The need for Corporate Governance in averting banking crises -Lessons from the Banco Latino Crisis-.

Speech delivered by Drs. Alberto G. Romero; Executive Director Bank van de Nederlandse Antillen at the KPMG banking seminar in the Dominican Republic.
October 2, 2003

[Download the Spanish version here]

Introduction

I would like to first of all thank you for the invitation to speak on the important topic of banking crisis and about adequate corporate governance structure as a tool to prevent banking crisis from arising. The recent high profile financial failures like “Enron” and “WorldCom”, to name but two, have undermined trust in the corporate sector in general, and in the financial sector, in particular. As you are well aware the financial world, especially the banking world, thrives on trust.

Today I would like to share with you our experience about the need for corporate governance in averting banking crisis. I will discuss the importance of corporate governance in promoting a sound financial system and will use the collapse of the Banco Latino Group in Venezuela in 1994 to illustrate this point.

Definition of Corporate Governance

According to the Organization for Economic Cooperation and Development (OECD), corporate governance is defined as involving “a set of relationships between a company’s management, its Board, its shareholders, and other stakeholders. Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Corporate governance should also provide proper incentives for the Board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.”

From a financial industry perspective, corporate governance involves the manner in which the business affairs of individual institutions are governed by their Boards and management. It also includes the effective management of compliance with applicable laws, regulations, and guidelines.

The focus on corporate governance is particularly acute in financial services and, most of all, in the banking sector.

Governance in banks is a considerably more complex issue than in other sectors. Banks will attempt to comply with the same codes of board governance as other companies but, in addition, factors like risk management, capital adequacy and funding, internal control, and compliance all have an impact on their matrix of governance.

Governance is also a curiously two-sided issue for banks since their funding and, often, ownership of other companies makes them a significant stakeholder in their own right.

The Board of Directors stands at the heart of many systems and structures encompassing the totality of corporate governance.

In the financial system, corporate governance is not only vital at the individual company level, but it also is a critical element in maintaining a sound financial system and a robust economy. A good example of this is the case of Banco Latino CA in Venezuela. Banco Latino CA collapsed on January 16, 1994, triggering a real banking crisis in Venezuela and throwing the Venezuelan economy into a deep recession.

But before I go into the corporate governance lessons that can be learned from the events in 1994, let me first give you a historic perspective of the crisis in a nutshell. Second, I will highlight the elements of corporate governance in the banking world. I will conclude with the lessons we have drawn from the Banco Latino case.

The Crisis

On January 13, 1994, the Central Bank of Venezuela removed Banco Latino CA from the clearing system because of an insufficient balance in its account with the Central Bank. In anticipation of the outcome of the presidential election, depositors had withdrawn substantial amounts of liquidity from the banking system. In this process, almost all banks were going through a major liquidity crisis. In addition, rumors were circulating about the financial instability of Banco Latino CA and the involvement of its management in irregularities.

As Venezuela's second largest financial institution, Banco Latino CA had enjoyed an excellent relationship with the Government at that time, and this situation provided political and financial support as well as protection from competitors. FOGADE, the state deposit insurance agency, held one-third of its funds in Banco Latino's vaults. Many Banco Latino depositors were unaware of the impending collapse. Others believed that the government, which had a solid record of 'bailouts', would never allow such a politically connected bank to fail. However, the new Government that came into power in 1994 was slow to react.

The collapse of Banco Latino- whose account-holders made up more than 10 percent of Venezuela's adult population- would prove devastating. The loss of confidence immediately spread, sparking a contagion of runs on banks across the country. Hordes of citizens and businesses withdrew their bolivars, converted them into dollars, and took them abroad. A long list of bankers fled the country. The Venezuelan Central Bank estimates that capital flight drained more than $3.5 billion from its initial $12.7 billion foreign exchange reserves in the first half of 1994.

By the time the crisis abated, the government had taken over or bailed out more than half of all banks in Venezuela. The government appointed new members to the bank boards, who used funds from FOGADE to recapitalize the banks. When these funds ran out, the government seized and shut down numerous banks and issued arrest warrants for bank directors on charges of fraud. The $1.1 billion bailout plan would in the end amount to 13% of Venezuela's GDP and 74% of its total budget that year.

Eventually, by mid-1995, the disaster had run its course. In 1996, the government began selling off the banks it had taken over in order to raise funds. This sale led to a slew of privatizations. Within two years, 40% of the failed financial institutions had been purchased by foreign banks. Some observers credit the "internationalization" of the Venezuelan banking sector with the cleaner books and improved corporate governance it enjoys today.

Our Central Bank involvement in the Banco lantino case was mainly because the group also had an international bank operating under the name of Banco Latino NV in our jurisdiction.
Banco Latino NV, an affiliate of Banco Latino CA, had a substantial claim on Banco Latino CA in an amount close to USD 170 million. In the period right before the removal of Banco Latino CA from the clearing system by the Venezuelan Central Bank, the amount of lending from Banco Latino NV to Banco Latino CA increased significantly. As it turned out, during the liquidity crisis, many funds were being exported to Banco Latino CA from Banco Latino NV to supply Banco Latino CA with the necessary liquidity to pay its depositors during the run on the bank.

As you can appreciate Banco Latino NV got into trouble as a result of its affiliation with Banco Latino CA in Venezuela. This has been a typical case of 'contagion' that resulted from excessive intercompany receivables, insider transactions, and other unsound banking practices. Some of these unsound banking practices were:

That all transactions were concluded outside Curacao and, thereafter, booked in the accounts of Banco Latino NV. A local trust company functioned as the local managing director but did not influence the management of the bank in any material way.

A substantial portion of the loans extended by Banco Latino NV were extended to affiliates, principals of the bank, and their related interests.

Let us now turn the attention to corporate governance as an important instrument to avert banking crises. From the experiences in the Banco Latino Group –case we have learned some painful lessons.

Bank Corporate Governance

From a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, affecting how banks do the following:

- Set corporate objectives (including generating economic returns to owners);
- Run the day-to-day operations of the business;
- Consider the interests of recognized stakeholders;
  Align corporate activities and behaviors with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and
- Protect the interests of depositors.

The Board's Role in Promoting Sound Corporate Governance

An institution's Board of Directors, hereafter referred to as "the Board," ultimately is responsible for the conduct of the institution's affairs. The Board controls the institution's direction and, hence, its overall policy. In so doing, the Board determines how the institution will conduct its business in the long term. In general, the Board establishes or approves and monitors the policies by which management will operate.

The financial stability and continuity of an institution is very much dependent on the strength and quality of the Board, its independence from management, and its degree of involvement in the institution's affairs. In favorable and unfavorable times, the Board contributes by setting tone and direction; it oversees and supports management's efforts by testing and probing their recommendations before approving them.

The Board also makes sure that adequate systems and controls are in place to identify and address problems before they become a threat. In adverse times, an active and involved Board can help an institution survive by taking the necessary corrective actions and, when needed, keep the institution on track until effective management can be re-established.

The Board periodically should evaluate its own effectiveness and take appropriate steps to improve its performance. Orientation programs for new members of the Board and ongoing education programs that keep all members of the Board abreast of developments in the industry should be considered. Additionally, periodic reviews by third parties (e.g., auditors, supervisory authorities, or management advisors) may help the Board assess how well it and its committees are meeting their responsibilities.

The Responsibilities of the Board and its Members

In addition to the collective responsibilities of the Board, each member has individual responsibilities. The Board as a whole has seven distinct responsibilities.

1. Ensure competent management on an ongoing basis.
2. Ensure appropriate plans and policies for the institution.
3. Monitor operations to ensure compliance and adequate control.
4. Oversee business performance.
5. Ensure that the institution serves the (credit, insurance, or investment) needs of the community well.
6. Ensure that the individuals involved in the daily management and operation of the institution are of professional, social, and moral integrity.
7. Ensure that timely and accurate disclosure is made on all material matters regarding the institution.

The Board's Role in Managing the Risk of an Institution

Developments in the international and domestic sector in recent years imply a significant increase in the risks affecting institutions established in our jurisdiction. If left uncontrolled, these risks may have adverse implications for the ongoing abilities of those institutions. Therefore, the Board must establish procedures and policies to identify, measure, monitor, and control the risks involved in the institution's various products and lines of business. Principles of sound management should apply to the entire spectrum of risks facing an institution including, but not limited to credit risk, market risk, liquidity risk, operational risk, legal risk, and reputational risk. Therefore, periodically the Board should receive from management information on risk exposures and risk-management activities of the institution.

The Board's Role in Monitoring the Institution and Taking Corrective Measures

The Board should be aware of the importance of corporate governance and its impact on corporate performance. The Board should determine that the institution has in place processes that ensure that management and employees are fulfilling all of their duties and responsibilities. An institution's Board ultimately is responsible for the performance of the institution. As such, the Board typically supervises to ensure that an institution is being properly governed and to bring to management's attention any problems detected through their supervisory efforts. When the institution takes risks that it cannot measure or control, the Board must hold the management accountable and require that corrective measures be taken in a timely manner. The Board should be attentive to any warning signs of deterioration in the management of the institution's activities.

The Relationship between the Board and Management and the Right of the Board to Obtain Information

about the Institution

The Board ultimately is responsible for the operations and financial soundness of the institution. The Board and management of the institution must work together to ensure that the best interest of the institution is pursued at all times. Therefore, the management should guarantee an appropriate flow of information and provide the Board on a timely basis with sufficient information to judge the performance of management. Management also should provide the Board with new ideas and recommendations. The Board should review carefully and discuss management's recommendations to ensure that these recommendations are in the institution's best interest.

The Relationship between the Board and the External Auditor

The role of auditors is vital to the corporate governance process. The effectiveness of the Board and management can be enhanced by (1) recognizing the importance of the audit process and communicating this importance throughout the institution; (2) taking measures that enhance the independence and stature of auditors; (3) utilizing, in a timely and effective manner, the findings of auditors; (4) ensuring the independence of the head auditor through his reporting to the Board or the Board's audit committee; (5) engaging external auditors to judge the effectiveness of internal controls; and (6) requiring timely correction by management of problems identified by auditors. The Board should recognize and acknowledge that the internal and external auditors are their critically important agents. In particular, the Board should utilize the work of the auditors as an independent check on the information received from management on the operations and performance of the institution.

The Role of Supervisors

Supervisors should be aware of the importance of corporate governance and its impact on corporate performance. They should expect banks to implement an organizational structure that includes the appropriate checks and balances. Regulatory safeguards must emphasize accountability and transparency. Supervisors should determine that the boards and senior management of individual institutions have processes in place that ensure they are fulfilling all of their duties and responsibilities.

A bank's board of directors and senior management ultimately are responsible for the performance of the bank. As such, supervisors typically check to ensure that a bank is properly governed and to bring to management's attention any problems they detect through their supervisory efforts. When the bank takes risks that it cannot measure or control, supervisors must hold the board of directors accountable and require that corrective measures be taken in a timely manner. Supervisors should be attentive to any warning signs of deterioration in the management of the bank's activities. They should consider issuing guidance to banks on sound corporate governance and the pro-active practices that need to be in place. They also should take account of corporate governance issues in issuing guidance on other topics.

Sound corporate governance considers the interests of all stakeholders including depositors, whose interest may not always be recognized. Therefore, supervisors must determine that individual banks are conducting their business in a way that does not harm their depositors.

Governance Lessons from the Banco Latino Crisis

Looking back, a number of factors contributed to the Banco Latino Crisis in Venezuela. One of those factors was definitely poor corporate governance structures in place around mid 1990s.

The Boards of Directors of both Banco Latino CA and Banco Latino NV neglected their responsibility to manage the risk of their respective institutions. Moreover, the Latino Group structure was set up to conceal most of the unsound practices of the different institutions within the group.

The unsound operation of the bank was the result of the following factors:

- Effective domination of the bank by one person overriding others with power of attorney;
- Inadequate supervision by the Board of Directors;
- Inadequate internal control by the internal audit department of the group;
- Little or no external supervision of the group;
- Nontransparent structure of the group;
- Excessive insider transactions; and
- Illegal actions.

One now can ask themselves where the banking supervisors were when all this was happening. Keep in mind that in the period before the Latino Crisis, the supervisory laws in place in the Netherlands Antilles clearly were not adequate to supervise the international banking sector. In fact, the National Ordinance on the Supervision of Banking and Credit Institutions of 1972 excluded this sector from prudential supervision, thus creating opportunities for unsound and unsafe banking practices.

The lessons from 1994 learned us about the importance of having all supervisory structures in place to enable proper and efficient oversight on (financcial) institutions. The current banking supervision ordinance already was drafted and was immediately rushed through parliament giving the Central Bank of the Netherlands Antilles the necessary tools to properly supervise this sector. The National Ordinance was enacted in February 1994.

Since the Latino episode, the Bank has introduced a set of supervisory regulations and policy memoranda to enhance the corporate governance of the institutions subject to our supervision.

The newly introduced rules and regulations in this context are:

- Policy Memorandum on the periodic filing of a Management Report: The Management Report is a periodic briefing by management on the performance of the institution and a reflection on the future direction of the institution.
- Supervisory Regulation I : extension of credit to Executive Officers, Supervisory Directors, Principal Shareholders and their related interest and to employees of a credit institution. This regulation formally limits the amount of lending to executive officers, supervisory directors, principal shareholders being natural persons (including the related interests of those persons), and employees of the institution.
- Supervisory Regulation II: restrictions on transactions with affiliates and loans to affiliates. To reduce the risk of contagion by affiliates, restriction was placed on the type of and volume of transactions with affiliates and the resulting receivables from these affiliates.
- Limitations on extensions of credit to any one borrower or group of connected borrowers: This regulation aims to avoid overexposure to one single borrower or group of connected borrowers.
- Guidance Notes for the Board of Directors of Supervised Financial Institutions on Corporate Governance: The guidance notes describe the general responsibilities of the Board of institutions, the legal obligations of directors, and the role of auditors.
- Summary of Best Practice Guidelines on Corporate Governance: The best practice guidelines contain a discussion and presentation of various systems, policies, and measures potentially effective in dealing with corporate governance issues in financial institutions.

Concluding Remarks

Today I have illustrated how the lack of good corporate (bank) governance can lead to a banking crisis and ultimately to an economic recession. The failure of the Banco Latino CA in Caracas, Venezuela, was triggered by a number of factors. However, the unsound and unsafe banking practices of bank management exacerbated the situation and were possible because of the lack of adequate corporate governance.

The collapse of Banco Latino NV in the Netherlands Antilles had its origin in the fall of Banco Latino CA in Venezuela. However, as mentioned earlier, the directors of Banco Latino did not observe any of the principles of good corporate governance. Insider abuse, conflict of interest, poor risk management, lack of proper internal control and supervisory oversight all led to the failure of Banco Latino N.V.

This episode brought home to the Netherlands Antilles, particularly the financial sector, the message of the importance of good corporate governance in promoting general stability and successful functioning of the overall financial system. Therefore, the Bank has been very active in promoting sound corporate governance in the financial sector of the Netherlands Antilles.

Thank you for your kind attention.