The absence of corporate governance in the banking sector and its consequences





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The Independent Commission on the Future of the Banking Sector in Cyprus (www.icf-cbs.org) issued its interim report last June, making recommendations on our banking system in the context of best international practices.

In its 100-page report the Commission analyses the economic crisis in Cyprus, and notes that although many of the factors that led to the collapse of our banking system are exogenous, there are as many endogenous reasons.

In fact the report focuses on two major endogenous factors contributing to the banking crisis, namely the absence of corporate governance and the politicisation of the banking system, which together significantly hindered the restructuring of the banking system.

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One of the Commission's essential and highest-priority recommendations is that there is a clear boundary between the banking world on the one hand and the world of politics on the other. In the opinion of the Commission, the banks must be independent from politics, with new people with new ideas, unsusceptible to political influence, connections and interference. The same must go for those on who the banks depend for advice.

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that the banking system in Cyprus is highly politicised is unhealthy for several reasons. To focus on just two: political interference in the management and control of banks has been shown consistently to lead to bad decisions being made. Furthermore, in Cyprus the same political cliques constantly reappear with their fixed ideas, shouting down any outsiders who might challenge the status quo. Any new ideas that might actually improve the running of the banks are dismissed out of hand, as the same sterile orthodoxy is continually recycled.

The principles of good corporate governance are a powerful tool by which companies are managed and controlled, for the benefit of all stakeholders, including society at large.

The objective of corporate governance is to maintain an appropriate balance between economic and public objectives and social responsibility, so that the company can work with social responsibility and also be profitable for its members, not only in the short term, but also in the longer term. Effective corporate governance includes appropriate and effective checks and balances, ensuring that the company's officers serve the company, not themselves. It makes the officers, including the board of directors, accountable to the shareholders who elect them. It ensures that auditors are independent and act in the interests of those who elect them, and do not become toothless lapdogs for the board of directors.

In Cyprus, even though we have corporate governance rules under the auspices of the Cyprus Stock Exchange and the Central Bank of Cyprus (CBC) in accordance with the European Directive, it is apparent that for most companies corporate governance is merely an abstract concept with no practical relevance. The failure of corporate governance is one of the most important reasons why the major Cypriot banks were led to disaster. It allowed ambitious senior executives to choose risky strategies without risk assessment, and conflicts of interest to go unchecked, leading to disastrous lending decisions.

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The independent Commission recommends upgrading the level of corporate governance of banks and cooperatives by putting in place experienced directors, by increasing the number and powers of non-executive or independent directors, improving directors' awareness of the principles of corporate governance and by creating committees for internal audit, for risk assessment, for preparation of long term plans and strategy. Improvement of corporate governance.

As a first step the CBC's Directive on Corporate Governance needs to be revised and then effectively enforced, with emphasis on internal control assessment and risk management. Supervision needs to be tightened in order to ensure that banks genuinely comply with its requirements in practice, not merely on paper.

The Memorandum of Understanding (MOU) as agreed with the Eurogroup recognises the need to strengthen corporate governance and align it with acceptable international standards in all sectors, including semi-governmental organisations. While the MOU will not itself promote growth and economic recovery, it lays the foundations for the restructuring of the banking system, which is essential if we are to achieve a recovery.

The General Meeting of the Bank of Cyprus shareholders has now elected the bank's new board of directors who will now have a huge task to work within the principles of Corporate Governance and bring the Bank back to profitability and growth. It is therefore appropriate now for the Central Bank to consider what the European Directive and the MOU has to say about the appointment,

composition and conduct of board of the directors of Banks and to confirm that the Directors elected meet the fit and proper test as described in the Directive. Having learned from the bad experience of the recent past, the Central Bank has to upgrade its supervision as Regulator of the Banking Sector.

Section 1.10 of the MOU stipulates that the majority of the board members must be independent. It also requires that legislation should be enacted before mid September to strengthen the corporate governance of banks by prohibiting commercial banks and co-operatives from giving loans to independent directors and their relations and associates, and forcing the resignation of any director whose existing debt to the bank is non-performing according to the new CBC definition. Lending to other members of the board will be allowed only up to a fixed amount calculated by the CBC. Loans and other credit facilities to any member of the board will be published.

Both the Independent Commission's Report and the MOU make it clear that the strict application of corporate governance is essential for healthy companies to earn public confidence and give value to a country's economy. It is up to our supervisory authorities to ensure that in future adherence to the principles of corporate governance is real, practical and consistent, and not just lip-service.



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