failed in the UK, LTCB had placed growth over risk management. The parallel is limited, because LTCB grew slowly over several decades, whilst the UK banks expanded rapidly within a few years. The UK banks thus showed a much greater emphasis on growth than LTCB. The second important observation is that LTCB did not acknowledge, and in fact covered up, the fact that it had so many non-performing loans. It demonstrates that, at best, senior management and the board were not effective in dealing with the problems once they were aware of their existence. This observation is of a similar nature to the one made about boards and management at UK banks. The effectiveness of the board as well as the skills and knowledge of senior management were reasons behind the failures of UK banks. The final observation is that the Japanese government sold LTCB very swiftly after it was nationalised. The fact that such

a quick turnaround is possible supports the observation that the nationalised UK banks could, and probably should, have been privatised earlier as well.

## 4. Legal Reform

### a. The Big Bang Reforms

The Big Bang plans were proposed by the government in November 1996. Although gradual reform had been introduced in the years before, it was the first radical departure from the financial system set up in the nineteen twenties, strengthened during wartime. The reforms were based upon three principles: first, free markets; second, fair trade secured by transparent and reliable rules; and, third, an institutional framework that would satisfy international standards in areas such as legal, accounting and supervision.[27] These three principles recognise some of the main problems. It addresses the absence of free competition within Japan's financial system and the slow and inadequate response by the Ministry of Finance since the start of the crisis.

In June 1998, the Laws for Financial System Reformation were enacted. They included amendments to the Banking Law, the Law of Securities Transactions and the Law of Insurance Industry. One of the focus areas was to improve the asset management sector. Despite large personal assets, most of this was kept as postal savings or other savings accounts. The market, in which formerly only life insurance companies and trust banks were allowed to operate, was opened up to banks and other insurance companies. Another area of focus was the corporate finance area, which had been liberalised with the introduction of several new financial instruments. Although large multinational companies already had access to international capital markets, the smaller sized companies now also gained access to ways of finance beyond simple loans. This also reduced the dependency of the smaller companies on their (main) bank, which were unwilling to lend to new applicants due to their own problems.

In order to improve the working of capital markets, the rules on accounting and transparency were strengthened. It also served to clear up the problems of non-performing loans, as to date the scale of the problem for individual institutions was largely unknown. Further increase in competition in the financial sector was reached by allowing cross-over entry, for example, deposit-taking banks would now be allowed to set up a securities firm.

[27] Akiyoshi Horiuchi, 'The Big Bang: Idea and Reality' in Takeo Hoshi and Hugh Patrick (eds), *Crisis and Change in the Japanese Financial System* (Kluwer Academic Publishers 2000) 234

Holding companies were again permitted to facilitate this. As mentioned previously, in order to regulate the financial industry independently from the Ministry of Finance, the Financial Supervisory Agency was created, reporting directly into the prime minister. More importantly, as a newly created agency, it did not have a history or close ties with financial institutions and could supervise at arm length, making it altogether a much more credible regulator. [28] One of the first main tasks of the FSA was to administer the Prompt Corrective Action rule. Under this rule, financial institutions periodically have to calculate and assess their own capital ratios, although subject to external audit, and take corrective action if they are taking too much risk. It was a preventive measure aimed at solving the tactics of forbearance used to that date. Unfortunately, it had the effect of exacerbating Japan's economic difficulties by forcing the banks into conservative lending policies.[29] Overall, the policy was accepted because drastic measures were necessary to force through changes.

### b. Commercial Code Changes

From the period shortly after the crash in the early 1990s to well into the 2000s incremental changes were made to the Commercial Code.[30] Until 2005, Japanese company law was part of the Commercial Code. In 2005 company law was separated out through the enactment of the Company Law, which exists next to the remaining Commercial Code. The Commercial Code in Japan has existed for some time. After *Meiji Ishin* in the late nineteen hundreds, when Japan started to look at how European nations had organised their affairs, and after arguments between proponents of French, English and German legislation, the Commercial Code was enacted in 1899 based largely upon the German Commercial Code of 1861.[31] As a result, the Commercial Code before the end of the Second World War was mainly German. Not surprisingly, after the Second World War, during the American occupation, the Commercial Code was amended in 1950 based on US company law, focusing on three areas: first, the facilitation and simplification of financing of companies, second, the reorganisation of corporate bodies and, third, strengthening the status of shareholders.[32] It meant that ownership or capital and management were separated and

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[28]Takatoshi Ito, 'The Stagnant Japanese Economy in the 1990s: The Need for Financial Supervision to Restore Sustained Growth' in Takeo Hoshi and Hugh Patrick (eds), *Crisis and Change in the Japanese Financial System* (Kluwer Academic Publishers 2000)

[29] Akiyoshi Horiuchi (n 24) 245

[30] Ronald J Gilson and Curtis J Milhaupt, 'Choice as Regulatory Reform: The Case of Japanese Corporate Governance' (2005) 53 Am J Comp L 2, 343; Hiroshi Oda, *Japanese Law* (3rd ed, 2009 OUP) 219; Harald Baum and Moritz Bälz (eds), *Handbuch Japanisches Handels- und Wirtschaftsrecht* (Carl Heymanns Verlag 2011)

[31] Oda (n 30) 217

[32] ibid 218

the board of directors was introduced. Despite US efforts, Japan was reluctant to include the protection of minority shareholders.

Due to the behaviour of companies during the Oil Crisis, there was public anger and a push to place companies under greater control. Combined with the fallout from the failures of several major companies in the mid-60s, various changes were made to the company law in 1974. The Special Measures Law on the Audit of Large Companies Limited by Shares was enacted. The changes resulted in more power for auditors in the supervision of business and the requirement of audit by accounting firms for large companies.[33] In the 1980s, following more corporate scandals, more reforms were enacted although in a piecemeal manner. These included the general strengthening of supervision by shareholders, for example by introducing the right for shareholders to make proposals for the general shareholders' meeting and by introducing voting in writing, as well as strengthening the power of auditors.

Whilst these incremental changes were being enacted, it was clear that further amendments were needed following the financial crash in 1990 and the oncoming recession. The general belief was that the financial and economic crisis was caused by over-regulation and thus by an over-regulated company law.[34] Early deregulation included the lowering of the ceiling of the issuing of corporate bonds in 1990 and the abolition of this ceiling in 1993. In the same year, both the supervision of shareholders and the audit system were strengthened, for example by the reform of derivative actions and by the introduction of external auditors.[35] The following deregulation plan that was introduced in 1998 included more reforms to the company law. Changes included the introduction of a stock option scheme and the simplification of merger procedures. In 2001, the Three Year Program on the Promotion of Regulatory Reform started, which encompassed a review of both the Civil Code and the Commercial Code. Changes included further reform of derivative actions, the introduction of new classes of shares and a series of corporate governance reforms, which are discussed in 6.3.4. Finally, in June 2006, the Company Law came into force, replacing much of the Commercial Code and surrounding legislation.

[33] ibid 218, 219
[34] ibid 218
[35] ibid 219

### c. Corporate Reform

Before 2005, there were four different types of companies under Japanese law. First, there were the companies limited by shares. These were designed for large public companies. Second, there were the limited liability companies, which were intended for small and medium-sized companies with a maximum number of fifty members. In practice, after the Second World War, companies limited by shares were often used instead, usually unlisted and without issuing any shares. It has to be noted that Japanese limited liability companies are similar to the German 'Gesellschaft mit beschränke Haftung (GmbH)' and not to the US-style LLC, as this part of the Japanese law was based upon German law dating from 1922. Third, there were limited partnership companies and, fourth, full partnership companies. Partnerships under Japanese law have a legal personality.

With the enactment of the 2005 Company Law, limited liability companies following the German law were abolished and pushed into the expanding category of companies limited by shares. This therefore became an enormous category, ranging from small companies with virtually no capital to large multinational enterprises. It reflected the fact that distinction between the two categories had blurred already in practice. However, a new type of limited liability companies was created based upon the US style LLC. Besides the companies limited by shares and the new limited liability companies, the 2005 Company Law also provided for limited liability partnerships, modelled on the limited liability partnerships in the UK in 2000, and full partnership companies. The Company Law further distinguishes between public and remaining companies. Public companies have a restriction on assignment only in relation to part of the issued shares.[36] Thus the remaining companies require the consent of the company in the transfer of shares in relation to all the issued shares. Note that public companies do not have to be listed. Another distinction is made between large companies and other companies: large companies either have a share capital of at least half a billion Yen in the last business year or a debt of twenty billion Yen or more.[37] The categories of public companies and large companies matter when determining the legally allowed governance structure of the company.

Faced with a large number of corporate insolvency which followed the financial crisis and the Asian crisis, the then existing insolvency laws were deemed to be hopelessly out of date. Three new laws were introduced following a review initiated along with the Big Bang

[36] ibid 224
[37] ibid 225

Reforms.[38] Although radical reform was planned, the economy worsened at such a rate that the rehabilitation of companies became most important. The first of the three new laws was therefore the Civil Rehabilitation Law of 2000, replacing the Composition Law of 1927 which was based on the German system. The old Composition Law had several shortcomings, especially the absence of means to enforce an agreed composition plan, which meant that many resorted to settlement out of court.[39] The new law therefore tried to improve both the economic and the legal situation by allowing debtors to rehabilitate with a majority consented plan approved by the courts.

The Civil Rehabilitation Law of 2000 was quickly followed by the Law on the Recognition and Assistance for Foreign Insolvency Proceedings of 2000, based upon the UNCITRAL model law on cross-border insolvency in 1997,[40] and the Corporate Reorganisation Law of 2003. Before that, corporate reorganisation in Japan was based on legislation introduced from the US in 1952 and was aimed at large companies.[41] The problem was that, as it meant that current management would lose power over the business to an administrator, many were reluctant to apply for this. The new Corporate Legislation Law amends this and allows the debtor in possession system.[42] The last step was to replace the Bankruptcy Law 1922 with the new Bankruptcy Law 2004. The aim of this new Law was to speed up the procedure and ensuring its fairness.[43] As part of the new Bankruptcy Law, and following similar procedures in the Civil Rehabilitation Law and the Corporate Reorganisation Law, there is a system for pursuing the liability of directors for unlawful acts or breaches of fiduciary duties.[44] Finally, the Company Law provides for special liquidation, which can be applied for to the courts by creditors, auditors, liquidators or shareholders when there are circumstances that obstruct liquidation.

### d. Corporate Governance

The choice of governance structure under the Company Law of 2005 is based upon whether a company is classified as a large or non-large company and as a public or non-public company.[45] There is a large choice for smaller companies, but for large public companies the choice is limited to two options. The first option, which is relatively new and

[38] ibid 285
[39] ibid 288
[40] ibid 291
[41] ibid 289
[42] ibid 290
[43] ibid 286
[44] ibid 288
[45] ibid 242

introduced by changes to the Commercial Code in 2002, is the US-style board system. Here the company has a board, three committees within the board and an independent auditing firm. This option is so far not very popular as almost all large public companies are using the second option, which was already the convention before the US-style option was given, requiring only a board, a corporate auditor and an accounting firm.

The general shareholders' meeting may decide on various issues set out in the Company Law. [46] Shareholders who have held a certain percentage for a longer period of time are entitled to make specific requests. Shareholders who have held three percent or more of the voting shares from six months before the meeting without interruption are entitled to require directors to convene the general shareholders' meeting, specifying the subject matter and reason for convening. Furthermore, shareholders who have held one percent or more of the voting shares without interruption for six months or longer are entitled to request directors to include a matter in the agenda. They cannot do this if a similar proposal had been made within the last three years and it failed to gain at least ten percent of the votes. Provisions have been made to reduce the influence of cross-shareholding and to empower other shareholders. If company A holds more than twenty-five percent of company B, or in effect controls it by other means, then company B does not have a vote. In other words, companies with cross-shareholdings cannot vote in each other's general shareholders' meetings.

Until late in the 1990s, the general shareholders' meetings in Japan did not have much meaning and were largely a formality. In practice, most of the companies would organise their meetings on exactly the same date, such as the last Thursday of June.[47] The meetings would last for about thirty minutes and there would be no questions. In some cases it was not uncommon to have the first rows of the audience taken up by lifetime employee shareholders, who would cheer the management. This created an atmosphere in which it was particularly difficult to ask awkward questions, to criticize or to oppose the management. Although this did get complaints from other shareholders, the courts upheld that the meeting was conducted in a way compatible with what the law prescribes and that the other shareholders could have asked questions.[48] The law has now been amended to strengthen the position of shareholders as this practice was unsustainable.

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[46] ibid 243
[47] ibid 245
[48] ibid 245

Companies limited by shares are required to have a director.[49] Public companies, as well as remaining companies with certain choices of governance structures, must have a board of directors comprised of at least three directors. At the general shareholders' meeting, directors can be appointed and dismissed with a normal majority, although companies have the option of issuing shares with a veto right on the appointment of directors, which implies that agreement beyond the general shareholders' meeting is required. The standard period of appointment for a director is two years, unless the company has committees, in which case it is only one year. Shareholders, who have held their share for longer than various specified lengths of a few months, have additional rights to apply to the court to dismiss directors in case of inappropriate behaviour. The board must, amongst the directors, appoint representative directors who conduct the business of the company.[50] If the company has committees, then there are senior executive officers, who are not necessarily directors, appointed by the board.

The role of directors depends on whether the company has a board of directors or not. In those with a board, only the representative directors can conduct the business of the company, but in companies without a board all directors can. If a company has committees within the board then the directors do not conduct the business but perform merely oversight or supervision. However, as discussed, this last form is not yet very popular. Except for this last form, with committees on the board, the board has the following powers:[51]

1. To determine the execution of the business of the company,
2. Supervise the carrying out of duties by the directors,
3. Appoint and dismiss representative directors.

The following fall within the exclusive jurisdiction of the board:[52]

1. Disposal or acquisition of significant assets,
2. Borrowing of a large amount,
3. Appointment and dismissal of important employees,
4. Establishment, change, and abolition of branches and other organisational units,
5. Significant matters involving the issuing of bonds,

[49] ibid 247
[50] ibid 249
[51] ibid 250
[52] ibid 250

6. Introduction of a system to ensure compliance with the carrying out of duties by directors in accordance with the law and the Articles of Incorporation (created under the influence of the Sarbanes-Oxley Act in the US)

This structure, which is still in place in most Japanese companies, was based upon the US board system in 1950 when it was introduced. Consequently, it is regarded as a single tier system. Hence, until the recent reforms, the Japanese board was a combination of both execution and supervision in a single board, which consisted of a large number of directors. A board size of over forty directors was not uncommon with effective power concentrated with just a few. Furthermore, these directors would be company insiders, with almost no externals appointed. In acknowledgement of some of the criticism on this system of corporate governance, the average number of directors has reduced since the 1990s and the position of executive officers was created. Although on only a voluntary basis, and not on a legal basis, the executive officers conduct the actual business without being members of the board. This creates in effect a two tier structure in which the directors become supervisors. Nonetheless, most of the directors are still lifetime employees of the company.

This is different to the newly introduced company which has committees within its board, based upon the current US style, which has of course moved on since the 1950's situation on which the old Japanese model is based. In these companies there is a statutory requirement for a senior executive officer. The role of the board is hence to supervise the senior executive officer. The three committees, which are the nomination committee, the remuneration committee and the audit committee, must each have at least three members of which at least half are external directors. External directors are directors who are 'not a business executing director of the company or subsidiary, their senior executive officer, manager or employee, and have, in the past, not occupied such a position in these companies'.[53]

## 5. Conclusions

### a. Comparison of Bank Organisation and Corporate Governance

Japanese companies operate in an alliance rather than on their own. In practice, it means that strong ties are formed between the companies that operate together. It results in strong relationships between companies that last for a very long time. This concept is not present in the UK. Although companies may frequently do business together, this does not

[53] ibid 252

take the form of the k*eiretsu* in Japan. This implies that the role which other firms play as external stakeholders in corporate governance is very different as well. In Japan, a much greater importance is placed on the firms within the k*eiretsu* than a UK firm would place on its trading partners. Furthermore, in Japan these relationships are often strengthened through cross-shareholdings and regular exchange of employees, which is not the case in the UK.

The practices within the companies themselves are fundamentally different as well. As per the analysis of the A-firm and the J-firm, the employee has a clear role as stakeholder in the Japanese company. He has, for example, the benefit of life-time employment, promotion by seniority and a large degree of protection in case of a downturn. The employee in the UK can be described, by contrast, as someone who seeks promotion by way of changing jobs and does not have a strong connection to the company. There is thus a clear difference between the importance of the employee as stakeholder in corporate governance in Japan and the UK.

Finally, the banks play a different role in the corporate governance process in Japan as they do in the UK. The Main Bank sits in the middle of the *keiretsu* and assumes the role of monitoring the other companies. It holds a large amount of equity in cross-shareholdings and provides many of the loans within the group. It is therefore assumed that the Main Bank has the best knowledge on the companies' financial health, in order to perform its role of monitoring and controlling these companies. This does not mean that the Main Bank should automatically be relied upon to do these tasks. After all, the Main Bank performs a substantial part of its business within the group based on the relationships rather than on financial fundamentals. This is very different from the role of the banks in the UK financial system. The UK banks are under pressure to achieve a good return on equity. This means that they are more conscious of the riskiness of any counterparties and how much capital they may need to hold against any loans. It is therefore fair to say that banks in the UK and in Japan play a fundamentally different role in corporate governance.

### b. Comparison of the Financial Crises

There are clear similarities in the causes of the crises. Both started by the bursting of a property bubble: one in Tokyo and the other in subprime US mortgages. This points to the same underlying problem of poorly performing loans. In Japan, banks had a large amount of non-performing loans on their books. The UK banks had exposure to the non-performing loans, but in different forms. Domestic lenders, such as Northern Rock, had leveraged

themselves by securitising large parts of their risky mortgage portfolio. Large international banks, such as RBS, were active in and directly exposed to traded mortgage backed securities. In both crises, this resulted in a credit crisis as liquidity dried up. Banks were not willing to lend more money and those banks relying heavily on short-term funding got into trouble. Ultimately, in both crises, several banks collapsed and had to be taken into temporary government ownership. All these factors point to great similarities between the two financial crises.

### c. Comparison of Responses and Reforms

In both the UK and Japan the insolvency laws were not designed to deal with the crisis at hand. In the UK, the insolvency laws did not provide adequately for the failure of a bank, which resulted in the Banking Act 2008 and 2009. In Japan, the insolvency laws were outdated overall. This caused problems when, during the prolonged period over economic decline, many companies became insolvent. The solution adopted in Japan to deal with the failure of large banks was to nationalise them. The difference is that, in the UK, a return to the private sector is proving to be a lengthy process, whilst in Japan this was done swiftly. The latter observation is somewhat deceptive, because after the privatisation followed several years of struggles between the bank, the government and the Japanese regulator. The struggles mainly concerned the non-performing loans the bank still had on its books. This is an argument in favour of keeping a nationalised bank under government control for a longer period, allowing an unhindered restructuring and clean-up to take place. Once privatised, this would become more difficult for the government to control. It must be noted that within Japan the government can more easily exercise its influence through MITI, the regulators and the Bank of Japan, compared to position the UK government is in. However, whether through formal or informal control over the bank, any interference by the government, as discussed in chapter four, is likely to conflict with the bank's commercial and regulatory objectives.

There is similarity between the problems emanating from the board during the crises in the UK and Japan. In the UK, the general observation was that boards at banks were ineffective in challenging and in conducting oversight. It was further concluded that the board and senior management lacked the skills, knowledge and experience required in their roles. The situation in Japan was that boards were equally ineffective but for different reasons. This can a large extent to be explained by the different role of the board in a Japanese company. The role has been described in this chapter as benevolent guardians of the community, and

as mediators between shareholders, employees and unions. As a consequence, Japanese boards can be very large in size. They can be composed of people from other companies within the *keiretsu* or former government employees. It is fair to say that these boards cannot challenge effectively and they do not contain the relevant skills and knowledge. However, this observation is grounded in the notion of what a UK board must do, not what a Japanese board must do. Following the crisis in Japan, the role of the board is slowly changing. It is difficult, given the different role of the board, to compare meaningfully the changes made to the UK and Japanese boards.

Perhaps the most interesting difference between the responses in the UK and Japan is the difference in emphasis on aspects of ethics and culture within the banks. In short, there appears to be no response on this subject in Japan. In the UK, there is great emphasis on the accountability of senior management, on improving the culture and on preventing future scandals. This is at least partially driven by the fact that the taxpayer is still aggrieved over having to bail out the banks in the first place. But although, for example, non-performing loans in Japan have increased demands for transparency, it does not appear to have driven a change in culture. It is not unlikely that this comes from the different roles banks play within the *keiretsu*, as well as from the different role of the employees themselves within the company. There are less, or at least there are perceived to be less, problems with business ethics within Japanese companies. This makes it difficult to compare meaningfully any changes made in the UK as regards the culture and values with any measures taken in Japan.

Despite these difficulties, some broad and high level lessons can be drawn. The most important one is that neither the UK nor the Japanese model appeared to be able to prevent a financial crisis from occurring. In the UK, there was arguably too large a focus on short-term profits combined with a focus on shareholder value. In Japan, the opposite was true, with a focus on long-term relationships rather than short-term profit. The absence of commercial pressures and a sole focus on stakeholders is thus not an absolute solution for the UK. However, a combination of the two approaches, where all elements are combined, would appear to retain the best of both models.

# Chapter 7 – Recommendations for Corporate Governance at UK Banks

## 1. Introduction

The previous chapters provided detailed information on the failures of UK banks and the various reports, measures and legislation that were drafted in response. In this chapter, these are brought together to answer the following question: how can corporate governance at UK banks be improved? The issues raised by bank failures in the UK are compared with the relevant measures that have been examined so far. They are also compared with similar problems that arose during the financial crisis in Japan and the corresponding solutions. All of this is done in the form of reviewing the central weaknesses in corporate governance at UK banks and formulating recommendations accordingly.

Before discussing the difficulties, weaknesses and recommendations for corporate governance at UK banks, it is worthwhile reflecting on the theories of existence of the company and of corporate governance outlined in chapter two, in particular in light of the research and conclusions drawn so far in this thesis. The contractual theory, which, either from a legal or economics perspective, models the company as a nexus of contracts, is not sufficient for banks. It lacks the important external elements, such as customers, the regulator, and society at large. It therefore cannot provide a good model for banks. The communitarian theory may go some way in describing the nationalised or rescued UK banks. In this theory, the state would use the company to further social welfare. This is in line with the conflicts observed between the commercial objectives and the political objectives for the rescued banks.

In terms of models of corporate governance, the agency model appears to suffer from similar shortcomings as the contractual model for the existence of companies as it ignores the important external parts particularly relevant for banks. The stewardship model, which describes that board members look after the benefit of the company in the long term, would be able to capture this. External stakeholders' interests can clearly be included under this long term objective. It would be possibility to extend, for example, the directors' duties codified in the Companies Act 2006, which in s172 already includes the success of the company having regard for various stakeholders. It could be extended for banks to include special duties given the special nature and importance of banks in society. This

suggestion would raise the question whether such a special duty should then be included for all financial services firms or indeed for any firm with some national or strategic importance, or wherever the taxpayer may find himself on the hook.

## 2. Difficulties in Formulating Recommendations

### a. Difficulties of Comparative Analysis

In answering the question posed, it is important to keep in mind the difficulty associated with the comparative analysis performed in this research. These difficulties, which have been discussed to some degree in chapter two, may otherwise prevent the formulation of clear recommendations. They mostly arise when comparing international reports, EU and national legislation, or when conducting a comparative analysis with the case of Japan. The danger is that, as was outlined in the first chapter on methodology, one resorts to contrasting the different legal systems rather than to comparing them.[1] Any comparison and thus recommendation made, must include an appreciation of the wider context in which the different legal systems reside. The international reports, such as those issued by the Basel Committee on Banking Supervision, are a compromise between representatives of many different national regulators. These include representatives from European countries, the US and Asian countries. This means that they reflect a variety of cultures and backgrounds. It combines an enormous diversity of financial history and culture. With the realisation that certain UK banks have become globally systemically important must come the observation that rules and regulations may need to rise above the national level as well. It must be recognised that there is a clear need to set regulations at a global level, for example to avoid or minimise regulatory arbitrage and to recognise that many banks are truly global organisations.

The problems of comparative analysis are not restricted to finance and financial regulation. As the discussion in chapter one showed, the definition of corporate governance itself depends on the background of who defines it.[2] Corporate governance is largely defined by a country's history, the development of its rules, habits, laws and its culture.[3] The problem here again is that, with banks operating globally and international organisations setting standards, corporate governance itself goes outside these national boundaries to become a

[1] Pierre Legrand, 'How to Compare Now' (1996) 16 Legal Stud 232, 234
[2] Donald C Clarke, '"Nothing But Wind"? The Past and Future of Comparative Corporate Governance' (2011) 59 Am J Comp L 75, 79
[3] See Mark J Roe 'Some differences in Corporate Structure in Germany, Japan, and the United States' (1993) 102 Yale L J 1927 or Lucian Arye Bebchuk and Mark J Roe, 'A Theory of Path Dependence in Corporate Ownership and Corporate Governance' (1999) 52 Stan L Rev 127

global concept.[4] This can create friction between the need to regulate globally and the different nation laws and customs. As was noted for the regulation of globally systemically important UK banks, their corporate governance standards and norms may also need to rise above the national level. The problem is that corporate governance is a national concept, with different practices across the globe. This means that for these UK banks both UK specific elements will play a role as well as international guidelines, which may contain foreign elements. These different elements can easily conflict because, given their different background, they are not necessarily aligned.

### b. Difficulties of Comparative Corporate Governance

Some of the general principles of corporate governance that are mentioned in international as well as UK standards of corporate governance were laid down as early as in the Cadbury report. Because they are so fundamental, they are a returning feature in many international reports on corporate governance that followed. The first general principle is transparency (or openness). It is also mentioned widely in Basel II as it is essential for its third pillar, the functioning of market discipline.[5] Transparency can take different forms, depending on what part of corporate governance is analysed. For internal controls and risk management to function within the organisation, the right information must flow up to senior management and the board. For customers to make the right decision on where to open a bank account, sufficient information must be available to them on their risk, return and deposit protection. The second principle is accountability. It is especially important in banks because the increased importance of the risk management function. Decisions on defining the risk profile and actual risk taking must be challenged both upwards and downwards throughout the organisation. It has to be clear who is responsible for each decision. The third principle is integrity. The integrity usually refers to the information that is used in the management control systems, but especially in banking it should be extended to integrity of the people working there.

However, in light of the discussion on comparative analysis, the question is often not whether these internationally accepted principles are part of good corporate governance, but what they mean and how they are implemented at a national level. This is where various national ideas on good corporate governance can differ. The case study of Japan

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[4] Arthur R Pinto, 'Globalisation and the Study of Comparative Corporate Governance' (2005) 23 Wis Int'l L J 477, 485-488

[5] Basel Committee on Banking Supervision, 'Internal Convergence of Capital Measurements and Capital Standards: A Revised Framework' (June 2004) <http://www.bis.org/publ/bcbs107.pdf> accessed 20 November 2015

demonstrated clearly that what is understood by these elements differs greatly from the UK. The concept of accountability implies that there is something over which you are accountable for towards someone else. In the old *keiretsu* structure, the board may be accountability towards the other companies within that *keiretsu* or towards its employees. The board was described in chapter six as a group of elderly statesmen looking after the various interested parties. The idea of assigning responsibility and challenging decisions thus takes on a very different form compared to a UK company. It has to be considered how the UK notion of transparency differs from that in Japan, where relationships itself are more important as well as trust and avoiding embarrassment or loss of face. Business partners, both within the UK and Japan, share information, thus providing transparency, but they do so on a totally different basis. In light of this difference in transparency, the third pillar of market discipline, which is based on transparency. Another difference is the concept of share ownership. In Japan, it is used to create friendly relationships between companies and to work together in a corporate alliance. In the UK, it is regarded as an investment without such intention. The role of employees is another difference between the UK and Japan. With concepts such as lifetime employment, the employee in Japan is regarded as a key part of the corporate governance arrangements. In the UK, the situation of the employee is different and often employees will change company several times in their career.

Corporate governance in summary varies significantly between Japan and the UK. Such national differences make a comparative analysis more difficult. Comparing corporate governance between supranational and national levels will bring even further problems. At international level, inevitably some compromise is made as to common elements of corporate governance. Other considerations at this level may be to exclude areas in which no compromise can be reached. It is clear that any internationally determined idea will look very different once implemented in different countries. Each country will give its own interpretation based on nationally established rules, regulations and customs.

### c. The Minimum Standard of Good Corporate Governance at Banks

The research in the previous chapters demonstrated that the complexity around corporate governance at banks has increased significantly and that it continues to increase. The main areas of raised complexity are a consequence of the increasing size of the banks, increasing complexity of the markets and products they operate in, and increasing regulation of capital, liquidity and other areas. Although this research focusses on the regulatory side,

the increase in complexity due to the increased size of banks and the developments in financial markets is substantial. The direct consequence is that the task of running a bank is becoming an increasingly difficult one. The knowledge and experience of the board has to be enhanced accordingly if it is to provide effective challenge and oversight of senior management. The internal systems and controls need to be more sophisticated to allow the required information to flow through the organisation. The regulatory requirements demand a both more and a higher level of detail to be contained in that information. The complexity of markets and products demands some increase in volume and detail on information, especially the information concerning the associated risks. These demands on internal systems and controls are further increased for the largest banks by their increased global presence and the associated needs to satisfy local legislation and regulators.

The point is that the rise in complexity has led in turn to an increase in the minimum standard for each of the elements of good corporate governance. It means that the practices that constitute good corporate governance at UK banks are part of a concept that develops over time. And, it does not just develop, but raises its minimum standards. Every case study conducted as part of this research supports this observation. At Northern Rock and HBoS, the board and senior management failed to understand properly the risks associated with the complexity of their funding model. At RBS, senior management failed to understand the complexity of the markets they were involved in as well as the complexities arising from the take-over of ABN Amro. There was the additional failure to appreciate the wider importance of the bank within the UK economy. At Barclays, emphasis on growth and profit led to a culture that stimulated disregard towards all increasingly important external stakeholders. Finally, at the Co-operative, the governance structure was woefully inadequate for the increasing complexities associated with running a bank. All these cases point to a rising minimum standard of what constitutes good corporate governance at UK banks.

### d. Framework for Recommendations

With these difficulties in mind, this chapter deals with the risks identified in the previous chapters and contains a framework of recommendations to address them. The principal starting point is that the identified risks can be addressed by improvements to corporate governance at banks. To address the risks at the right place, it is important to distinguish whether they relate to internal or external corporate governance. The distinction between internal and external corporate governance at banks is what the names suggest and has

been dealt with in more detail in chapter two. External corporate governance at banks focusses on the shareholders, the bondholders and, eventually, stakeholders. It shows the external relationship between a bank and its environment. This also comes back to the idea of corporate social responsibility: there is an obligation on the banks to ensure financial stability and to provide a sound financial infrastructure for the wider society. Additionally, in the unfortunate event of a bank failure, the costs to the economy and society should be minimal. Internal corporate governance describes the legal and regulatory framework for the management and supervision of an organisation and includes the instruments needed for good management, such as a system for internal control and risk management, and its understanding thereof.[6]

This distinction needs to be considered alongside the observation that banks as organisations have unique properties. The three main unique properties are, first, the enormous importance of the system of credit for the economy at large, second, the unique properties of the corporate model, including the organisation of its legal entities and its typical opaqueness, and third, the way they are regulated and supervised.[7] The main concern is for risks that are specific for banks, whether for banks individually, also known as micro-prudential, or for the banking system as a whole, or macro-prudential. The regulator is introduced as a stakeholder to monitor these risks or, in other words, for risk governance.[8]

The proposition is thus to use a framework for recommendations based upon the distinction of internal and external corporate governance whilst taking into consideration banks' unique properties. As discussed in previous chapters, it should be acknowledged that some progress has been made already. However, it is argued that it is not adequate as it mostly does not address the core reasons for the failures identified by this research. The core reasons are that some of the proposed basic elements of corporate governance were not in place and that their absence is not being addressed properly.

## 3. Recommendations for Internal Corporate Governance

### a. Balance between Risk, Growth and Profit

This research covered several UK banks which failed during the financial crisis. One of the main observations was that the risk appetite and culture within these banks was

[6] Gottfried Wohlmannstetter, 'Corporate Governance von Banken' in Klaus J. Hopt and Gottfried Wohlmansstetter (eds), *Handbuch Corporate Governance von Banken* (Verlag 2011) 33
[7] Ibid 38
[8] Ibid 42

inappropriate. The emphasis was on growth and profit only. The first UK bank that failed was Northern Rock, as discussed in chapter three. This was a lender based in the north of England with little direct exposure to the US mortgage market. The main reasons it failed, discussed in the case study, were that its business model was based on, first, underestimating risks, in particular liquidity risk, and, second, a too high risk-reward strategy. The aggressive and high-growth-strategy was based on retrieving funding from the wholesale markets using securities mortgages as collateral, as opposed to the more conservative and traditional approach. When the crisis hit, management at Northern Rock was surprised because they had expected to maintain liquidity based on their collateral.

The board and its risk committee at Northern Rock had discussed and approved the funding strategy. This same strategy was described from anything between inadequate to reckless in several reviews.[9] The board had thus reached the wrong conclusion on its strategy and had done so without a backup plan. The fact that the board set out a course that was, certainly with the benefit of hindsight, the wrong one is in itself not so problematic provided it understood and took reasonable business risks: every organisation takes risks. The point is that the reviews clearly show that the risks taken were unacceptably high, certainly considering the nature of the business Northern Rock was engaged in. Its main business was consumer banking, which means it should have defined its risk appetite accordingly. It should not have undertaken an aggressive growth plan as it did, based on obtaining funding solely by using its securitised mortgages as collateral. It would appear that both the risk appetite and the strategy were not sufficiently challenged by the risk committee and by the board of directors as a whole.

An even more dramatic example of inappropriate risk appetite was the take-over of ABN Amro by the RBS-led consortium. As discussed in chapter three, it was 'the wrong price, the wrong way to pay, at the wrong time and the wrong deal'.[10] The transaction was completed when the financial crisis had taken the markets in its grip. The transaction was financed almost completely by short term funding and was based on extremely limited due diligence. Additionally, it was found that, during earlier aggressive expansion, not enough attention had been paid to the risks associated with this rapid growth. By way of example,

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[9] See: Treasury Select Committee, 'Fifth Report of Session 2007-2008, The Run on the Rock' (2008) <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf> accessed 20 November 2015; Financial Services Authority, 'The Supervision of Northern Rock: a Lesson Learned Reviewed' (2008) <http://www.fsa.gov.uk/pubs/other/nr_report.pdf> accessed 20 November 2015

[10] Financial Services Authority, 'The Failure of the Royal Bank of Scotland' (December 2011) <http://www.fsa.gov.uk/pubs/other/rbs.pdf> accessed 20 November 2015, 227

the investment banking arm did not provide any risk analysis of the markets in which it sought to aggressively grow. These factors ultimately contributed to the failure of RBS and the rescue by the UK government. Similarly, the case study of HBoS demonstrated that growth was the main driver to engage in securitisation and increasing reliance on wholesale funding. This caused a significant increase in complexity of the business model, which ultimately led to its collapse. Finally, the case study of Barclays showed that an increased pursuit of profit and growth, personified by its CEO, Bob Diamond, led to a culture where moral and ethics were largely absent. This in turn led to many scandals, from market manipulation and designing aggressive tax avoidance schemes to a breakdown in relations with its regulators.

Based on these cases it can be concluded that there was a culture at board level within most of the UK banks to engage in strategies carrying a high risk in pursuit of growth and profit. Going back to the fundamental principles set out by the Basel Committee, it is clear that this course of action by the board and senior management, at the banks aforementioned, is completely contrary to the following principles:

> 'Principle 1: The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The board is also responsible for providing oversight of senior management'.[11]
>
> 'Principle 5: Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board'.[12]

Setting out the risk strategy is a fundamental responsibility of the board and must be done in harmony with its strategic objectives. Accordingly, the board would need to define a clear risk policy framework. Within such a framework, important strategic decisions, including a take-over or other growth strategies, can be measured. In other words, it may well be acceptable for the board to engage in higher risks and a more aggressive culture, but taking higher risks has to imply that the controls and risk management framework around it are designed accordingly. The board must ensure that all of the bank's activities are monitored and measured against such a framework. In the examples of Northern Rock

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[11] Basel Committee on Banking Supervision, 'Principles for Enhancing Corporate Governance' (October 2010) <http://www.bis.org/publ/bcbs176.pdf> accessed 20 November 2015, 7
[12] ibid 16

and HBoS, this would have meant that if the funding strategy had been based on short term funding, then the board should have set controls accordingly. This might have included frequent monitoring of the relevant funding markets or carrying out stress testing. If it was not realistic to implement such controls, then this risk should not have been taken.

### b. Remuneration and Culture

A direct consequence of the pursuit of profit and growth, as described previously, is that this was reflected directly in the remuneration within banks. Targets were often short-term and based on financials only. The variable part of the total remuneration package was by far the largest component and often cash based. This exacerbated the cultural problems within the banks. The reason for taking high risks is the potential of gaining high rewards. The employees within the bank at all levels would thus pursue such a strategy. The potentially high rewards lead to the question how staff remuneration and their targets should be linked. Clearly, if the link between high risks and high rewards continues without safeguards, then this would be the wrong choice. It would stimulate excessive risk-taking amongst staff at all levels. The targets for employees must be more than financial targets. It is perfectly understandable to make financial targets part of staff's objectives. As was examined in chapter five, the pressure on return on capital from the new regulation makes it more important to achieve sufficient returns to keep the bank a viable business. Equally important is the way in which these targets are achieved. Financial targets might be most important to the shareholders, but the way in which they are achieved is important to other stakeholders. In the two earlier case studies, Northern Rock and RBS, this is obvious because both banks failed, which was clearly not in the interest of stakeholders. Other examples include selling products to customers who do not need them, such as the PPI case discussed in chapter three. Setting targets and objectives drives the culture. By setting a wide range of non-financial targets, as is proposed here, stakeholders' recognition can be improved.

One way of tackling this problem is to set regulatory restrictions on variable pay within UK banks. This is, to some extent, already done by CRD IV, which was dealt with in chapter five. Note that this is one area where CRD IV differs significantly from Basel III, which it seeks to implement. The possible cause of this is that it was not possible to agree on any remuneration restrictions globally, as for some countries, such as the US, this would be unacceptable. Within Europe, where a more socialist thinking dominates, it has been possible to add such regulation and this is now applicable to the UK as well. The

shortcoming of such regulation is that it focuses only on the level of pay which it tries to restrict to an extent that is deemed to be socially acceptable. From 1 January 2015, the variable component is capped to the level of the fixed component for staff captured. This includes senior management, risk takers, staff engaged in control functions and anyone else whose salary and risk profile takes them to that level. Only with sufficient shareholder approval might this ratio be raised to twice the level of the fixed component. Equally important are the requirements to include clawback provisions of variable pay in case of conduct resulting into significant losses or failing to meet the standards of fitness and propriety.

These provisions need to have some more teeth. Firstly, fixed pay levels will raise as a result of these provisions.[13] This means that the overall level of remuneration remains unchanged. Secondly, if the variable part is reduced then the clawback will cover a smaller part of the remuneration. Thirdly, and most importantly, awarding remuneration, especially variable remuneration, should be linked directly to targets that measure the conduct and thus the employee's standards of fitness and propriety. It is accepted that this cannot always be accurately done at the time of payment, as some misconduct may only come to light afterwards. But it is not good enough to have the standards of conduct included only in the claw back provisions. The closest CRD IV comes to moving away from financial performance targets is in Article 94(1)(a) where it states that for assessing individual performance, financial and non-financial criteria should be taken into account, and in Article 94(1)(k) where it states that all types of current and future risk shall influence the variable remuneration. The mandatory inclusion of risk is a good start. It forms a natural balance for financial performance targets. It should go further and include conduct related risk. It would have been better if non-financial criteria had been made mandatory.

### c. Board Effectiveness and Senior Management Experience

The effectiveness of the board is of paramount importance. In the case study of Japan, it was apparent that many of the boards where ineffective, if only because they were composed of sometimes as many as forty people. Some of the measures taken to improve the effectiveness of these boards were: to stimulate reduction in size; the introduction of outside, independent non-executive directors; and to introduce committees with specific responsibility for nomination, remuneration and audit. Other measures to align the

[13] Financial Times, 'City bankers to evade EU bonus cap with role-based allowances' (13 April 2014) <http://www.ft.com/cms/s/0/02213446-c19d-11e3-b95f-00144feabdc0.html#axzz3bApKRGyx> accessed 20 November 2015

interests of the board with those of the shareholders include the introduction of option award schemes. Although the boards at Japanese companies were seen to be ineffective for very different reasons from those relating to UK banks, and although the responses were different from what is proposed in the UK, the essential point is that an ineffective board is a serious problem for good corporate governance. Of course, the measures adopted in Japan should not be followed blindly, only what they were trying to achieve.

The very first deeper underlying reason for the failure at RBS, discussed in chapter three, was the overall lack of effectiveness of board oversight and challenge. These failures of effectiveness include: the failure to challenge the focus on increasing revenue and assets, rather than capital and liquidity; the failure to identify the aggregate risk across the businesses; and the failure to challenge assumptions underlying the business model, including those behind the US subprime market and behind the funding market. This was particularly problematic when combined with the leadership capability and management style of Fred Goodwin. It was concluded that his management style deterred robust challenges from the board or other senior managers. From these observations it may be concluded that the board must not be merely reactive but it needs to challenge where appropriate. A prerequisite for making the challenge is that the board has sufficient knowledge to be able to do this.

Similar problems of an ineffective board emerged from the case study of HBoS, discussed in chapter three. The board regarded itself, incorrectly, as a beacon of good governance, resulting in complacency rather than detailed scrutiny of how the bank was run. It was combined with a lack of banking knowledge on the board, which further reduced its effectiveness in challenging any decisions. The situation at RBS and HBoS confirms the importance of an active board that actually challenges the decisions taken. This is precisely the point highlighted earlier from the Japan case study. It also emerged from the case studies of Northern Rock and Barclays. The effectiveness of the board of banks was one of the main areas covered by the Walker Review, discussed in chapter five. Instead of amending the Companies Act 2006, the Walker Review suggests that much can be done within the existing framework, including ensuring sufficient knowledge exists within the board. It is further suggested that the FSA, now the FCA, must ensure that the non-executive directors commit sufficient time, engage proactively in board discussions and act in line with the risk strategy. This means that the FCA must monitor the directors monitoring the senior management. Although the FCA under the Financial Services and

Markets Act 2000 has its 'approved persons regime' and although it has a regular dialogue with the banks' boards, it would seem a stretch to suggest that this is sufficient to ensure an effective board.

To make the board more effective, various measures have been implemented to improve the accountability of the board in case of failure. It should be noted that at present several amendments to these measures is proposed and that change is imminent. Chapter five deals with two measures in particular: namely the criminal liability under the Financial Services (Banking Reform) Act 2013 s36; and the new liability added to the FSMA 2000. It is an either-way offence which, on indictment, would carry a maximum sentence of seven years. As discussed previously, the criminal liability regime under s36 is unlikely to get anyone convicted. The obstacles to any conviction include that the risk of a bank failure must have been foreseen, rather than should have been foreseen, and that the failure of the bank must have been caused by the alleged mis-management. The problem with the second part is that, as demonstrated by our case studies, there are usually many underlying factors contributing to the failure of the bank, many of which are beyond the control of senior management. It is not unreasonable to assume that, if it ever comes to a trial, enormous amounts of time will be spent on hearing expert witnesses on these points. Although it might be argued that even to be subject to a criminal investigation relating to this offence will cause more than enough problems for the individuals involved, it can hardly be regarded as a strong deterrent.

On the other hand, the amendments made by FS(BR)A 2013 to FSMA 2000, in particular s64A and s66A, which come into force on 7 March 2016, do have teeth. As dealt with in chapter five, the FCA and PRA currently have a joint consultation paper out on this so-called Senior Management Regime. Under s66A, the FCA can find a senior manager guilty of misconduct contrary to rules of conduct defined under s64A. The action that the FCA can take against individuals in these cases is specified under s66 and include: a fine; publishing a statement of his misconduct; suspend its approval; and limits or restrict the functions the individual may undertake. There is a much greater chance that an offender will be subject to action under these provisions compared with the regime under s36. The question is whether such regulatory action may form a sufficient deterrent which will stimulate the board to operate better and more effectively. There are sufficient roles a disgraced bank manager could perform, consider for example the speaking circuit or consultancy and advisory roles. It would seem likely that criminal liability, including the threat of going to

jail, is a more appropriate reflection of the seriousness of contributing to the failure of a systemically important bank.

The effectiveness of the board can be further increased by implementing appropriate information control systems. From the Lloyds case study, it was apparent that divisions underestimated their risk. The risk function was not designed to check this whilst the divisions that recorded the largest losses went largely unchallenged by the board. In the case of RBS it was found that the quality of risk control and management information was severely lacking. The problem of inadequate risk and control systems was aggravated by an increasing level of complexity in the activities and products in which the bank engaged. In the period leading up to the financial crisis there had been a sharp increase in complex financial instruments, discussed in chapter three. In particular, as a consequence of the capital requirements introduced by Basel II, there had been a large growth in the securitisation market. This created highly leveraged products based on loans and mortgages, which allowed banks to transfer the risk of losses to the buyers. It formed part of a general trend towards more complex products and derivatives, where pay-off structures are leveraged and depend on some underlying benchmark or security, such as an exchange rate, interest rate or share prices. The rise of these products is not wrong in principle, apart from their use to avoid capital constraints. But what it does mean is that everything in the bank has to be lifted to a level capable of defining the strategy and monitoring and controlling the risks relating to these products. By way of example, senior management needs to provide sufficient guidance in its business strategy. Part of this concerns the clients and counterparties they are willing to engage with. Senior management must outline how it fits within its risk appetite. The associated risks must be understood, monitored and controlled. Both knowledge at board level and an appropriate risk and control system to support it are essential.

## 4. Recommendations for External Corporate Governance

### a. Too-Big-to-Fail

#### *i. Capital Requirements*

The financial crisis had its initial causes, perhaps better described as triggers, which affected individual institutions, and reasons that allowed these trigger events to be exacerbated into the world-wide financial crisis. These two categories of problems, as they are different in their nature, require different consideration. The first category stems mainly from decisions taken at individual firms, even though many banks had made the

same problematic decisions. It contains, for example, overexposure to the US subprime mortgage market and a poorly construed business model. The second category relates to systemic risk in the financial system and the fear of contagion, discussed in chapter three. In summary, several banks had become too-big-too-fail and the 'inter-connectedness' in the financial system had increased dramatically. This means that if a very large bank would fail, it would have repercussions throughout the system, potentially causing a domino effect amongst other banks. It is proposed that this needs to be fully resolved before there can be good corporate governance at banks because it poses a danger to the interests of external stakeholders, from depositors to the general public and the overall economy.

One of the first responses[14] to the G20, discussed in chapter five, in order to reduce the systemic risk in the financial system was to address the opaqueness caused by the growth of over-the-counter products. These are more or less complex derivatives which are traded directly between banks themselves or between them and their clients. The main solution was to push these products to exchanges, which have become the newly created central clearing platforms, or CCPs. Although whether the creation of these CCPs has actually reduced the systemic risk or merely concentrated it with these CCPs is a much debated question, which is beyond the scope of this research. It was also suggested to strengthen capital and funding requirements to prevent bank failure. This is covered by Basel III and, within the EU, by CRD IV. In the UK, the reduction of systemic risk was further explored by the Independent Commission on Banking[15]. The main idea, discussed in chapter five, was to create a ring-fence within the bank that would separate the investment banking activities from the retail activities. In case of a bank failure, this fence would protect the retail bank from losses at the investment bank. This approach has been open to criticism from both sides: one side argues that the fence would reduce the benefits of the wholesale banking model, making the model riskier by reducing the effect of diversification. The other side argues that the approach does not go far enough and banks should be split up completely.

[14] Basel Committee on Banking Supervision, 'The Basel Committee's Response to the Financial Crisis: Report to the G20' (October 2010) <http://www.bis.org/publ/bcbs179.pdf> accessed 20 November 2015

[15] Independent Commission on Banking, 'Final Report – Recommendations' (September 2011) <http://www.ecgi.org/documents/icb_final_report_12sep2011.pdf> accessed 20 November 2015

### *ii. Ring-Fencing*

Ring-fencing made it into statute by way of the FS(BR)A 2013 ss1-12 and needs to be implemented by 2019. It has been the subject of a recent consultation paper by the PRA.[16] The one criticism of ring-fencing that is difficult to argue against is that its implementation will be riddled with problems. First of all, it will be difficult to define in statute or regulations how this fencing has to work exactly. Second, it will be extremely difficult to monitor. It requires a complete overview of all the different entities under a banking group as well as an overview of all the capital residing in or allocated to each entity. These entities would have to be separated artificially based on whether they are inside the fence or not. Likewise, the capital would have to be distributed and the actual flow of capital between the entities, or simple reallocation, would have to be closely monitored. Considering some banking groups consist of at least hundreds of different legal entities, this is difficult at best and, in case of a bank failure, open to endless challenges in the courts. Consider, in the daily running of the ring-fenced bank, how intrusive the PRA and HM Treasury would become. The question is also how UK banks will respond to the ring-fence requirements. HSBC, which has a large part of its operation overseas, is already reported to consider moving its headquarters out of the UK to Hong Kong.[17] Such a move might include the sale of its UK retail branches but in any event would circumvent the ring-fencing requirement and the bank levy on its balance sheet. Overseas banks with a retail operation in the UK, such as Santander, are considering to move their non-retail activities out of the UK.[18] It appears that the Treasury might be giving in to the pressure and water down the ring-fencing requirements.[19]

Finally, it should be noted that monitoring ring-fencing would take up considerable resources of the regulator. This would take time and resources away from other areas of supervision. During the period leading up to the crisis such a targeted approach by the FSA

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[16] Prudential Regulation Authority, 'Consultation Paper CP19/14 The Implementation of Ring-fencing: Consultation on Legal Structure, Governance, and the Continuity of Services and Facilities' (Oct 2014) <http://www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1914.pdf> accessed 20 November 2015

[17] The Sunday Times, 'HSBC threat may torpedo plan to break up banks' (17 May 2015) <http://www.thesundaytimes.co.uk/sto/business/Finance/article1557065.ece> accessed 20 November 2015

[18] Sky News, 'Santander sounds alarm over bank ring fencing' (23 January 2015) <http://news.sky.com/story/1413672/santander-sounds-alarm-over-bank-ring-fencing> accessed 20 November 2015

[19] The Sunday Times, 'Ring-fencing zeal wilts after banks' threat to quit Britain' (24 May 2015) <http://www.thesundaytimes.co.uk/sto/business/Finance/article1559833.ece> accessed 20 November 2015

contributed to the problems. The FSA would have picked up on the strategy Northern Rock embarked on. The FSA should have had regard for the safety of deposits, continuity of the bank and financial stability in the UK. Under any of these scenarios, it should have concluded that the aggressive growth strategy was dangerous and not in the best interests of deposit holders or of the UK financial system. At Lloyds, discussed in chapter three, the FSA was far more concerned with correct implementation Basel II than it was with other issues such as funding. The reason for this is obvious: resources at the regulator are limited and their time need to be justified. Hence committing a large amount of resources at the regulator to ring-fencing will lead to less supervision in other areas. And that is before one considers the amount of costs and resources it will require on behalf of the financial institutions itself.

There are several ways in which the difficulties of implementing the ring-fencing requirement can be alleviated. First, clear rules and guidelines must be provided on how to deal with any technological infrastructure needed for both parts of the bank. It must be clear how, in all situations, the ring-fenced bank can continue to rely on the technological infrastructure when it is owned by the other part of the bank. This could be done, for example, by way of service agreements or by a form of separation of internal service providers from the banks. Second, there is a need to keep the migration process as straightforward, short and cost-effective as possible. Simple arrangements, such as dedicated specialist teams at both the banks and the regulators, who maintain open lines of communications, are a basic necessity. Third, some sort of assurance that it will work in case of an actual failure is needed. This may be rather difficult. The regulators' usual tools such as stress-testing are not best suited to test potential legal challenges to ring-fencing. It would be possible for banks to extend their recovery and resolution plans to include scenarios where legal challenges are made, which could cause delays or further payments or compensation. Perhaps these plans could outline scenarios not relying solely on this mechanism, but to ensure that others, such as the FSCS, are capable of serving in conjunction or as alternative. After all, ring-fencing is merely a part of a whole range of measures.

As it stands, ring-fencing as originally proposed appears to be problematic. A possible way of improving it is by insisting merely on only separating out proprietary trading activities and specific other derivatives and securities related activities into separate legal entities.

This would be more akin to the Volcker rule and the Liikanen report.[20] This would result in a much smaller and more practicable separation. There is an alternative. Consider the simple objective of the ring-fence:

> 'the purpose of the retail ring-fence is to isolate those banking activities where continuous provision of service is vital to the economy and to a bank's customers in order to ensure, first, that this provision is not threatened as a result of activities which are incidental to it and, second, that such a provision can be maintained in the event of the bank's failure without government solvency support'.[21]

It raises the question whether this is not achieved in a much better way by a complete split between the retail activities and the rest of the banking activities. Admittedly, re-introducing a Glass-Steagall-type separation would be extremely intrusive. However, it is arguably no more intrusive then any of the forced mergers that took place during the crisis. The differences are that these mergers happened in the heat of the moment and often appeared to be good deal for both sides: one was rescued and the other got a bargain. Furthermore, providing of state-aid or even state-ownership, which happened as a result of failures, is equally intrusive as can be seen by the direct political interference in how RBS is run.

However, a further step is needed to make it work. The UK cannot be alone in introducing this type of legislation. It would be too easy for banks with a retail presence in the UK to work around it by moving the bulk of their non-retail operations abroad, as is allegedly being considered by HSBC and Santander. Furthermore, at least within the EU but preferably also other major financial centres, including the US, such restrictions need to be the same, otherwise it has little chance of succeeding. The EU already has the plan in the form of the Liikanen report, mentioned previously, but does not appear to be keen on implementing it. One may further argue that a complete separation between different banking activities would not prevent failures such as Northern Rock, which was once a retail bank to start with. This argument misses the point: the objective of neither the ring-fence nor a complete separation is to prevent a bank failure, it is to reduce overall systemic risk and to facilitate the orderly wind-down of a bank without causing great harm to the

[20] Liikanen et al 100
[21] ibid 35

wider economy. It is clear that a clear cut separation would achieve this without the legal wrangling a ring-fence might cause.

### *iii. Recovery and Resolution*

The major step to ensuring that banks can fail without causing detriment to the overall economy is to have an appropriate recovery and resolution regime in place. In other words, it must be recognised that the failure of a bank cannot be resolved by means of the ordinary insolvency laws due to the impact on the external stakeholders. If deposit holders fear that their savings are no longer secure then this will trigger a run on the bank. An example of this was presented in the case study of Northern Rock, which was done under the Banking (Special Provisions) Act 2008. The first step towards allowing an orderly failure of a bank must thus be the safeguarding of deposits. This has been implemented by way of the Financial Services Compensation Scheme ("FSCS"), discussed in Chapter four. The effect of the FSCS is that depositors have climbed up in the ranking of creditors in case of insolvency as protected deposits now rank equal with preferential debts. However, protecting deposits only is not sufficient as they need to remain accessible as well. The scheme therefore must include provisions which state that the bank liquidator must work closely together with the FSCS to facilitate prompt pay-outs to eligible depositors or to facilitate the transfer of deposits as a whole to another institution.

The second part of an appropriate resolution regime is that it would allow for a failure whilst minimising its impact on the wider economy and without requiring emergency state support. The Special Resolution Regime, which forms part of the Banking Act 2009 and was discussed in chapter four, goes a long way in achieving this. It grants sweeping powers to the regulators, especially to the Bank of England, to intervene and transfer parts out of the failing bank or to trigger a bail-in. These powers come with appropriate limitations, linked to the objectives of the powers, and with appropriate rules on compensation of parties affected. As always, the effectiveness of these new powers will only be truly tested in case of a future bank failure. However, they are a significant improvement on the situation before the financial crisis, when no resolution regime was in place. Its absence contributed to the problems around the failures during the crisis, including the capital injection by the government and the resulting state-ownership. The point must be made that, if one accepts that bank failures will happen, then it is at least equally important to focus on drafting an appropriate resolution regime as it is to draft adequate capital requirements.

Finally, it must be noted that it is of equal importance that banks diligently prepare their recovery and resolution plans. The PRA has issued a statement on how it expects banks to do this, besides the relevant parts of the rule book and the relevant directives.[22] The PRA expects these reports to contain a series of options for the bank, depending on the type of stress it is under, addressing severe capital or liquidity difficulties. It should also include a wind-down analysis. The key point is that writing such a detailed plan is a serious undertaking for a bank but it will also force it to critically analyse its business model, financial resources, risk management and controls during a stress scenario leading to failure.

### b. Fair Treatment of Clients and Customers

Since the financial crisis, various cases of misconducts by bank employees have been reported. This misconducts flows directly from points made previously under internal corporate governance, especially in relation to culture, remuneration and the prioritisation of growth and profit. Most of these have resulted in heavy fines for the banks and individuals involved, as well as damage to the sector as a whole. These failures of bankers' conduct, as discussed in chapter three, include the miss-selling of products, including PPI and interest rate swaps, money laundering and violating international sanctions, rogue traders and market manipulation. The regulators and other law enforcement agencies have come down hard on the financial institutions involved, handing out record fines. Some of the individuals involved are facing criminal prosecution. However, the underlying question is why it keeps happening. The argument that this is a hangover from the years leading up to the crisis does not hold. The exchange rate rigging took place after the crisis whilst the investigation into LIBOR rate rigging was making news headlines. The argument put forward by banks that it involves only a handful of bad apples is quickly becoming less convincing. Every time a new scandal breaks, a new handful of bad apples is found. Furthermore, the problem is not restricted to the individual culprits, but to their line management, the risk and control functions, the compliance functions and everyone else responsible for internal oversight. The argument becomes even less compelling when considering the PPI-scandal: these were bundled with products and were sold to many retail customers. Surely the whole retail sales network is not a bad apple. The problem is directly connected to the culture within the banks.

[22] Prudential Regulation Authority, 'Recovery Planning: Supervisory Statement SS18/13' (16 Jan 2015) <http://www.bankofengland.co.uk/pra/Documents/publications/ss/2015/ss1813update.pdf> accessed 4 July 2016

The Fair and Effective Markets Review conducted a review of the practices in the fixed income, currency and commodity markets in wake of the LIBOR and FX scandals.[23] The report includes various observations, including a market structure presenting opportunities for abuse, failings of internal governance and controls and poorly designed remuneration and incentive schemes. The review makes several recommendations, including: increased individual accountability, especially with front-line staff; making the market itself collectively responsible for maintaining high standards; and maintaining a credible deterrence for when standards do slip.[24] The report further recommends that the senior management regime, which was introduced for banks following the crisis, is extended to cover all companies which operate in these markets.

The central point in all these scandals more generally is that the people involved, whether traders rigging rates or retail sales staff miss-selling PPI, had a clear personal financial incentive to do so. This highlights the link with the remuneration practices. In the case of the traders, the manipulated rates showed their trading positions in a more favourable light. This would normally directly affect their variable pay at the end of the year. In the case of a retail sales network, the targets are usually set in terms of selling a particular new product. It should be noted that PPI in itself is not a bad product and some people really need it. However, selling it to anyone because this product needs to be pushed, usually because it is profitable, is not appropriate. Earlier in this chapter, when discussing the culture within the bank, it was concluded that targets need to be based on more than financial measures. This observation very much holds here as well. Obviously, there are more issues, such as a conflict of interest for those who set rates and trade related products at the same time. These need to be addressed separately. But it does not invalidate the point that, besides making money, it is equally important how you make it. External stakeholders must be recognised and included in the targets and objectives set to staff. It must also be reflected in how staff is rewarded. The provisions in CRD IV on remuneration, which were discussed earlier, may apply to traders if they are significant risk takers but they certainly will not apply to retail staff. Perhaps it is possible to extend some parts of these provisions to all costumer facing staff.

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[23] HM Treasury, Bank of England, Financial Conduct Authority, 'Fair and Effective Markets Review, Final Report June 2015' (2015) <http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf > accessed 4 July 2016

[24] Tracey McDermott, 'Fair and Effective Markets Review' (2015) <https://www.fca.org.uk/news/fair-and-effective-markets-review > accessed 4 July 2016

The outcome of the scandals has been record fines for the banks involved. These fines are usually part of a settlement with the enforcement agency, which include a discount on the fine and immunity from criminal prosecution. The question is what this actually achieves. The fines are effectively passed on to the shareholders of the bank as they reduce profit and thus reduce dividend payments. The regulator may even get worried about the height of the fine as it could have a negative impact on the capital position of the bank. And when the agreement includes immunity from criminal prosecutions, then nobody is held to account. This in part reflects the importance of the systemically important banks. They cannot be allowed to fail as a consequence of these malpractices, something that would certainly happen if they were found guilty and had their banking license revoked. Consider action brought against institutions that were not systemically important. Companies such as Arthur Andersen, WorldCom or Enron have all become insolvent. In 2002, Arthur Andersen, one of the world's largest accounting firms, was found criminally liable in relation to its handling of Enron. The firm did not survive the damage done to its reputation. Both WorldCom and Enron were engulfed in scandals and filed for bankruptcy. It seems deeply wrong that, because a bank is deemed too-big-too-fail it should be allowed to escape criminal liability and, by implication, continue to operate as normal. This is another compelling reason to resolve the issue of too big to fail.

### c. Ownership

Shareholders are often rather passive. At Northern Rock, it was not just the directors and the risk committee that had failed. The board had communicated its funding strategy clearly to its shareholders. It would appear that either the shareholders had not sufficiently scrutinised the plans themselves, or, if they had, then they had accepted the high risk in return for the promise of a high reward. It is of additional concern that some of the shareholders were employees. One would have expected them to scrutinise the business strategy in great detail as it affects not only their employment but also their capital. The employees had, in addition to the usual channels available for employees, an additional way to express their opinion on the strategy as shareholders. One may point out the rough analogy with Lehman Brothers, where employees had their pension and savings invested in the firm, yet failed to scrutinise the business strategy and challenge it. At RBS, the situation was even worse. The shareholders overwhelmingly supported the disastrous take-over of

ABN Amro.[25] The question is why do shareholders act in this way and what can be done about it?

One may simply state that the shareholders have invested their own money and, should things go wrong, they lose it. This is what happened with the shareholders of the UK banks that failed. So what is the real problem? This is answered by the UK Stewardship Code for institutional investors, one of the aims of which is 'to promote the long term success of companies in such a way that the ultimate providers of capital also prosper'.[26] In this way, the interests of the shareholders and other stakeholders in the banks are aligned. It may well be possible that these guidelines, which are currently operated on a 'comply or explain' basis, need to be strengthened for investments in financial institutions. This would recognise the importance of the stakeholders and the role of banks in our society. However, one must bear in mind the conclusions drawn by the US Financial Crisis Commission. In summary, everyone made errors in assessing the risks. So although corporate governance might be defective by not including all stakeholders, it must not just include them, but also ensure that the correct information reaches them to make informed decisions.

The government is a special shareholder. As discussed in greater detail in chapter four, UKFI was created to manage the government's stake in Northern Rock, RBs and Lloyds HBoS. Part of the rules governing the relationship between HM Treasury and UKFI are set out in the Shareholder Relationship Framework Document[27] and the Investment Mandate.[28] This includes the rule that investments will be managed on a commercial basis without much intervention by the government, which was to be kept at arm's length. It is clear that this has not been the case for every bank in which the government had a stake. On one hand, there is Northern Rock, which has now successfully been reprivatized. On the other hand, there is RBS, which has been the focus of public debate and has been, or at least appears to have been, instructed by HM Treasury to adopt certain strategies or reforms. It would appear that this is what led to the resignation of the CEO, Stephen

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[25] Reuters, 'RBS investors back ABN deal' (10 August 2007) <http://www.reuters.com/article/2007/08/10/us-abn-takeover-rbs-vote-idUSL1076842520070810> accessed 20 November 2015

[26] Financial Reporting Council, 'The UK Stewardship Code' (September 2012) <https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx> accessed 20 November 2015

[27] UK Financial Investments Ltd, 'UKFI Framework Document October 2010' (2010) http://www.ukfi.co.uk/releases/UKFI_FD_20101001.pdf accessed 20 November 2015

[28] UK Financial Investments Ltd, 'UKFI Investment Mandate October 2010' (2010) http://www.ukfi.co.uk/releases/UKFI_IM_20101001.pdf accessed 20 November 2015

Hester, who was supportive of investment banking, and his replacement by Ross McEwan, an expert in retail banking. RBS is still a long way from a full return to the private sector.

It is clear that the political interference has done RBS little good. It has led to instability both in board strategy and in board composition. The bank has performed badly in the last few years, although this is also partially to blame on bankers' misconduct. Nonetheless, the comparison is there: Northern Rock has stayed out of the limelight and has been turned around successfully in a short timeframe. Likewise, the Japanese case study has shown that a swift reprivatisation of its nationalised lenders was the right decision. It is clear that the commercial objectives of a bank do not sit well either with the political objectives of a government, or the volatility of their objectives. The long term strategy of a bank must not be driven by the politics of the day. It is imperative that for a quick and successful recovery the reprivatisation must happen quickly.

## 5. Conclusions

There are several problems or themes that keep coming back in this research. There are three main themes that stand out. The first, which was discussed in this chapter as part of internal corporate governance, is the effectiveness of the board and the knowledge and experience of senior management. Especially the cases of RBS, Northern Rock and the Co-operative Bank, discussed in chapter three, bring out this theme. The second and third themes were discussed as part of external corporate governance. The second theme is that of a culture placing profit and growth above risk management and stakeholders. Examples discussed in chapter three include the case studies of RBS and Barclays. The third theme is the creation of a bank insolvency regime, including the protection of depositors and the economy, which did not exist at the time of the crisis. The failures and required government rescues discussed in chapter three underline this point. It is the conclusion of this research, based on the case studies presented in the third chapter, that these three elements caused the main weaknesses in corporate governance at UK banks at the time of the financial crisis. It is a further conclusion, based on the analysis of the short- and long-term solutions in chapters four and five, that only the third element is being addressed sufficiently. This third element has been the focus of many reports as well as UK and EU based regulation. Whilst the second element is partially being addressed, through European legislation on remuneration as well as increased accountability, this falls well short of resolving the problem. The first element is hardly addressed at all. As with the second, it is partially addressed by increased accountability.

Perhaps the most interesting improvement is suggested by the Basel Committee in its recommendations for corporate governance at banks, discussed in chapter five. Their new principle thirteen, which appeared in the latest version of the report for the first time, is that in effect the financial regulators should take on the roles of custodians of corporate governance. It explains that the regulators should provide guidance for corporate governance at banks as well as supervise it. It further explains that this supervision must be done by way of comprehensive evaluations and regular interaction with boards and senior management. Regulators should require improvement and remedial action as necessary. This would be an extension of the role of the regulator as it currently stands. However, the first and second element, as outlined above, could well be improved and safeguarded by increased supervision from the regulators.

Within the UK, the regulator best placed to perform this task is the FCA. In a response to the proposals by the Parliamentary Commission on Banking Standards, the FCA went out of its way, not only to outline the tools it already had, but in particular to point out its existing focus on supervision of standards, governance and culture.[29] The FCA's Director of Enforcement and Market Oversight, Mark Steward, recently delivered a speech on culture and governance.[30] The problem, as he correctly pointed out, is that, although the regulator can draw up rules and standards, which describe the expectations and the boundaries, they do not create a situation in which good governance magically appears. He describes several things that are needed to achieve this, the main one being knowledge and expertise at senior management level. Acknowledging that culture is often intangible, he concludes that there are no prescriptions. However, as the Basel Committee points out, the regulator will get a good feel for what is happening at a bank through comprehensive evaluations and regular interaction with those at the bank. A further empowered FCA might well be the most effective custodian of corporate governance at UK banks.

[29] Financial Conduct Authority, 'Tackling Serious Failings in Firms: A Response to the Special Measures Proposal by the Parliamentary Commission on Banking Standards' (June 2014) <https://www.fca.org.uk/static/article-type/news/tackling-serious-failings-in-firms.pdf> accessed 20 November 2015, 6-10

[30] Mark Steward, 'Culture and Governance' (11 November 2015) <https://www.fca.org.uk/news/culture-and-governance> accessed 20 November 2015

# Chapter 8 – Conclusions

## 1. The Principal Conclusions of this Research

The hypothesis of this thesis, as defined in chapter one, is: corporate governance at UK banks before the financial crisis was weak and post-crisis reforms did not address these weaknesses. The three central research questions in chapter one were formulated accordingly:

1 What weaknesses in corporate governance at UK banks contributed to their failure?
2 What is the effect of new legislation and other initiatives on corporate governance at UK banks?
3 What is the effect of (part-) state ownership of UK banks on their corporate governance?

The case studies in chapter three of UK banks that failed during the crisis reveal several main weaknesses in corporate governance at UK banks, as discussed in the conclusions of chapter three as well as in the recommendations in chapter seven. The first weakness is that growth and profit are placed over sound risk management. The second weakness identified is the remuneration schemes and the culture it stimulated. This is directly linked to the first weakness. The targets given to individual members of staff are often based on short-term financial objectives. The third weakness identified is the lack of effectiveness, experience, knowledge and skills at board level and with senior management. At many of the failed UK banks, the board failed to provide effective oversight and challenge of senior management. The fourth weakness is the absence of an adequate insolvency regime to deal with the failure of a UK bank. Banks are a special case due to the large potential impact a failure has on its environment. Potential problems are deposits lost, cash-machines running out of money, reduced lending to small businesses, and so on. This is a weakness in corporate governance at UK banks because it fails to recognise the importance of external stakeholders.

This research makes the distinction between short-term measures, as discussed in chapter four, and long-term solutions, in chapter five. The short-term measures are those that were passed during the crisis to deal with the actual failure of some of the UK banks. They

include the Banking Act 2008 as well as the creation of UKFI and the interventions by the EU on state-aid and competition. UKFI is the vehicle created by the UK government to manage its interests in the nationalised banks. The EU interventions include the forced sale by some of the nationalised banks of some of their branches, in order to safeguard competition. The Banking Act 2009 is also categorised under the short-term measures, although it is not an emergency measure. The reason for doing so is that it provides the current mechanisms within the UK for dealing with the failure of a bank. It includes the Special Resolution Regime, with the relevant tools for the regulators, as well as the FSCS.

The long-term solutions, discussed in chapter five, include those reports and measures drafted after the crisis when there had been time for reflection. The overall observation is that these reports and measures increase the complexity of managing a bank significantly. In fact, it must be noted that the minimum standard of the required elements of good corporate governance at banks had increased in the period leading up to the crisis.

The recommendations in chapter seven, based upon the weaknesses identified and the measures already taken, are split in those for internal- and those for external governance and controls. For internal governance and controls, the three main areas for recommendations are: the balance between risk, profit and growth; remuneration and culture; and board effectiveness. For external governance and controls, the main areas for recommendations are: the tackling of too-big-to-fail through ring-fencing and recovery and resolution mechanisms; the treatment of customers; and behaviour of owners.

An important overall recommendation, made in the conclusions of chapter seven, which is one of the new principles of corporate governance at banks as prescribed by the Basel Committee on Banking Supervision, is that the regulator should be the custodian of corporate governance at UK banks. The most suitable regulator would be the Financial Conduct Authority, because they already provide oversight on management, governance and culture. Their role should be extended so they can perform the role of the regulator as prescribed by the Basel Committee.

## 2. Future Developments

### a. Addressing the Weaknesses

It is one of the key observations in this research that many of the weaknesses of corporate governance, discussed for example in the conclusions of chapter three, are not necessarily related to the bank-specific elements. It is acknowledged that they are probably of

increased importance in a bank, but nonetheless they are general elements of corporate governance. The first approach to tackle these weaknesses should therefore, logically, emerge from strengthening corporate governance in general, rather than introducing measures specific to banks. Given the enormous impact of the financial crisis, it seems only reasonable to question whether a corporate governance code can operate on a comply-or-explain basis. In light of this research, it seems unrealistic to rely on this principle and adherence to the spirit of the code. If one really wants to address the weaknesses, then such a code needs to be further enshrined in legislation, adhered to and monitored. In the case of the banks, this monitoring could be done by the financial regulators.

A similar argument holds for board reform. It is a general point of corporate governance, which in case of a bank merely amplifies. Instead of focussing on, for example, gender quotas, however important this might be in itself, it would be wise to ensure that a board has sufficient knowledge and experience to challenge senior management. In the case of banks, the regulators already need to approve new board members and these rules have sharpened up. Some additional requirements have been introduced by way of CRD IV, for example in the form of board committees. However, in light of the serious failings in board effectiveness during the crisis, it is necessary to introduce more general guidelines or requirements on board members.

The cultural problems in banks are more difficult to resolve. Changing the culture within an organisation or company takes several years. In this case, it appears that the culture of an entire industry needs to change. This is especially concerning as some of the most effective measures on remuneration come from the EU, which the UK may well leave in the near future, as discussed later. There appears to be few measures emerging directly from the UK that would seek to correct the ethical standards in the industry. There is new legislation that specifically seeks to address the rigging of benchmarks and to ensure accountability of senior management, but there are no general measures aimed at tackling the problem at large. Accountability throughout the banks should be increased, although this is merely the stick rather than the carrot. Nonetheless, in order to hold staff to account their objectives and responsibilities need to be clearly defined and should go well beyond pure monetary targets to include directions on how targets should be reached. This may include, for example, the way the target market for products is selected or considerations regarding complexity and suitable during the design process of new products.

### b. State-ownership

Within this research, several case studies were examined in chapters three and four that dealt with failed banks ending up in state-ownership. The government created UKFI to deal with its investments at arm's length. This was always a struggle as, in practice, it would always be difficult for politicians to resist meddling in the day-to-day affairs of the state-owned banks. To a degree, this is perfectly understandable when the annual bonusround would come along and the media headlines would be dominated by payments made in the bailed-out banks. However, in the greater picture, the meddling has proven undesirable. The objectives of the politicians are simply incompatible with those of the banks and of the regulators. The politicians want the banks to lend more to stimulate the UK economy. The banks do not want to do that because, firstly, if someone has decent credit quality they would lend to him anyway, and, secondly, they would otherwise like to improve their capital positions to satisfy their regulators. The interference by the government, especially at RBS, appears to have created an unclear strategy which means that the banks as a whole has suffered. In contrast, the government appears to have interfered far less in Northern Rock, which has successfully been privatised within a few years. This seems to strengthen the case against state-ownership in banks and, for those that are state-owned, a swift return to the private sector.

### c. The Question of EU Membership

The UK is experiencing an uncertain time in that it faces a general referendum on its EU membership by the end of 2017 whilst the referendum on Scottish independence is not yet forgotten. The outcome of the Scottish referendum is that the UK will stay together, but it is likely that there will be further devolution of power over time from Westminster to Scotland. Furthermore, the Scottish National Party does not rule out a future referendum on the same matter. This is significant for corporate governance at UK banks as discussed in this research. Several of these banks have their headquarters in Scotland. They may have a large customer base in Scotland or employ many people there. The future of the British pound, the role of the Bank of England and other regulators, membership of the EU and the use of Euro are all uncertainties that these banks face in the months and years ahead.

The governor of the Bank of England, Mark Carney, has indicated that RBS may have to move its headquarters to England as EU rules require banks to be based in the same country as most of their business. He further claims that an independent Scotland would have to guarantee deposits held in England by Scottish-domiciled banks under EU law.

Similarly, Lloyds may have to move its headquarters to England. The first point to observe in this debate is that, had Scotland been independent at the time of the global financial crisis, it would most likely not have had the financial resources to bail out RBS, let alone both banks. The situation would be of comparable or worse scale than Iceland, which suffered from a bloated banking sector compared to the country's GDP. The second point to note is that, depending on how negotiations for independence develop, Scotland may neither have a lender of last resort, such as the Bank of England, nor any other experienced regulators. This means that it could not provide emergency liquidity to troubled banks, nor could it adequately supervise them.

The above arguments alone should convince the stakeholders in these Scottish based UK banks that a move to England is in their best interest, regardless of the legal position under EU law. As argued throughout this thesis, both transparency and accountability are essential elements of corporate governance. For that, an experienced central bank and experienced regulators are required. The other argument is that, if there would be problems at a Scottish based UK bank, the remedies are less obvious. A short-term liquidity problem could not be resolved. A run on the bank would be disastrous as no capital or guarantees could be provided. This impacts the stakeholders in the broadest sense. Beyond the depositors and customers, who stand to lose money directly in case of trouble, the impact on the Scottish economy could be devastating. As carefully argued by Paul Krugman, the situation would be worse than that faced by Spain in the recent crisis. It would thus seem prudent for Scottish based UK banks such as RBS, even if for the moment Scotland would remain in the UK, to move their headquarters to England.

The referendum to be held before the end of 2017 on EU membership may result in the UK leaving the EU. This would raise many issues for the UK banks that are difficult to oversee. For the moment, it is worthwhile pointing out that several of the remedies to weakness identified in this research have come from EU legislation. The recovery and resolution mechanisms come from an EU directive, as do the mechanisms on remuneration. Overall, it would appear that the EU has contributed significantly to improving corporate governance at UK banks.

## 3. Future Research

### a. Corporate Governance at Banks as a Special Case

Corporate governance at banks is often seen as a special case of corporate governance, as discussed in chapter two. The main reasons for doing so are: it includes significantly more regulation and supervision; it has a greater emphasis on risk management; and it has 'debt-management'. These differences also apply to what constitutes internal and external corporate governance at banks. Internal governance and controls at banks may additionally include a good corporate culture, behaviour and risk management. External governance and controls at banks will additionally include the regulators. These special elements often attract most attention, academically as well as in practice.

In light of this research, it is suggested to have at least equal regard to the non-special parts of corporate governance at banks. It would be useful to investigate these general, or non-special, parts on its own, but also how they interact with and drive the bank-specific elements. It is suggested this could also be done within the context of internal or external corporate governance. Future research could furthermore focus on general elements not discussed as part of this research as they did not establish themselves as weaknesses during the crisis, but they may have done so in other corporate crises. In fact, links could be discovered between weaknesses of general corporate governance in other corporate crises and the global financial crisis.

### b. Comparative Corporate Governance

There were two major elements of comparative corporate governance within this research. The first is that of the case study of Japan in chapter six. It proved too difficult to cross the differences due to: the very different nature of corporate governance; the different role of the banks; and the difference in corporate culture and corporate organisation in general. As such, it was not possible to find useful functional similarities from which to draw strong conclusions. This clearly shows the limits of comparative corporate governance. This limitation must be considered when embarking on any future research in corporate governance of a comparative nature.

The other major comparative element in this research, as introduced in chapter two and discussed in more detail in chapter seven, arises from the fact that much of UK financial regulation is derived from international reports and from EU directives and regulations. When studying corporate governance at UK banks, comparative problems emerging from

this are simply unavoidable. One must always consider the context of the international reports of how EU law is made. It might be beneficial to conduct more research in this area, as not only will it affect corporate governance at banks, it impacts all of the financial regulation.

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