Financial Sector Governance in the Emerging Markets of Europe and Central Asia

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THE WORLD BANK

Today's Presentation

- Why financial sector governance—World Bank perspective
- World Bank assessments in Europe and Central Asia
  - Findings
  - Issues
  - Recommendations
- Priorities for China SOE corporate governance
- Latin America program

Why is financial sector governance important?

- Builds public confidence in the financial sector
- Contributes to maintaining financial stability
- Protects the interests of consumers
- Reduces the need for expensive state systems

Particularly in ECA transition economies:

- Region of profound economic transformation
- CG became very important very quickly
- Remains critical for the Region’s growth and financial stability

World Bank Group Assessments

- Financial Sector Assessment Programs (FSAPs) since 1999
- Corporate governance reviews in 26 of the 29 ECA countries
- 17 CG ROSCs (using OECD CG Principles)
- Bank governance reviews in 11 countries
- In depth financial governance studies in Czech Republic, Slovenia, and Slovakia
- IFC surveys of banks in Russia and Ukraine

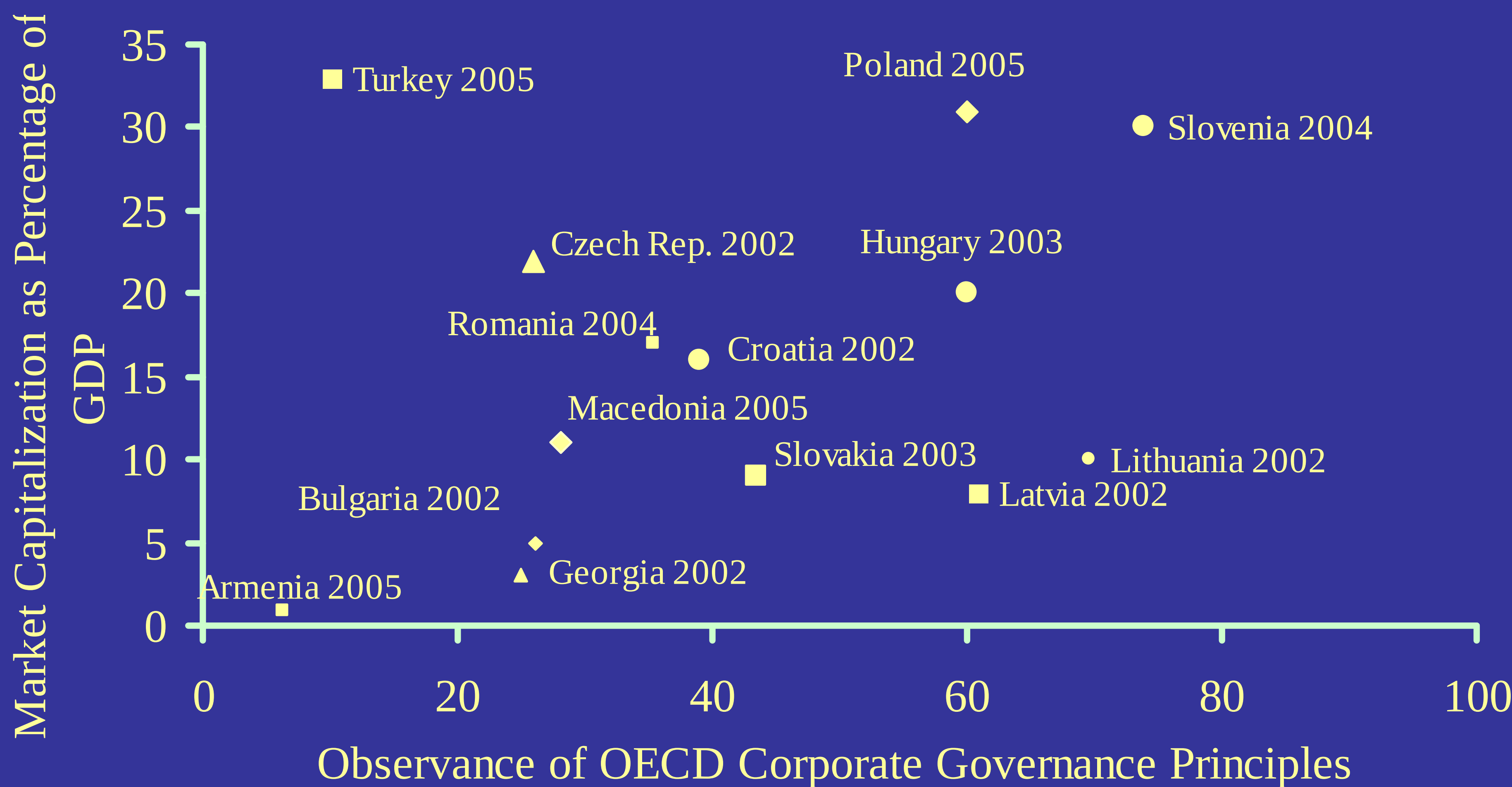
What we look at:

1. Legal framework: financial and company laws
2. Regulatory framework: supervisory and enforcement institutions
3. Common business practices and behavior: business culture, values, and ethics

Financial Sector Governance

- At its heart, financial sector governance is based on transparency and accountability.
- Accountability is needed to ensure that the governing bodies of a financial institution are accountable to the its stakeholders—including consumers and shareholders.
- Transparency is the mechanism by which accountability is achieved.
- In the absence of transparency, little accountability can be expected.

Market Capitalization vs. Corporate Governance



Key Findings

1. Insufficient **transparency of ownership** & control
2. Strong presence of financial **conglomerates & business groups**
3. Weak **financial reporting**, internal controls and risk management
4. Weak **supervisory boards**
5. Weak **supervisory agencies**

Developments in ECA

Significant governance improvements, particularly in banking, resulting from:

- Increased foreign ownership of banking assets
- Determination to adopt the Directives of the European Union

However key shortcomings remain.

Division into Two Groups: EU-11 vs. non EU-11 Countries

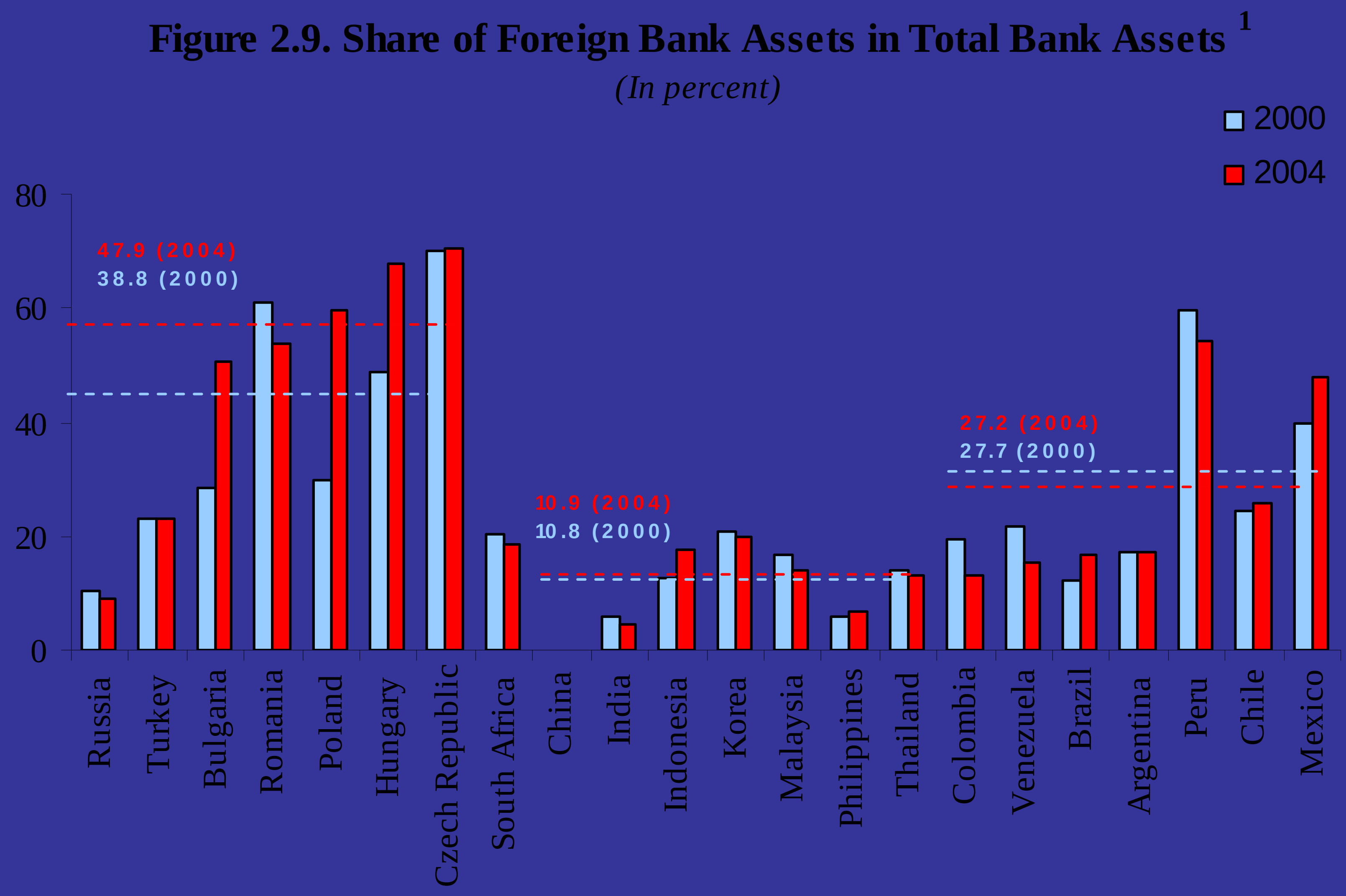
Transparency of Ownership & Control

Single most important issue: who owns and controls the institution?

EU-11

- Ownership in the financial and corporate sectors is clear (more than 60% of the banking sector is owned by foreigners).
- The cornerstone for transparency is business registry (EU's First Directive).
- EU's Transparency Directive is expected to improve disclosure.
- Key concern is enforcement.

Sale of Local Banks to Foreigners

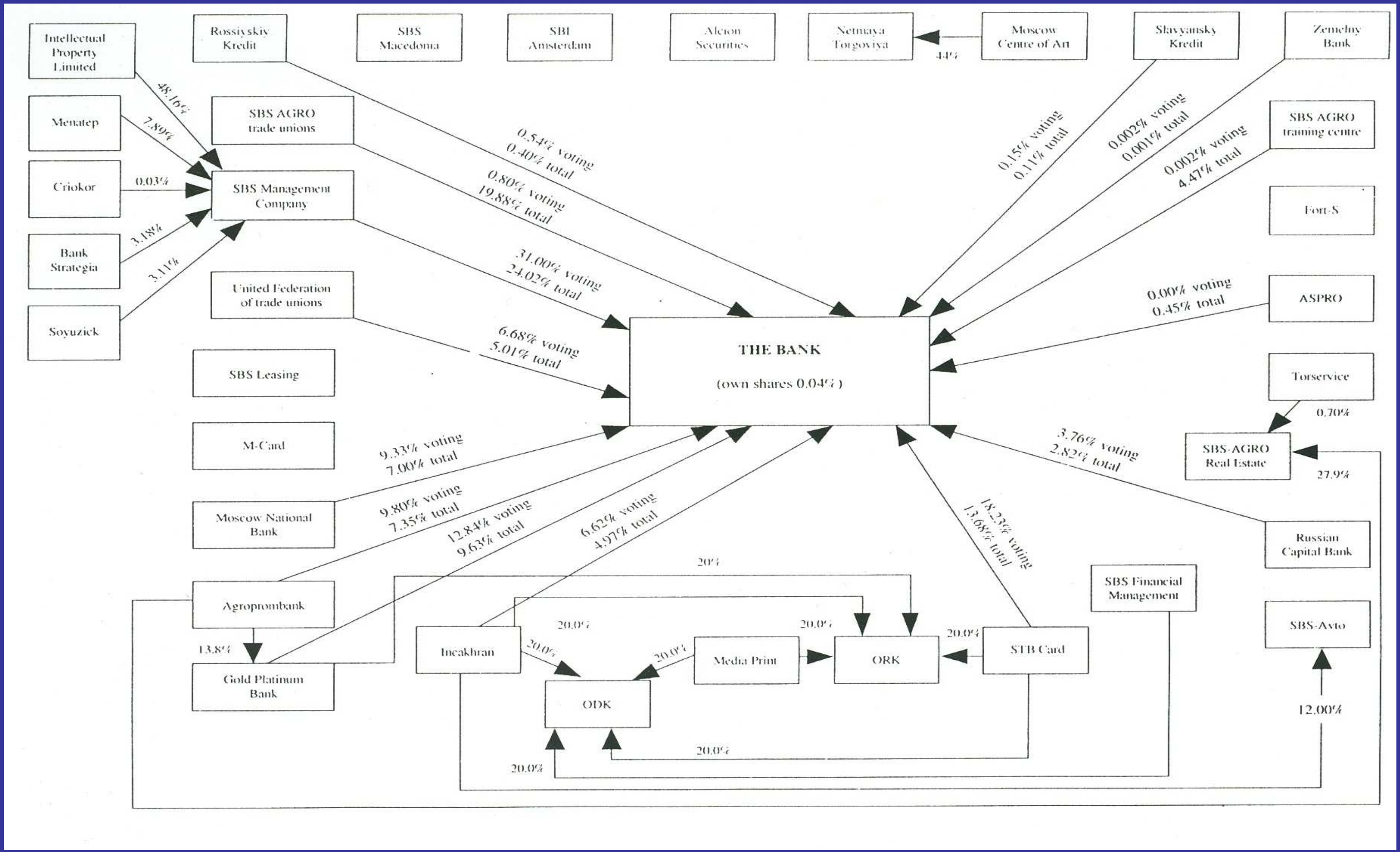


Transparency of Ownership & Control

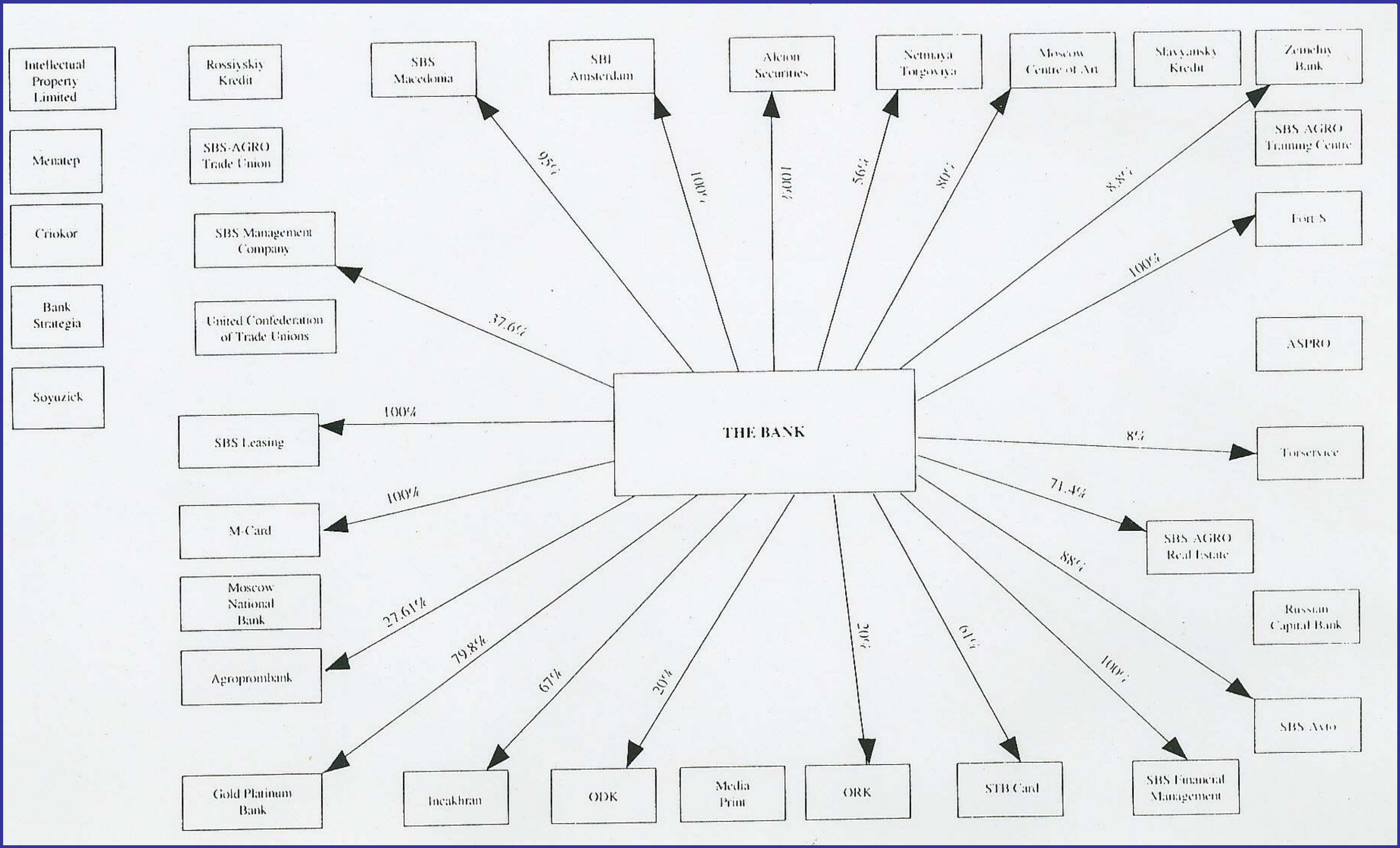
Outside of EU-11

- No publicly available ownership information of banks or companies. Supervisors often have to rely on marketplace information.
- Complex ownership structures.
- Survey found 24% of Ukrainian & 20% of Russian banks do not disclose ultimate shareholders to supervisory agencies.
- Antiquated business registries.

Case Study:
A Russian Bank's Owners



The Bank's Subsidiaries



Conglomerates & Business Groups

EU-11

- Related party transactions not uncommon.
- EU Directive on Conglomerates not always applied. No lead supervisory agency in place.
- Private pension companies do not always segregate planholders' assets.
- Front running and market timing are issues for investment funds.

Conglomerates & Business Groups

Outside of EU-11

- Corporate and financial sectors are dominated by business groups.
- Fewer than 10 business groups lead the economy.
- Most have controlling interests in banks.
- Asset stripping and self-dealing are major issues.
- Requirements for arm's length pricing are uncommon.

Financial Reporting

EU-11

- EU requires IFRS for listed companies starting 2005.
- Local laws can conflict with IFRS.
- Auditing standards are usually local, not international.
- Internal controls not an issue if the company is a subsidiary of foreign financial institution.
- But risk management is weak and viewed solely as capital adequacy.

Financial Reporting

Outside of EU-11

- IFRS is uncommon. Reports are produced for tax authorities, not investors.
- Accounting laws are infrequently updated to reflect changes in international standards.
- In the absence of local auditing standards, most countries have adopted ISA—but auditing practices remain weak.
- Actuarial profession remains to be developed.
- Difficult to ascertain the quality of internal controls.

Supervisory Boards

- EU's recommendations on supervisory boards are generally not implemented.
- Some countries do not have minimum fiduciary duties in company laws.
- Few require purchase of director liability insurance.
- Few have corporate governance codes for financial institutions.
- In subsidiaries, board members are usually executives of the parent company, leading to conflicts of interest.
- Few non EU-11 countries require that supervisory boards have audit committees.

Supervisory Agencies

– Agencies are hindered by lack of capacity, legal authority, protection against lawsuits (or extortion).

Outside of EU-11

– Supervision is very difficult in opaque business environments.

– Fines are not high enough to act as deterrents (maximum fine of $15,000 is not uncommon).

– Some agencies are not required to maintain transparency and accountability for their actions. Few requirements for publication of official decisions.

Supervisory Agencies II

- Even Bank regulators cannot require the change of organization structures in cases of non-transparency.

- Fit and proper requirements are not uniformly applied for significant shareholders.

- Virtually all bank collapses have resulted in restructuring or liquidation—few in bankruptcy. But fit and proper limitations are generally limited to bankrupt banks.

Key Recommendations

- Apply EU Directives on disclosure of ownership and control of listed companies and financial institutions.
- Provide internet access to business registry.
- Require use of IFRS in financial reporting.
- Require financial institutions to prepare solo financials with disclosure of related party transactions.
- Build up the quality and number of accounting, and auditing professionals.

Key Recommendations II

– Ensure supervisory boards have statutory fiduciary duties.

– Develop corporate governance codes for financial institutions.

– Authorize supervisory agencies to apply fit and proper standards to significant shareholders.

– Authorize agencies to require organizational changes to financial institutions.

– Require that agencies publish all official decisions.

SOE Governance in China

The Case in 2002

Fragmented governance

- Multiple government entities
- Role of the Communist party

Some diversified ownership: 1100 SOE IPOs

- 18% of GDP
- Good assets “packaged" for listing during 1990s
- Ongoing problems with related party transactions
- On average, 70% of shares non-tradable

SOE Governance in China

Priorities for 2006

Focus of rights/responsibilities in supervision agency

- Hiring/firing
- Performance monitoring
- Board governance & incentive compensation
- Better financial reporting

More protections for public shareholders

- Fiduciary duties & independent directors
- Public shareholder approvals
- Conversion of non-tradable shares
- Disentanglement of parents-subsidiaries

ROSCs in Latin America & Caribbean

- Chile 2003
- Colombia 2003
- Mexico 2003
- Panama 2004
- Peru 2004
- Brazil & Bolivia to be published
- 2-3 ROSCs in 2006

Thank you

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