BUILDING AN ETHICAL CORPORATE CULTURE IN BANKING SECTOR

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Abstract - This study aims to understand and explain the factors and reasons that created the world's financial crisis. The output was with social impact and high uncertainty of public trust. It influenced the banking sector which was not qualitatively regulated at that time. The research is made in the field of Regulation and corporate governance, concerning the ethical values incorporated into new policies of the main financial institutions. The study makes research of the basic principles that recommends incorporation of culture and values in overall banking operations. The case Macedonia is taken as example as practical experience of the researcher and gives short description of the current movements in the banking sector in Macedonia. Questionnaire to the board members has been distributed to the Boards in Macedonian banks in order to reflect the objectiveness of implementation of strategies, decision making processes and awareness of ethical and cultural improvements in respective institutions. Macedonian banks in order to reflect the objectiveness of implementation of strategies, decision making processes and awareness of ethical and cultural improvement in respective institutions. Banking sector, Committee, Corporate Governance, Ethical values and culture, Financial crisis, Macedonian Banks, Regulation.

I. INTRODUCTION

Macro level issues - economic topics, fact and figures

The financial crisis that happened in 2008, corporate scandals, deregulation, technology, global terrorism are factors that lead the world to significant changes and also create uncertainty in business and financial systems.

The corporate scandals like Enron, Arthur Andersen, World Com and Merrill Lynch are connected to firms and corporates that already had public confidence in Wall Street and strongly influenced millions of employees, shareholders, governments and regulation, and different stakeholders. This influenced trust in businesses. According to Weiss, only 22% Americans express a great deal or quite a lot of confidence in big business, compared to 65% who express confidence in small businesses[1.]

The 2008 financial crises emerged in economic crisis with wide social consequences. The modern economics stress out that the financial crises which have been followed with economic crises are long lasting, sharp and need more cure time. The economists rang the factors that had leaded to the financial crises and usually they separate micro and macroeconomic factors/reasons. The three main reasons can be defined as follows: securitization and implementation of innovative high risk financial derivatives, low level of transparency and deregulation of the financial markets, followed with abundance of ethical principles and ethical making decisions.

In America, where the financial crises has aroused, the banks practiced securitization of the loans, which meant that the banks transferred the loans to other financial entities that they established on their own and which they knew that were not regulated. By conducting these actions they transferred the risk to non-regulated entities and avoided the supervision of the national regulators. This was the way and the point of risk transfer, the moment of unethical decisions of the actors. [2]

The regulation influenced the financial crises as main factor. President Clinton administration encouraged the mortgage loans and the President Bush administration even released the regulation. The Fannie Mae and Frederic Mac, state owned financial entities in September 2008 guaranteed 6000bilionsUSD mortgage loans.[3]The high risk financial derivatives were allowed on the free market regulated by GLBA and CFMA adopted in 1999. Nevertheless the hedge funds remained non-regulated. The structure of the financial institutions and the regulation that covered them was dispersed and fragmented. Compensation policy and the excessive pay to chief executives officers, who actually had low performance and short term vision, did happen in reality. Even though compensations during the financial crises were controversial topic, the situation did not change a lot. According the Bureau of Labor statistics the median CEO salaries grew up 27% in 2010, overall worker pay only increased 2,1%.[4] Moving jobs from United States and Europe to China, India and Russia is also an issue and ongoing global process. According to Deloitte Consulting 2milion jobs would move from the United States and Europe to overseas destinations within the

[1]Weiss Joseph," Business ethics", Beret-Koehler Publishers, Inc. San Francisco, pp.5, 2014

[2]Ribnikar Ivan, "Banke, zajmove banka, krediti, dugovi I finansiska kriza Prilozi XXXIX" MANU, Skopje, 2008, pp2

[3]Parkin Michael, "Macroeconomics",Pearson Education, Boston 2012, pp.162

[4]Weiss Joseph," Business ethics", Berett-Koehler Publishers, Inc. San Francisco, pp.5, 2014

financial services business.[5]Artificial intelligence, robotics and their replacing the humans is happening around the world. The predictions that 50 million jobs could be lost to machines by 2030 and even 50% of all human jobs until 2040 are intimidating and really close.

All these macro level issues provoke ethical dilemmas in all businesses, among the individuals or among the corporates, among the countries in the world, among the professions and finally among the attitudes that shall be on place by the players.

Ignazio Angeloni, Member of the Supervisory Board of ECB says that the crises has shaken the foundations of the financial system, with social and economic consequences and made overinvestment in real estate, excessive leverage and undercapitalization of financial institutions, overly complex and opaque financial instruments, wrong incentives, conflict of interest, excessive central bank liquidity, and so on and he argues that this is primarily a crisis if trust and it won't be overcome until we somehow restore the trust. He continues that compliance and regulation is required but, social trust also requires ethics, ethics at all levels and in all processes.[6]

Key insights related to ethics and culture concerning regulation

It can be concluded that the financial crises have revealed a multitude of cultural failures. Actually the cultural failure in the financial institutions, banks have caused reputational damage and fall of the public trust. Financial institutions and banks should rely on trust. After 2008 professionals, experts, board members, supervisors, governors have been making efforts and working on documents related to culture and ethics in the financial world as follows key insights:

-Basel Committee on banking supervision, issued Consultative Document: Corporate Governance Principles for Banks, 2015. This is a revision of the document issued in 2010 and gives the fundamental principles for governance in the banks. The document does not give explicit guidance on culture values implementation, but underlines the importance of culture in the key banking activities.

Financial Stability Board, "Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture", April 2014. This document identifies the key elements that are important for risk culture for the risk management and for regulators and supervisors.

Financial Stability Board, "Principles for Sound Compensation Practices" September,2009. This document gives some other perspective to the understanding of compensation policy of the companies. It says that it should be in line with risk policy, but also with the culture of the whole organization.

G30: A new Paradigm: Financial Institution Boards and Supervisors, October, 2013. This new paradigm should be based on trust by the Boards, Regulators and Supervisors. The culture and good examples is needed for the all parties.
G30: Banking Conduct and Culture, A Call for Sustained Comprehensive reform, July, 2015.

The 2010 Corporate governance principles were focused on the effects of the financial crises and leaded the banks for learning the lessons through the process of recovering and through the process of implementation of overall governance practices and also leaded the supervisors to oversee the critical processes. Instead, the 2015 Corporate Governance principals focus on strengthening the governance of the banks and supervisors role. The risk governance is said to be the most important focus, underlining that national authorities and financial institution needs for continuous improvement of the processes for qualitative risk governance and high value risk culture.[7]

Board's overall responsibilities are set as implementation of the strategy and corporate culture. Corporate culture is defined as a fundamental component of good governance in terms of bank's risk awareness, risk taking behavior, risk management. It says that the Board should promote risk culture that does not support excessive risk taking by employees and by the management. The Code of conduct or code of ethics according to BIS corporate governance principles should define acceptable and unacceptable behaviors. It explicitly disallows illegal activities such as financial misreporting and misconduct, economic crime including fraud, breach or sanctions, money laundering, anticompetitive practices, bribery and corruption, or the violation of consumer rights. Employees are expected to conduct themselves ethically and perform their job in complying with laws, regulations, and company policies. According to these general, but strongly recommended instructions in this document regarding ethics and illegal activities, the banks could be protected from such intention, behavior, by individuals or by groups only if their boardstruly wish to implement the

[5]Weiss Joseph," Business ethics", Berett-Koehler Publishers, Inc. San Francisco, pp.6, 2014

[6]https:www.bankingsupervision.europa.eu/press/speechees/date/2014/html/se140926.en.html

[7]Basel Committee on Banking Supervision, "Guidelines: Corporate Governance principles for Banks", Bank for International settlements, July2015

principles and try to communicate with the employees. The document is implemented in national jurisdictions in European banks and the banks from member associates.

Concerning Board qualifications and composition, every member should be qualified, understand the corporate governance role and be able to exercise sound, objective judgement about the affairs of the bank. The principles define all the qualifications, knowledge, skills, ethical values and reputation that each board members should possess. Board committees are important to mention, because of their crucial role -Audit committee, risk committee, compensation committee and others. These committees are effective in order to give relevant picture and approval for the important processes within the bank's improvements. More parties are involved in process of decision making, even though the process refers the audit reports, risk taking or compensation policies. The importance of conflict of interest is highlighted, which may arise as a result of various banking activities and roles, or between interest of the bank and customers, clients or other relations. The Board should define what the conflict of interest represents, strictly define what activities create conflict of interest and define policy for acting in such situations.

Establishing compliance function as independent function and assuring incompliance of internal acts and procedures with external regulation is a challenge for all Board committees. Compliance function should identify, assess, monitor, report and advice on compliance risk.

Systemically important financial institutions should have compensation committees as integral part of their governance structure. The Financial Stability principles should be applied especially to large and important banks. The remuneration policy should be in line with the both, the business and risk strategy. Implementation of this principle shall avoid all the unethical and personal behaviors that happened during the financial crises within the banks and financial corporates.
Disclosure and transparency to its shareholders, depositors, other relevant stakeholders and market participants is required. Supervisors should supervise the corporate governance within the banks, which includes the expectations on corporate governance evaluations of a bank's corporate governance, regular interaction of the supervisors and management, cooperation and sharing of corporate governance with other relevant supervisors.

It can be concluded that these principles have spread coverage of all sensitive areas that might be potential risk or factors for frauds, illegal activities and factor for increasing insecurity.

Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform is a study by G 30, focused on governance challenges in large financial institutions.[8]The report recognizes the culture failure in these institutions, damage done by failures in culture, values and provides advices for boards, management and supervisors. The report is not just about overall culture and ethics within institutions, but its implementation in all other key processes underlined as important in this long-term path. The report underlines the need of focus on conduct and culture by banks, boards and management. The definition of desired culture is necessary. Desired values and conduct is a practical approach, and it is supposed to be the tone of the top, through middle management to whole structure of the organization. Report defines culture as the purpose to create trust in banks among internal and external stakeholders (parties). There are two key priorities: client and stakeholder perception for the bank is noted as the most important priority, and the second key priority is performance of the bank which satisfies shareholders. Rebalancing the focus from delivering for shareholders to broader stakeholder and public accountability will be critical to reestablish trust, both externally and with employees.

The management challenge of embedding values and desired conduct cannot be overestimated, but it needs urgent action, from the banks and their leaderships, as an ongoing task is proposed in the report. This call of G30 is opposite to the traditional principal agency theory and leads to stakeholder theory of corporate governance. In this context, if culture cannot be regulated, every bank should find its own way to implement these report recommendations and act socially responsible. Some bankers find out that financial firms exist, in part, to benefit the public, not simply their shareholders, employees and corporate clients. Unless the financial industry can rebuild the public trust, it cannot effectively perform its essential functions.

The report says that there are numbers of persistent implementations pitfalls into four areas such as senior accountability and governance, performance management and incentive, stuff development and promotion and effective three lines of defense. The report ends with the recommendations and action plans for banks, regulators and supervisor and they refer to all weak selected areas.
The case Macedonia as example

First, the legislative in the sphere of corporate governance in Macedonia is evaluated as satisfactory. Second, the development of the institutional basis for

[8]G30; "Banking Conduct and culture, A Call for sustained and comprehensive reform" , the Group of thirty, Washington DC, July 2015

good corporate governance has influenced the improvement. Third, the banking sector in Macedonia is well evaluated, stable and internationally respected. In general, the ownership structure of the banks consists of foreign capital in 4 of 5 systematically important banks whereat the foreign shareholders are represented with over 70% of the shares with qualified participation (the banking sector is consisted of 15 banks). Additionally, the Supervisory and Management Boards are composed of both domestic and foreign members. Banks and financial institutions are considered to be the most regulated companies in Macedonia and banking regulation is incompliance with the European legislative. Considering this fact, the first steps in implementing corporate governance principles and building business ethic climate in Macedonia, has its roots in the banking sector.

The study Corporate Governance in Southeast European banks,2012.researched by EBRD and IFC makes a few conclusions on corporate governance in Southeast European Countries banks' including Macedonia.[9]

Professional and competent boards of the banks are the key for good corporate governance in the banks and their performance. One of the main weaknesses of the corporate governance of Southeast European countries' banks, according the study, including Macedonian banks, is reflected in the close relations between the board members and management and CEOs (the governance system in Macedonia is two-tier board system) which at the end is reflecting in decision making processes. The Board members do not possess qualified skills and knowledge (especially the Macedonian members). The EBRD and IFC study makes this fact clear. The external board members (the representatives of foreign capital) import knowledge and skills.

The conclusions made in the study are supported by Questionnaire which has been delivered to the Board members in the banks in Macedonia.[10]

The Question - How often the Board members ask for additional analysis on the main issues discussed on the regular meetings, has been answered with rarely or no. This confirms the fact that the Board members possess insufficient knowledge and qualifications. Following, the members opinion, demonstrates well separated responsibilities of the Board members and executives are a good practice established, but even though the close relations between both parties leads to subjective decisions. On the question if the regulation in Macedonia has been well established and makes climate for good corporate governance, they answered with partial satisfaction. The same answer was given on the question if the institutions of the country are ready to promote and practice good corporate governance. Because the research was made in 2012, it can be concluded that even then there was a good climate for practicing good corporate governance. Since then, there have been improvements in the regulation and also in awareness that culture and values are necessary. Analyzing the webs of the banks in Macedonia indicates that every bank has adopted its Code of ethics, corporate values, Code of corporate governance and similar internal acts which strongly affect the improvement on the overall situation.

The first decision on good corporate governance in Macedonian banks has been adopted in 2008th and has become obligatory for the banks. The revised decision is adopted in 2018 and reflects Basel standards of the document for corporate governance. The corporative culture and values are defined as set of rules and standards that enables responsible and ethical behavior in the process of communicating the stakeholders, process of implementing the strategy of the bank and daily decision making processes. The Corporate Governance Decision is reflection of Basel principles for good corporate governance and is considered to be obligatory for the banks in Macedonia. The regulator is the National Bank of Republic of Macedonia.

CONCLUSION

Since the financial scandals in 1999, then the2008 the financial crises, the public trust in financial institutions is on low level. Even though there are groups of professionals and authorities, governments and countries that work on improvement of this issue, working on regulation and codes of ethics and conducts, the question is always provocative. This issue reflects on different views in theories regarding the regulation of the banks, how much and how deep should it go? Could too much regulation have negative impact on productivity and innovative oriented companies? Can ethics and culture be regulated? Do moral and ethical values differ from individual to individual, and at the end, what is good and what is bad? This dilemmas will always be present in the world of finance (the last Latvian cases convince that). The important thing is that the relevant financial institutions are conscious what are the real situations on this field and are continuously reporting and working in the frames of possible.

[9]EBRD and IFC, "Corporate Governance for Banks in Southeast Europe, Washington, DC2, pp.9,2012

[10]Nedelkovska- Fiti Nina, "Corporate governance in commercial banks in the Republic of Macedonia", doctoral thesis, Skopje,pp. 188, 2012