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DOMINICAN BANKING CRISIS: THE FIRST BANKING CORPORATE GOVERNANCE CRISIS?

*Carla Gabriela Alsina Nivar**

ABSTRACT

In 2003, the Dominican Republic suffered the failure of three of the country's largest banks; it was a costly banking crisis that had tremendous economic and social repercussions.

Under the premise of the Dominican banking crisis, the issue of banking corporate governance becomes important because banks are not ordinary corporations. The failure of a bank negatively affects a vast range of stakeholders, which include: shareholders, depositors, creditors, employees, taxpayers, and the public interest represented by the regulator. In fact, the agency problem is identified as the cause of recent banking crises. Thus, the interests of the stakeholders become crucial in taming the information asymmetries that cause this problem. Therefore, a broad approach to banking corporate governance is a necessary step in the prevention of future banking crises; an approach that takes into account the broad array of stakeholders, instead of the traditional shareholder-management relationship. This in turn, changes the roles of stakeholders and the dual role that must be assumed by the regulator as an agent of the public interest.

Based on the above, the current Dominican regulatory framework is analyzed to determine if it takes into account the broad base of stakeholders as a means to prevent the information asymmetries that cause the agency problem. This analysis is based on the Organization for Economic Co-operation and Development (OECD) standards of corporate governance as the predominant trend in corporate governance standards, concluding that different aspects of the law take into account stakeholder interests. But the regulator is only granted supervisory power and is unable to effectively act as agent for some of the stakeholders.

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I. INTRODUCTION

Leaving aside war, banking crises in developing countries, in general, and in Latin America, in particular, may stand as the major man-made catastrophe in recent history. The destruction of real and financial wealth that systemic banking crises entail is so large that there is little wonder that financial intermediation in Latin American remains shallow and well below the levels reached by industrial countries. Among developing countries, Latin American stands out for the frequency, depth and costs of its banking crises.¹

THE 2003 Dominican banking crisis was no exception to this sad account of banking failures in Latin America, including a rescue by the Central Bank of 25 percent of the country's gross domestic product (GDP), a cost that Dominicans could ill afford.² The broad scope of victims touched by the crisis evidences that the consequences were not only economic, but had a strong social dimension as well. These consequences are also evidence that banks are not ordinary corporations. Their very nature is tied to vast sectors of society, and accordingly, the authorities have taken a keen interest in regulating the market.³ Therefore, since bank failures affect a broad range of stakeholders, so must the corporate governance mechanisms installed to control risk in financial intermediaries.

Hence, after the bank crisis, "prevention is the best cure . . . a good cure goes a long way in preventing *recurrence*."⁴ Nevertheless, prevention can only work if the right tools are put into place, which means the banking corporate governance system in the Dominican Republic must protect the interests of the different stakeholders in relation to financial intermediaries.

In this respect, the forthcoming paper will proceed as follows: Section II, a description of the 2003 Dominican banking crisis with the purpose of highlighting the social and economic costs of the failure of three of the main banks in the country. Section III defines corporate governance as an important part of the internal functioning of the banks, defines and establishes the agency problem among stakeholders as the main cause of recent banking crises, and proves that it is appropriate to adopt a broad

1. Liliana Rojas-Suarez, *Banking Crises in Latin America: Can Recurrence be Prevented?* 1 (Mar. 2002) (paper on banking supervision presented at the World Bank Conference, Montevideo, 2002), available at http://www.claaf.org/documents/Rojas_Suarez2.doc.

2. JOSE FLORENCIO GUZMAN ET AL., *INFORME DEL PANEL EXPERTOS INTERNACIONALES: CRISIS BANCARIA REPÚBLICA DOMINICANA 12* (Banco Central de la República Dominicana, rev. Mar. 2005), available at <http://www.bancentral.gov.do/FMI/informecb.pdf>.

3. Kern Alexander, *Corporate Governance and Banking Regulation: The Regulator as Stakeholder* 6 (Cambridge Endowment for Research in Fin. Research Programme in Int'l Fin. Regulation, Working Paper No. 17, 2004), available at <http://www.cerf.cam.ac.uk/publications/files/WP17%20-%20Alexander1.pdf>.

4. Rojas-Suarez, *supra* note 1, at 2.

approach to banking corporate governance. Finally, Section IV evaluates the Dominican banking corporate governance regime in light of the standards set by the OECD and the Basel Committee on Banking Supervision (Basel Committee) as the current trend in corporate governance standards.

In conclusion, there is a strong need for the broad scope of stakeholders of financial intermediaries to participate in order to curtail management's tendency for excessive risk taking. This balance of interests prevents information asymmetries that cause the agency problem, and thus, aides in the effort to prevent future banking crises. Therefore, the Dominican banking crisis is the first corporate governance crisis, as it is an example of the need for a change and the recognition that a revolution of corporate governance is necessary in order to broaden the stakeholder spectrum and to include the important interests that will monitor and preserve the health of financial intermediaries.

II. DOMINICAN BANKING CRISIS

On March 13, 2003, the former governor of the Central Bank of the Dominican Republic gave a speech from the presidential palace announcing the financial collapse and breakdown of one of the largest commercial private banks in the entire country. He announced that Banco Intercontinental (Baninter) had been the victim of a horrendous fraud by some of its major executives and it now had a deficit of 55 billion Dominican pesos.⁵ He reassured the depositors of Baninter that their investments would be accounted for by the government. Not long after, two other large commercial private banks followed, and after more than three years, many uncertainties remain as the story of these events continues to unfold.

Baninter, Banco Nacional de Credito (Bancredito), and Banco Mercantil had gained the trust and investment of the Dominican people and became three of the largest banks in the country. Consequently, after the discovery of the frauds and due to the fact that these banks had the majority of the assets in the system, the authorities feared the outbreak of a systemic crisis.⁶ It was under these circumstances that the authorities turned to the International Monetary Fund (IMF) in order to re-capitalize the Central Bank.

A. BANINTER

Baninter was the third largest bank in the Dominican Republic with official assets ascending to 26 billion Dominican pesos.⁷ Its path towards growth began in October 1996 when it acquired Banco del Comercio, a

5. Padre Jorge Cela, *Implicaciones Éticas y Culturales del Tema de la Corrupción*, PARTICIPACIÓN CIUDADANA (Dom. Rep.), June 2, 2003, http://www.pciudadana.com/noticias/not_2003/06022003_discurso_jorge_cela.htm.

6. GUZMAN ET AL., *supra* note 2, at 9.

7. *Id.* at 13.

bank that had collapsed due to a bank run supposedly initiated by a rumor spread by a disloyal competitor.⁸

After a period of rapid growth, Baninter had become the third largest bank in the country. But in 2003, it was plagued with an immense liquidity crisis and had gone over its limit in the drafting facilities provided by the reserve of the Central Bank.⁹ By 2003, the Central Bank had lent Baninter one and a half times the amount of its declared patrimony, surpassing the limits established by the cap on this sort of lending.¹⁰ Thus, a sale of the bank to Banco del Progreso was negotiated.¹¹

Nevertheless, during the due diligence phase of the negotiations for the sale of the bank, a parallel bank was uncovered where many operations were kept off the official balance sheet. The calculations project that these hidden assets were twice as much as the official bank's reported operations, making Baninter the first ranking bank in terms of assets in the Dominican Republic with a sum of 81 billion Dominican pesos.¹² As expected, Banco del Progreso terminated the purchase negotiations and the authorities proceeded to seize Baninter and designate a committee to handle its liquidation, selling part of the branches to Scotia Bank along with some of the credit portfolio.¹³

According to the ex-governor of the Central Bank, a report from an International Panel of Experts designated by the IMF and the Dominican government, the specific mechanism that had been used to conceal the fraud was a parallel bank or parallel accounting. They used software to cover up part of the bank's operations from authorities and from the general public in order to reduce costs, evade the payment of taxes, gain market competitiveness, and provide loans to parties related to company officials who stand accused today.¹⁴

Nonetheless, the president of Baninter claims that both the technological and physical platforms of the bank were acquired from the Central Bank in 1996 when Baninter purchased Banco del Comercio, which included an offshore bank.¹⁵ In fact, he argues that the authorities knew of the true size of the bank, based on the fact that the purchase agreement between Baninter's shareholders and Banco del Progreso contained an appendix that revealed the bank's assets were worth over 80 billion Do-

8. La Verdad Sobre Baninter, SEGUNDA ENTREGA: Banco Central Indujo a Baninter Para Que Comprara Quebrados, http://diariohorizonte.com/CS/blogs/la_verdad_sobre_baninter/archive/2006/05/04/40.aspx (May 4, 2006, 7:00 AM).

9. GUZMAN ET AL., *supra* note 2, at 28.

10. *Id.* at 29.

11. La Verdad Sobre Baninter, PLAN MEJIA 1: Gobernador BC Presionó Para Vender el Baninter, http://diariohorizonte.com/CS/blogs/la_verdad_sobre_baninter/archive/2006/05/15/49.aspx (May 15, 2006, 6:47 AM).

12. GUZMAN ET AL., *supra* note 2, at 13.

13. *Id.*

14. *Id.* at 12-13.

15. La Verdad Sobre Baninter, PLAN MEJIA II: Los Activos del Baninter Superaban RD\$80,000 MM, http://diariohorizonte.com/CS/blogs/la_verdad_sobre_baninter/archive/2006/05/16/50.aspx (May 16, 2006, 6:50 AM).

minican pesos.¹⁶ He sustains that it is impossible for the authorities to claim there is a parallel bank, as they officially certified the purchase agreement.¹⁷

Moreover, the International Panel report states that in addition to the parallel banks, offshore banks were encountered and considered to exist parallel to the official bank, as they were also kept off the official balance sheet.¹⁸ This situation prevented the true nature of the entity from being recognized, as well as a true assessment of the risks from being made. The bottom line was that the depositors did not know where their money was going.

B. BANCREDITO

“Since the banking industry is inherently unstable, the authorities always need to be prepared to confront the possibility of crises or problems.”¹⁹ Thus, the liquidity crisis and subsequent intervention into Baninter, one of the largest banks in the Dominican financial system, led to tension in the functioning of other banks. This situation as a whole led to the liquidity problems of two more bank entities: Bancredito and Banco Mercantil.²⁰

With an already frail market and the uncovering of similar parallel accounting maneuvers as well as offshore facilities, Bancredito was facing a serious liquidity crisis. Public panic provoked an intense bank run on Bancredito. The Central Bank released resources from its reserve in order to cover the depositors’ investments that were being retrieved from Bancredito’s vaults. According to the International Panel, Bancredito had “non-registered operations similar to those run by Baninter,”²¹ with an unaccounted sum of 23 billion Dominican pesos.²²

Faced with the difficulties and lack of resources after Baninter’s downfall and with a general feeling of distrust from the public, the authorities transferred control of Bancredito to Grupo Leon instead of proceeding with another intervention. In return, the Central Bank offered Grupo Leon liquidity guarantees as well as the acquisition (in part) of the weakest portfolio and operations of Bancredito.²³ Furthermore, the authorities obtained assets from the former shareholders of Bancredito as well as

16. *Id.*

17. *Id.*

18. GUZMAN ET AL., *supra* note 2, at 13.

19. Rosa Maria Lastra, *Cross-Border Bank Insolvency: Legal Implications in the Case of Banks Operating in Different Jurisdictions in Latin America*, 6 J. INT’L ECON. L. 79, 80 (2003).

20. GUZMAN ET AL., *supra* note 2, at 10-11.

21. *Id.* (translated by the author).

22. Edith Febles, *Por Estafa a los Ahorristas y al Estado: Condenan a Arturo Pellerano y Felipe Mendoza a 3 Años de Cárcel y al Pago de RD\$1 millón, Cada Uno*, CLAVE DIGITAL (Dom. Rep.), Aug. 10, 2006, http://www.clavedigital.com/Portada/Articulo.asp?Id_Articulo=7976.

23. GUZMAN ET AL., *supra* note 2, at 11.

from the companies linked with the bank.²⁴

On August 9, 2006, three years later, the courts sentenced Bancredito's president and another top executive to three years of prison and the payment of 1 million Dominican pesos each.²⁵ They were convicted of elaborating and using false bank documents, altering and manipulating information and documents with the purpose of deviating the supervision and investigations conducted by the financial authorities, as well as altering and approving adulterated financial statements with the purpose of concealing operations.²⁶ This sentence is currently pending appeal by the convicted parties.²⁷

C. BANCO MERCANTIL

After what occurred with Baninter and the fear caused by the situation of Bancredito, the authorities recognized the importance of disclosure and requested affidavits from the shareholders and managers of the remaining banks declaring that they were unaware of off-the-books operations in their respective institutions. All the banks submitted the requested affidavits except Banco Mercantil. This refusal by Banco Mercantil led to an inspection of the bank where minor irregularities were encountered and where the need for capitalization was evident.²⁸

Consequently, Banco Mercantil was sold to The Republic Bank of Trinidad and Tobago, with the Central Bank assuming liquidity guarantees and acquiring part of the troublesome portfolio.²⁹

D. A BANKING CRISIS: BANINTER, BANCREDITO, BANCO MERCANTIL

According to George Kaufman, Finance and Economics Professor at Loyola University in Chicago as well as a consultant to the Federal Reserve Bank of Chicago, "[a] bank fails economically when the market value of its assets declines below the market value of its liabilities, so that the market value of its capital (net worth) becomes negative."³⁰ In the case of the 2003 Dominican banking crisis, in the weeks preceding the announcement by the governor, constant rumors of illiquidity plagued Baninter, which in turn provoked bank runs.³¹ A bank run occurs when, due to the spread of rumors of a bank run, its depositors go "to withdraw their funds, but depositors at other banks, not subject to the same bad news, may also run on their banks as bank runs are frequently viewed as

24. *Id.*

25. Febles, *supra* note 22.

26. *Id.*

27. *Id.*

28. GUZMAN ET AL., *supra* note 2, at 11-12.

29. *Id.*

30. George G. Kaufman, *Bank Failures, Systemic Risk, and Bank Regulation*, 16 CATO J. 17, 19 (1996), available at <http://cato.org/pubs/journal/cj16n1/cj16n1-2.pdf>.

31. Juan De La Cruz, *Ahorrrantes Reciben Dinero en Sucursales de Baninter*, EL DÍA (Dom. Rep.), Apr. 11, 2003, at 10.

contagious.”³²

The causes of the Dominican banking crisis appear to have been developing over time, but were triggered by the collapse of Baninter, which spread to two other large banks in the system: Bancredito and Banco Mercantil. The use of parallel banks, special accounting methods, and offshore banks, gave these seemingly healthy institutions places to hide assets and conceal the real risk exponents of their transactions. Evidently, the general public had no idea how their money was being handled.

In retrospect, the resources used for this massive rescue operation amount to approximately 25 percent of the country's GDP.³³ Moreover, according to *The Economist*, the Dominican Republic “was one of the Caribbean's success stories of the 1990s” but was robbed of this distinction in four years by the 2003 banking crisis.³⁴

But the worst consequences were the losses incurred by many stakeholders who have yet to be repaid, as well as the banks' employees who lost their jobs. Therefore, it is clear that there is a large range of stakeholders in the bank sector. This is evidenced by simply appreciating the amount of people affected by the Dominican banking crisis: shareholders, depositors, creditors, employees, market competitors, taxpayers, and society as a whole. All of these stakeholders need to be recognized in order to effectively represent their interests and control management from excessive risk taking in the prevention of future banking crises.

III. BANKING CORPORATE GOVERNANCE

A. CORPORATE GOVERNANCE AND BANKING

There is a general consensus that the failure of a financial firm is more severe than the failure of a non-financial firm.³⁵ This is because “[u]nlike firms in the nonfinancial sector, a mismanaged bank may lead to a bank

32. George G. Kaufman, *Bank Runs: Causes, Benefits, and Costs*, 7 CATO J. 559, 559 (1988), available at <http://www.cato.org/pubs/journal/cj7n3/cj7n3-2.pdf>.

33. GUZMAN ET AL., *supra* note 2, at 12.

34. *The Dominican Republic's Economic Recovery: A Cure but not yet a Miracle*, THE ECONOMIST, May 28, 2005, at 5.

35. See generally Renée Adams & Hamid Mehran, *Is Corporate Governance Different for Bank Holding Companies?*, 9 FED. RES. BANK N.Y. ECON. POL'Y REV. 123 (2003) available at <http://www.newyorkfed.org/research/epr/03v09n1/0304adam.pdf>; Kern Alexander, *UK Corporate Governance and Banking Regulation: The Regulator's Role as Stakeholder*, 33 STETSON L. REV. 991 (2004); Kern Alexander & Rahul Dhumale, *Enhancing Corporate Governance for Financial Institutions: The Role of International Standards* (ESRC Centre for Bus. Research, Univ. of Cambridge, Working Paper No. 196, 2001), available at <http://www.cbr.cam.ac.uk/pdf/wp196.pdf>; T.G. Arun & J.D. Turner, *Corporate Governance of Banks in Developing Economies: Concepts and Issues*, 12 CORP. GOVERNANCE: AN INT'L REV. 371 (2004); JAMES R. BARTH, GERALD CAPRIO, JR. & ROSS LEVINE, *RETHINKING BANK REGULATION: TILL ANGELS GOVERN* (Cambridge Univ. Press 2006); Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 19 FED. RES. BANK N.Y. ECON. POL'Y REV. 91 (2003), available at <http://www.newyorkfed.org/research/epr/03v09n1/0304mace.pdf>.

run or a collapse.”³⁶ Thus, the health of the entire economy depends on the effective performance of banks.³⁷ An example of this phenomenon was the above described banking crisis, where the collapse of one bank brought down two more and de-capitalized the Central Bank.³⁸

In addition, banks in developing economies have a dominant position in the development of the financial system and economic growth, as well as being the main source of finance and holder of the economy’s savings.³⁹ Therefore, society and the economy depend greatly on the health of the financial intermediaries. In fact, experts such as James Barth, Gerard Caprio, and Ross Levine argue that “[b]anking crises can completely disrupt economies, and the human costs can be very real, as, for example, when health and education programs are dramatically cut to fund a government bailout of the failed banks.”⁴⁰ To explain this phenomenon, Kaufman summarizes three main reasons for the fragility of banks:

(1) low capital-to-assets ratios (high leverage), which provides little room for losses; (2) low cash-to-assets ratios (fractional reserve banking), which may require the sale of earning assets to meet deposit obligations; and (3) high demand debt and short-term debt-to-total debt (deposits) ratios (high potential for a run), which may require hurried asset sales of opaque and non-liquid earning assets with potentially large fire-sale losses to pay off running depositors.⁴¹

In sum, because of the inherent instability of the financial markets, the government needs to intervene in order to provide protection to the different stakeholders,⁴² especially in the prevention of agency problems.

B. THE AGENCY PROBLEM: MAIN CAUSE OF BANKING CRISES

Studies have shown that the main causes of recent banking crises have been agency problems because “[m]anagement may have different risk preferences from those of other stakeholders including the government, owners, creditors, etc., or limited competence in assessing the risks involved in its decisions.”⁴³ The agency problem or principle-agent problem is based on the presumption “that managers have an information advantage and that this gives them the opportunity to take self-interested actions,”⁴⁴ where “[b]oth the principle and the agent are assumed to be

36. Alexander, *UK Corporate Governance and Banking Regulation: The Regulator’s Role as Stakeholder*, *supra* note 35, at 992.

37. Adams & Mehran, *supra* note 35, at 124.

38. Steve H. Hanke, *The Dominican Republic: Resolving the Banking Crisis and Restoring Growth*, CATO INST. FOREIGN POLICY BRIEFING No. 83, July 20, 2004, available at <http://www.cato.org/pubs/fpbriefts/fpb83.pdf>.

39. Arun & Turner, *supra* note 35, at 371.

40. BARTH, CAPRIO & LEVINE, *supra* note 35, at 2.

41. Kaufman, *Bank Failures, Systemic Risk, and Bank Regulation*, *supra* note 32.

42. See generally Alexander & Dhumale, *supra* note 35, at 4-5.

43. *Id.* at 6.

44. Alexander, *UK Corporate Governance and Banking Regulation: The Regulator’s Role as Stakeholder*, *supra* note 35, at 1007 (citing Joseph E. Stiglitz, *Principal and Agent*, in *THE NEW PALGRAVE: ALLOCATION, INFORMATION AND MARKETS* 241,

utility maximizers and will endeavor to pursue their own respective objectives.”⁴⁵

Consequently, these information asymmetries prevent proper control over the corporation by these various groups of stakeholders. Thus, “[a]dequate corporate governance structures for banking institutions require internal control systems within banks to address the inherent asymmetries of information and the potential market failure that may result.”⁴⁶ This in turn, will enhance the position of stakeholders to control excessive risk-taking by management.

The existence of so many interested parties causes the various types of agency problems that may occur with respect to one intermediary entity. In their book, *Rethinking Bank Regulation: Till Angels Govern*, Barth, Caprio, and Levine construct an institutional environment with various manifestations of the principal-agent problem, stating that “informational asymmetries make it difficult for the market – depositors, equity holders, other creditors, and rating agencies – to monitor and control bank managers.”⁴⁷ So, it is evident that in the financial industry there are several different types of stakeholders that have interests in the governance of the bank firm. Additionally, we have established that due to “the broader risk that banks and financial firms pose to the economy” the regulator has to intervene to protect some of the stakeholders.⁴⁸

Likewise, experts agree on the fact “that transparency of information is integrally related to accountability in that it could provide government supervisors, bank owners, creditors, and other market participants sufficient information and incentive to assess the management of a bank.”⁴⁹ Thus, prevention of information asymmetries and the participation of the market are key elements to the prevention of banking crises. This situation highlights the importance of disclosure in this prevention strategy, but more important is what is done with the disclosed information, and that is determined by the participation of the different stakeholders in policy and governance. As stakeholders are able to represent their interests, they can balance the agency problem with respect to management. But this position requires a change from the traditional approach to corporate governance.

241 (John Eatwell, Murray Milgate & Peter Newman eds., Macmillan Press Ltd. 1989)).

45. Henry L. Tosi, Luis R. Gomez-Mejia & Debra L. Moody, *The Separation of Ownership and Control: Increasing the Responsiveness of Boards of Directors to Shareholders' Interests?*, 4 U. FLA. J.L. & PUB. POL'Y 39, 45 (1992).

46. Alexander, *UK Corporate Governance and Banking Regulation: The Regulator's Role as Stakeholder*, *supra* note 35, at 1010.

47. BARTH, CAPRIO & LEVINE, *supra* note 35, at 7.

48. Alexander, *UK Corporate Governance and Banking Regulation: The Regulator's Role as Stakeholder*, *supra* note 35, at 992.

49. Alexander & Dhumale, *supra* note 35, at 2.

C. BROAD APPROACH TO BANKING CORPORATE GOVERNANCE

Theoretically, there are two approaches to banking regulation, the narrow approach and the broad approach. The first is the traditional conception that views corporate governance "as the mechanism through which shareholders are assured that managers will act in their interests."⁵⁰ The second is the broad approach "which views the subject as the methods by which suppliers of finance control managers in order to ensure that their capital cannot be expropriated and that they earn a return on their investment."⁵¹ This approach is different in the sense that it does not focus on the shareholder as the sole stakeholder in corporate governance, but rather all "suppliers of finance," as referred to by other authors such as Renee Adams and Hamid Mehran.⁵²

In this respect, the broad approach to corporate governance for the bank sector is key to the prevention of the agency problem that causes bank crises because the board of directors will have to respond to more than just shareholders and take into account other stakeholders represented by the regulator. Therefore, the principle-agent problems that will have to be attended to in the governance of banks are various because they are a consequence of the different interests directed towards one bank institution.

Moreover, the special nature of the bank firm and the risk it poses to the stability of the economy, make it necessary for the regulator to play a different and influential role. T.G. Arun and J.D. Turner, who echo Jonathan Macey and Maureen O'Hara, contend "that a broader view of corporate governance should be adopted in the case of banking institutions . . . because of the peculiar contractual form of banking, corporate governance mechanisms for banks should encapsulate depositors as well as shareholders."⁵³

The existence of various interested parties is a direct consequence of the very nature of the banking industry.⁵⁴ Consequently, the regulator must step in to ensure that these views are taken into account in the governance of the company, acting in representation of the public interest. This responsibility falls on the regulator because it "can act more efficiently than most stakeholder groups to ensure the bank's adherence to regulatory and legal responsibilities."⁵⁵

Critics to the broad approach argue that:

(1) politicians will attempt to use a powerful supervisory agency to pressure banks to lend to politically connected firms; (2) powerful banks will seek to "capture" bank regulators and induce regulators

50. Arun & Turner, *supra* note 35, at 372.

51. *Id.*

52. Adams & Mehran, *supra* note 35, at 124.

53. Arun & Turner, *supra* note 35, at 372.

54. See Adams & Mehran, *supra* note 35, at 124.

55. Alexander, *UK Corporate Governance and Banking Regulation: The Regulator's Role as Stakeholder*, *supra* note 35, at 992.

to act in the best interest of banks, not the interest of society at large; and (3) political and legal institutions are generally unable to contain these forces.⁵⁶

These critics side with the private interest view, which neglects the participation of government in the governance of bank firms. Nevertheless, regulation and policy must be clear and aim to require a corporate governance regime from banks that takes into account the public interest because of the risks that bank failures pose to the economy. In fact, as the 2003 Dominican banking crisis demonstrated, the general public may be directly affected by the failure of banks. Moreover, "banking policies matter because banks influence the ability of people, rich and poor, to improve their living standards."⁵⁷

If the consequences of a bank failure have a broad and devastating scope, then so must the measures installed to prevent the failures in the future. Consequently, banking corporate governance needs to be proportional to the costs of a banking crisis in order to effectively protect all of those that can be negatively affected by bank failure.

D. THE STAKEHOLDERS

One of the main causes of bank crises is the information asymmetry between stakeholders and the management of the bank. In this respect, stakeholders can limit management's excessive risk-taking by monitoring management's activities. Kern Alexander and Rahul Dhumale point out that "there seem to be three potential groups which can monitor the management of banks: owners, market, and supervisors."⁵⁸ They further conclude that "governance mechanisms need to be enhanced to encourage each of the potential monitoring groups to curb excessive risk taking activities by banks."⁵⁹

Based on the above, it is therefore necessary to identify the stakeholders whose interests must be protected to ensure the proper governance of banks. The experts consulted all include different stakeholders in the list: depositors, creditors⁶⁰, taxpayers⁶¹, employees, managers, the local community, suppliers, and customers.⁶² Specifically, Macey and O'Hara consider "the corporation as nothing more (or less) than a set of contractual arrangements among the various claimants to the products and earnings generated by the business."⁶³ Thus, stakeholders can be shareholders, creditors, managers, employees, the local community, suppliers, custom-

56. BARTH, CAPRIO & LEVINE, *supra* note 35, at 179.

57. *Id.* at 2.

58. Alexander & Dhumale, *supra* note 35, at 6.

59. *Id.* at 7.

60. See generally Alexander, *UK Corporate Governance and Banking Regulation: The Regulator's Role as Stakeholder*, *supra* note 35, at 993.

61. Adams & Mehran, *supra* note 35, at 125.

62. Macey & O'Hara, *supra* note 35, at 92.

63. *Id.*

ers, and regulators, because they all have a valid interest in the bank.⁶⁴

Owners of the bank, or the shareholders, are traditionally the parties most interested in making certain that the bank does well; consequently, they will monitor management in order to ensure they gain a return on their investment. "Investors or owners who own equity in a bank in principle have both the ability and the incentive to monitor the actions of their bank."⁶⁵ In fact, the OECD recognizes the importance of shareholders as effective stakeholders to manage the agency problem, devoting the entire second section of its Principles of Corporate Governance to "The Rights of Shareholders and Key Ownership Functions".⁶⁶ It recommends shareholders' "participation in key corporate governance decisions, such as the nomination and election of board members" as an element of sound corporate governance practice.⁶⁷

Moreover, the OECD recognizes the existence of other stakeholders, establishing that their rights may be contained contractually or in the law, such as "labour, business, commercial and insolvency laws."⁶⁸ Thus, stakeholders can be identified as all those entities having a contractual relationship with the bank, as well as all those identified as such by the law. The OECD clarifies that "[e]ven in areas where stakeholder interests are not legislated, many firms make additional commitments to stakeholders, and concern over corporate reputation and corporate performance often requires the recognition of broader interests."⁶⁹ In addition, "market participants who enter into creditor relationships with banks could serve as monitors."⁷⁰

For their part, Macey and O'Hara propose that directors "expand the scope of their fiduciary duties beyond shareholders to include creditors."⁷¹ They specifically "call on bank directors to take solvency risk explicitly and systematically into account when making decisions, or else face personal liability."⁷² Based on "this approach, depositors and other creditors could sue the board of directors for breach of fiduciary duties and the standard of care, in addition to whatever contractual claims they may have."⁷³ Alexander contends that this extension of responsibility for the board is especially important in the valuation of the bank's solvency risk, because control will "protect the broader economy from excessive risk-taking"⁷⁴ and opportunistic bank management,⁷⁵ which are both in

64. *Id.*

65. Alexander & Dhumale, *supra* note 35, at 9.

66. OECD, PRINCIPLES OF CORPORATE GOVERNANCE 32 (2004), available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf>.

67. *Id.* at 18.

68. *Id.* at 46.

69. *Id.*

70. Alexander & Dhumale, *supra* note 35, at 10.

71. Macey & O'Hara, *supra* note 35, at 92.

72. *Id.*

73. Alexander, *UK Corporate Governance and Banking Regulation: The Regulator's Role as Stakeholder*, *supra* note 35, at 993.

74. *Id.*

75. Arun & Turner, *supra* note 35, at 372.

the interest of all stakeholders.

But there are legal issues to attend to if fiduciary duties are to be expanded formally to other stakeholder groups. This implies that directors could face personal liability suits from stakeholders other than shareholders. This increased liability could provoke the opposite effect and the management will become risk adverse, which would also be detrimental to the bank.

E. THE REGULATOR

In the banking sector the regulator has “a more active role in establishing standards and rules to make management practices in banks more accountable and efficient.”⁷⁶ This role usually translates into the establishment of “additional responsibilities on bank boards that often result in detailed regulations regarding their decision-making practices and strategic aims.”⁷⁷ In fact, the regulators are to be considered among the claimants “in their roles as insurers of deposits and lenders of last resort and in their capacity as agents of other claimants.”⁷⁸ Consequently, it is clear that the regulator is a stakeholder with respect to financial intermediaries.

Thus, the regulator is both the architect of policies and the representative of the collection of stakeholders. For this, the regulator needs to create policies that strengthen the market by providing stakeholders with sufficient data to balance the information asymmetries that exist between the banks and all of its stakeholders.⁷⁹ At the same time, the regulator needs “to be entrusted with discretion to represent broader stakeholder interests in order to ensure that banks operate under good governance standards.”⁸⁰

But critics argue that regulators would not be suitable in this powerful position due to the ineffective hand theory and political corruption.⁸¹ The ineffective hand theory is based on well-intentioned governments that take unsuccessful measures to remedy market failures.⁸² The critics also argue that governments with power to regulate and oversee the governance of banks will pursue their own interests, such as directly financing government expenditures and extracting funds to ensure their political power.⁸³ Nevertheless, the regulator is the entity that can most efficiently handle the representation of the weak stakeholders.⁸⁴

76. Alexander, *Corporate Governance and Banking Regulation: The Regulator as Stakeholder*, *supra* note 3, at 3.

77. *Id.*

78. Macey & O'Hara, *supra* note 35, at 92.

79. BARTH, CAPRIO & LEVINE, *supra* note 35, at 11.

80. Alexander, *Corporate Governance and Banking Regulation: The Regulator as Stakeholder*, *supra* note 3, at 2.

81. BARTH, CAPRIO & LEVINE, *supra* note 35, at 33.

82. *Id.*

83. *Id.* at 41.

84. Alexander, *Corporate Governance and Banking Regulation: The Regulator as Stakeholder*, *supra* note 3, at 3.

Moreover, based on the fact that all of the stakeholder interests need to be balanced and attended to, this responsibility falls on the board of directors of the different financial intermediaries. So, "[t]he role of the board of directors therefore becomes crucial in balancing the interests of shareholders and other stakeholders (eg., creditors and depositors)."⁸⁵ Therefore, to control the board's "decision-making practices and strategic aims" the regulator will need to establish the appropriate policies.⁸⁶ No other institution has the ability to effectively represent the interests of all the stakeholders in the elaboration of the proper policies, as well as to participate in the continual governance of the banks and their overall supervision. The reasons being that the government has the ability to gather information and the strength to execute policies, and thus can effectively represent the interest of the weaker stakeholders, such as: taxpayers, the community, creditors, and employees.

Furthermore, today most "international standards of banking regulation are requiring domestic regulators to rely less on a strict application of external standards and more on internal monitoring strategies."⁸⁷ This means that the regulator will cooperate with the intermediary in order to create standards and controls that are appropriate for that individual bank.⁸⁸

In sum, corporate governance is an issue that is of the utmost importance in the banking sector because the principal-agent problem it aims to control is the main cause of banking crises. Furthermore, bank failures have a direct and devastating effect on a country's social and economic development; therefore, the corresponding regulations have to be elaborated with a broad approach to include all stakeholders of the intermediary. Consequently, the regulator has to assume the representation of some of the stakeholders in the governance of the bank in order to control the information asymmetries inherent to the relationships, and thus the solvency risk.

The next section will examine if the Dominican corporate governance framework takes into account the discussed elements in order to prevent banking crises such as the one that occurred in 2003, measuring the framework against the standards set by the OECD Principles of Corporate Governance.

85. *Id.*

86. *Id.*

87. *Id.* at 4.

88. See generally Alexander, *UK Corporate Governance and Banking Regulation: The Regulator's Role as Stakeholder*, *supra* note 35 (analyzing the U.K.'s Financial Services Authority role in the corporate governance of banks).

IV. EVALUATION OF THE BANKING CORPORATE GOVERNANCE FRAMEWORK OF THE DOMINICAN REPUBLIC

The 2003 Dominican banking crisis cost the country 25 percent of its GDP and the bailout of the failed banks de-capitalized the Central Bank. It is difficult for a country to recuperate after such devastation, especially for those with developing economies. As Rosa Maria Lastra points out, “[t]hough crises are costly and difficult to resolve in developed countries, their effects are even more severe in the developing world.”⁸⁹

But bank “failures are part of risk-taking,”⁹⁰ but risk has to be used responsibly. Thus, an effective banking corporate governance regime is necessary for the prevention of banking crises, which implies the recognition and protection of different stakeholder groups and the participation of the regulator as an agent for some of the weaker stakeholders.

In this respect, Alexander points out that the standards set by the Principles of Corporate Governance produced by the OECD “have been influential in determining the shape and evolution of corporate-governance standards in many advanced economies and developing countries,” especially in “establishing internal control systems and risk-management frameworks for banks and financial institutions.”⁹¹ Additionally, the OECD Principles of Corporate Governance contain entire sections on the rights of shareholders and stakeholders, which is consistent with the broad approach to corporate governance. For this reason, the forthcoming sections will compare and contrast the existing legislation on banking corporate governance in the Dominican Republic with the international corporate governance standards set by the OECD.

The first international organization to highlight the importance of corporate governance was the OECD with its Principles of Corporate Governance in 1999 and the latest revision in 2004. The weight of these principles is demonstrated by the fact that they are the standards upheld by the Financial Stability Forum, the World Bank, and the IMF in the evaluation of the corporate governance practices in those entities’ member states.⁹²

The OECD Principles of Corporate Governance are divided into six sections, which will be used to evaluate the current Dominican corporate governance framework.

A. ENSURING THE BASIS FOR AN EFFECTIVE GOVERNANCE FRAMEWORK

The first section of the OECD Principles of Corporate Governance establishes the need for a governance framework that promotes trans-

89. Lastra, *supra* note 19, at 84.

90. *Id.* at 82.

91. Alexander, *UK Corporate Governance and Banking Regulation: The Regulator’s Role as Stakeholder*, *supra* note 35, at 1017.

92. OECD, *supra* note 66, at 3.

parency and efficiency based on a clear division of responsibility among the supervisors, the regulators, and those in charge of enforcing the regime.⁹³ The Principles also recognize the need to create incentives for the market participants in order to ensure economic performance,⁹⁴ which is also recognition of the importance of considering the general public in the governance of corporations.

The banking corporate governance regime in the Dominican Republic is contained in the Commercial Code, the Monetary and Financial Law (Law 183-02), and the corresponding resolutions of the Monetary Board and the Superintendence of Banks.⁹⁵ Law 183-02 governs the monetary and financial system with the purpose of maintaining price stability and overseeing that the financial intermediaries comply with the rules of fair competition in the market.⁹⁶

In charge of carrying out these objectives are: the Monetary Board, the Superintendence of Banks, and the Central Bank. These entities are also responsible for protecting the users of the bank facilities as well as maintaining the stability of the financial and banking sector. The Monetary Board is "the highest body of the Monetary and Financial Administration,"⁹⁷ and it approves or does not approve the establishment of any financial intermediary.⁹⁸ The Superintendence of Banks is in charge of the supervision of the intermediaries in order to ensure that they comply with the legal instruments in force, especially concerning the reserves for risk management. The Superintendence of Banks also lends assistance to the Monetary Board in the granting of operation permits and issues guidelines and sanctions for which it must have the approval of the Monetary Board.⁹⁹ Lastly, the Central Bank has the responsibility of supervising all of the operations of the financial intermediaries, as well as to operate as lender of last resort.¹⁰⁰ Additionally, the Central Bank has the authority to sanction these regulated entities in the event of non-compliance with the legal reserves standards or failure to provide the necessary information to supervisors.¹⁰¹

The OECD Principles focus on a framework that enables the authorities to clearly carry out their responsibilities in favor of the public interest.¹⁰² In this respect, the work carried out by the Superintendence of

93. *Id.* at 17.

94. *Id.*

95. It is important to highlight that Law 183-02 was not in force during the evolution and materialization of most of the causes of the 2003 banking crisis, as it entered into force on December 3, 2002. *Ley Monetaria y Financiera*, Ley No. 183-02, (2002) (Dom. Rep.).

96. PELLERANO & HERRERA ATTORNEYS AT LAW, *MONETARY AND FINANCIAL LAW OF THE DOMINICAN REPUBLIC 1* (2003), available at http://www.phlaw.com/pubs/rejec/en/ren_Monetary_and_Financial_Law_of_the_Dominican_Republic.pdf.

97. *Id.* at 4.

98. Ley No. 183-02 at art. 9(f) (translated by the author).

99. PELLERANO & HERRERA, *supra* note 96, at 8.

100. Ley No. 183-02 at arts. 27(b), 33.

101. PELLERANO & HERRERA, *supra* note 98, at 6.

102. OECD, *supra* note 66, at 17.

Banks and the Central Bank over the financial intermediaries is purely as a supervisor. The law does not contemplate their collaboration with these entities in the development of efficient internal controls or risk management plans, in order to ensure that it does serve the public interest. Therefore, it can be concluded that according to the Dominican regime, the authorities are not part of the stakeholder group and are not agents of stakeholders. Consequently, the quality of protection that will be provided to the stakeholders that rely on the regulator will depend strictly on their supervisory abilities. But there are three exceptions in Law 183-02 where the authorities have hands-on responsibilities: (1) when it approves or does not approve potential financial intermediaries; (2) when the entity enters in the regularization process; and (3) during the dissolution procedure contained in the law.¹⁰³

Based on the above, it is important to highlight that the International Panel of Experts that examined the Dominican banking crises recommended the designation of a responsible authority to work individually with each financial intermediary or group.¹⁰⁴ This way they will be able to effectively cooperate with the bank's board in establishing and implementing effective internal controls that take into account the various stakeholders' interests.

Furthermore, the Basel Committee, an authority in the international financial and monetary sector, has recognized the importance of corporate governance for banks by designating a working group on the issue. In this respect, the former chairman of the Committee states that "[b]anking supervisors have long recognised the importance of good governance; supervision can not function properly if sound corporate governance is not in place."¹⁰⁵

Ideally, a proper framework should ensure accountability among the various interested parties. So in this scenario, the Monetary Board, the Superintendence of Banks, and the Central Bank, would be the regulatory entities called to represent the broad scope of stakeholders in order to ensure that the information asymmetries between them are lessened and the principal-agent problem is avoided. But if the responsibilities of those entities are not clearly defined and carried out efficiently, the public interests that depend on them will surely suffer and can provoke the information asymmetries that cause the agency problem.

Nevertheless, the International Panel highlights that the lack of control, consistency, and inexistence of communication between the Superintendence of Banks and the Central Bank led to the spending of more

103. See generally Ley No. 183-02 at arts. 37, 59-64.

104. GUZMAN ET AL., *supra* note 2, at 38.

105. Jaime Caruana, Chairman, Basel Comm. on Banking Supervision, Speech at the Second Islamic Financial Services Board Summit 2005: The Rise and Effectiveness of Corporate Governance in the Islamic Financial Services Industry 2 (May 24, 2005), available at <http://www.bis.org/review/r050525a.pdf#search=%22Jaime%20Caruana%20Basel%20II%20and%20Corporate%20Governance%20Issues%22>.

money in the alleged rescue.¹⁰⁶ In turn, the evident lack of cooperation between the regulators ended up costing the taxpayers more money. This situation contradicts Ruth De Krivoy, former president of the Venezuelan Central Bank, as cited by Lastra, who believes that crisis management has to consider "how the cost of crisis is to be shared between shareholders, depositors, and taxpayers."¹⁰⁷ This approach is consistent with the broad view that is necessary in banking corporate governance.

B. RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS

In order to ensure effective corporate governance within a company, the OECD establishes the need to protect the rights of shareholders, as well as their participation in the company. With this purpose, section two of the Principles of Corporate Governance states that the corporate governance structure should provide a secure method of ownership, availability of information regarding the corporation on a timely and regular basis, participation in general shareholder meetings, the power to elect and remove board members, and the right to share in the profits of the corporation.¹⁰⁸ The OECD especially emphasizes the importance of shareholder participation in the governance of the corporation,¹⁰⁹ as a means of mitigating the principal-agent problem.

In order to establish any financial intermediary in the Dominican Republic, the bank first needs to be incorporated as a stock company with a minimum of seven shareholders in accordance with the rules of the Dominican Commercial Code.¹¹⁰ The shareholders, in turn, select the members of the board of directors and company commissaries.¹¹¹ Moreover, as banks are no ordinary corporation, Law 183-02 establishes certain requirements or prohibitions in order to ensure that shareholders are qualified to participate in financial intermediaries.¹¹²

Furthermore, one of the rights of the shareholders granted by the Dominican Commercial Code is to elect the board of directors of the bank, which is required to have a minimum of five natural persons, who will have the authority to administrate and represent the entity. The members of the board cannot fall into the prohibitions that are also applied to shareholders.¹¹³

Moreover, with respect to the issue of the methods of ownership and the transfer of shares, Law 183-02 states that the transfer of shares or any type of fusion, absorption, convergence, segregation, excision, or sale of more than 30 percent of the paid-in-capital transfers of total or part of the assets or debt of the financial intermediary will require the favorable

106. GUZMAN ET AL., *supra* note 2, at 28.

107. Lastra, *supra* note 19, at 83.

108. OECD, *supra* note 66, at 18-19.

109. *Id.*

110. CÓDIGO DE COMERCIO [CÓD. COM.] art. 56 (Dom. Rep.).

111. *Id.* at art. 57.

112. Ley No. 183-02 at art. 38(f).

113. *Id.* at arts. 38(c), (f).

opinion of the Superintendence of Banks and approval of the Monetary Board, but, are in principle allowed.¹¹⁴ Thus, the regulator monitors and approves both directors and shareholders of intermediaries as a safeguard of the public interest, ensuring that capable persons assume these roles.

Additionally, one of the ingredients for effective corporate governance is a timely informed shareholder as a means to control the information asymmetries that cause the principal-agent problem between shareholders and management. In this respect, the Dominican Commercial Code, as supplementary legal instrument, establishes that there has to be a general shareholders meeting at least once a year. The first shareholders' meeting has the purpose of verifying the proportioned funds, electing the first administrators or directors of the company, and confirming the declarations of the founders of the company.¹¹⁵ In fact, every shareholder has the right to participate and vote in accordance with the shares each of them owns, but only half of the social capital must be represented. For the rest of the shareholders meetings, the bylaws have to establish the amounts of shares that need to be represented in order to validly deliberate; but the Dominican Commercial Code requires a minimum of one fourth or half of the social capital to be represented, depending on the topics that will be addressed in the meeting.¹¹⁶ In these meetings the commissaries and directors will present a report of the company's balance and accounts,¹¹⁷ fulfilling in part the right of shareholders to be informed of the company's operations.

In addition to the yearly shareholders meeting, the commissaries will always have access to the company books where they can verify its operations and, in case of urgency, can call an emergency meeting. Moreover, the shareholders will have access to a summary statement of the company's assets and debt, which will be prepared every six months.¹¹⁸ Under this regime, shareholders do have access to the information regarding the company's operations and health, which in turn is analyzed by commissaries designated by them. This ensures that they have timely information that will enable them to represent their interest to the board.

Furthermore, this section of the OECD Principles encourages shareholders to participate, especially with respect to "key corporate governance decisions" such as the selection of the board members and their remuneration policy.¹¹⁹ But in the Dominican framework, the remuneration policies of the corporate entity are to be stipulated by the company bylaws, as the law does not specifically regulate these policies. Nevertheless, the audits and inventories are to be available for shareholders fifteen days prior to the general shareholders meeting along with the commissa-

114. *Id.* at arts. 35(a), 38(e).

115. Cód. Com. at art. 57.

116. *Id.*

117. *Id.*

118. *Id.* at arts. 57-58.

119. OECD, *supra* note 66, at 34.

ries' report.¹²⁰

With respect to dividends, article 7 of the Monetary Board's Resolution dated June 24, 2004, establishes that dividends must be the consequence of the operation of the banks.¹²¹ Nevertheless, article 35(b) of Law 183-02 establishes that the Monetary Board can limit the distribution of dividends to allow the bank to grow when it has only recently been incorporated, but only for a maximum of five years.¹²² Through this mechanism the regulator can provide security to those stakeholders that depend on the evolution and growth of the company, such as employees, depositors, and creditors. The reason for this protection is to control shareholders' desire for excessive returns on their investment.

Moreover, article 38 of the same law states that the Monetary Board has to approve any issuance of preferred shares and its characteristics.¹²³ But they may never authorize the right to perceive anticipated dividends not generated by the operation of the bank. In fact, the law clarifies that the payment of dividends will be subject to requisites established by the monetary and financial authorities through specific regulations. The regulator acts as an agent of some of the stakeholders by establishing and controlling the flow of dividends to the hands of shareholders, which in turn mitigates the possibility of the agency problem in the relationships that other stakeholders may have with shareholders.

C. EQUITABLE TREATMENT OF SHAREHOLDERS

The third section of the OECD Principles focuses on the protection of minority shareholders, calling for the equitable treatment of all shareholders including foreign shareholders.¹²⁴ In fact,

[i]n jurisdictions where the enforcement of the legal and regulatory framework is weak, some countries have found it desirable to strengthen the *ex-ante* rights of shareholders such as by low share ownership thresholds for placing items on the agenda of the shareholders meeting or by requiring a supermajority of shareholders for certain important decisions.¹²⁵

In the Dominican Republic, the law requires a minimum of one half of the social capital to be present when the meeting will deliberate on any of the following issues: (1) modification of the company bylaws; (2) the continuation of the company for more time than it was established; (3) dissolution of the company before the established time; and (4) incorporation of additional capital from special reserves.¹²⁶ The rest of the sharehold-

120. Cód. COM. at art. 58.

121. Administración Monetaria y Financiera Junta Monetaria, Reglamento Para la Apertura y Funcionamiento de Entidades de Intermediación Financiera y Oficinas de Representación art. 7, de 11 de mayo de 2004 (Dom. Rep.).

122. Ley No. 183-02 at art. 35(b).

123. *Id.* at art. 38.

124. OECD, *supra* note 66, at 20.

125. *Id.* at 40.

126. Cód. COM. at art. 57.

ers meetings require a minimum of one fourth of the social capital to be represented.¹²⁷ Evidently, other issues of corporate governance, such as the remuneration of the board members, are not included, which is a deficiency in the law.

Furthermore, the Dominican Commercial Code establishes that the number of shares required to attend the shareholders' meeting will be determined by the company bylaws. But these limitations can only be agreed to when they affect all shares in the same way.¹²⁸ In fact, Law 183-02 establishes limitations to this rule specifically for financial intermediaries. First, there may not be any pacts or stipulations in the company bylaws that can be considered abusive to minority shareholders or that contain excessive limitations to the decision making process.¹²⁹ Secondly, the bylaws cannot request more than .01 percent of the social capital as a condition to attend shareholders meetings.¹³⁰

In addition to the above, this section also prohibits insider trading and abusive self-dealing, and instructs that all shareholders must disclose if "they directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation."¹³¹ Insider trading is the "manipulation of the capital markets," and "is prohibited by securities regulations, company law and/or criminal law in most OECD countries."¹³² Moreover, "self-dealing occurs when persons having close relationships to the company, including controlling shareholders, exploit those relationships to the detriment of the company and investors."¹³³ The OECD explains that "[t]hese practices can be seen as constituting a breach of good corporate governance inasmuch as they violate the principle of equitable treatment of shareholders."¹³⁴ This section highlights the possibility of information asymmetries amongst shareholders, and the importance of disclosure as a tool that provides the information for the different shareholders to protect themselves from each other.

On this issue, article 45 of Law 183-02 expressly prohibits the following activities:

To grant financing for subscription of shares, payment of fines, and any other type of securities issued by related entities of the Financial Institution; [and]

...

To grant or transfer through bonds, goods, loans or securities of the institution to its shareholders, officers, and employees or to related individuals, or to enterprises or Institutions controlled by these per-

127. *Id.*

128. *Id.*

129. Ley No. 183-02 at art. 37(c).

130. *Id.* at art. 38(c).

131. OECD, *supra* note 66, at 45.

132. *Id.* at 44.

133. *Id.*

134. *Id.*

sons, under conditions lower than those prevailing in the market.¹³⁵

Moreover, article 47 of the same law prohibits the allowance of credits directly or indirectly to shareholders, administrators, directors, executives, and employees, including their spouses, family, and related companies, for more than 50 percent of the bank's technical patrimony.¹³⁶ Nevertheless, there are some exceptions established expressly by the law. Additionally, non-compliance with this provision is subject to monetary sanction by the authorities.¹³⁷

Thus, the adequate participation of shareholders in corporate governance issues enables them to be well informed of what is going on in the company, which in turn reduces the risk of any individual shareholder manipulating company policy for personal advantage. After extensive research in various jurisdictions, Gerard Caprio, Luc Laeven, and Ross Levine have concluded that "weak shareholder protection laws" lower bank valuations,¹³⁸ because part of shareholder protection is the right to be informed of the company's activities, which in turn allows them to protect their investment from other stakes in the company. Furthermore, bank valuations are an indirect indication of the market perception of the bank's corporate governance.¹³⁹

D. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE

An effective corporate governance framework needs to "recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises."¹⁴⁰ Therefore, corporate governance should take into account the general public interest when elaborating regulation, as well as when implementing governance structures.

The OECD Principles recommend that stakeholders are kept informed of the company's governance, promoting "[p]erformance-enhancing mechanisms for employee participation,"¹⁴¹ as well as protection for all employees and stakeholders that wish to voice their opinions or concerns regarding "illegal or unethical practices," without compromising their rights,¹⁴² and "foster wealth-creating co-operation among stakeholders."¹⁴³ Moreover, the Basel Committee establishes that:

135. PELLERANO & HERRERA, *supra* note 96, at 20.

136. Ley No. 183-02 at art. 47.

137. *Id.* at arts. 47, 67(a).

138. Gerard Caprio, Luc Laeven & Ross Levine, *Governance and Bank Valuation 2* (Nat'l Bureau of Econ. Research, Working Paper No. 10158, 2003), available at <http://www.nber.org/papers/w10158.pdf>.

139. BARTH, CAPRIO & LEVINE, *supra* note 35, at 247.

140. OECD, *supra* note 66, at 21.

141. *Id.* at 47.

142. *Id.*

143. *Id.* at 46.

[f]rom a banking industry perspective, corporate governance involves the manner in which the business and affairs of banks are governed by their boards of directors and senior management, which affects how they: [s]et corporate objectives; [o]perate the bank's business on a day-to-day basis; [m]eet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders; [a]lign corporate activities and behavior with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and [p]rotect the interests of depositors.¹⁴⁴

In fact, the Basel Committee's working group on corporate governance clarifies that "[s]upervisors, governments and depositors are among the stakeholders due to the unique role of banks in national and local economies and financial systems, and the associated implicit or explicit deposit guarantees."¹⁴⁵ The Committee recognizes the specialty of the bank corporation and elevates the role of the supervisor, government, and the depositors to stakeholders.

In the Dominican system, Law 183-02 establishes that the regulation of the financial system will have the objective of protecting the competitiveness, efficiency, and free market for which it will require all financial intermediaries to comply with the mandatory liquidity, solvency, and governance conditions.¹⁴⁶

Moreover, the law establishes that it is a serious infraction to not fulfill the duty of providing shareholders, depositors, and other creditors of the entity with information regarding liquidity or solvency problems.¹⁴⁷ Also, the regulator is entitled to information as a supervisor of the entity, and the failure to comply is considered a very serious infraction.¹⁴⁸

Law 183-02 also contains rules concerning the information that should be given to the public and establishes a minimum time to schedule for customer service. Compliance with the rules is monitored by the Superintendence of Banks.¹⁴⁹ Moreover, the law requires that each financial intermediary publish its financial statements, interest rates, expenses, and commissions, as well as its exchange rate, stating that it is prohibited to charge for expenses not expressly agreed to by the parties and disallows verbal agreements.¹⁵⁰

Furthermore, one of the protections granted to the broad base of stakeholders is the requirement of prior authorization for operation and establishment of any financial intermediary. As explained before, this authorization is given by the Monetary Board based on the fulfillment of

144. BASEL COMMITTEE ON BANKING SUPERVISION, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANISATIONS 4 (2006), available at <http://www.bis.org/publ/bcbs122.pdf>.

145. *Id.* at 4 n.7.

146. Ley No. 183-02 at art. 2(b).

147. *Id.* at art. 68(b)(1).

148. *Id.* at art. 68(a).

149. *Id.* at art. 52(a).

150. *Id.* at art. 52(b).

certain requirements established by law or regulation.¹⁵¹ Through this process the regulator ensures that the financial services that will be available to the public are secure and legal. This screening procedure is one of the few examples of how the regulator can act as a representative of stakeholders. The Monetary Board verifies the capital adequacy of the potential bank; the capacity of the founding shareholders, directors, and executives; that there are no abusive agreements in the bylaws that would violate the rights of minority shareholders or control the decision making process; and that all other requirements have been fulfilled.¹⁵²

Moreover, the OECD Principles state that in the event of insolvency of the financial intermediary, "[e]specially in emerging markets, creditors are a key stakeholder and the terms, volume and type of credit extended to firms will depend importantly on their rights and on their enforceability."¹⁵³ In fact, "[i]n some countries, when companies are nearing insolvency, the legislative framework imposes a duty on directors to act in the interests of creditors, who might therefore play a prominent role in the governance of the company."¹⁵⁴ It can be interpreted that the Dominican system adopts a similar approach for the regularization and the dissolution processes for intermediaries.

On this issue, the law establishes that when creditors' investments are in danger for any of the reasons expressly stipulated in the law, the regularization process can be initiated by the Superintendence of Banks, as well as by the bank itself.¹⁵⁵ The authorities will monitor the regularization plan and the bank's compliance with it.¹⁵⁶

Another example of the regulator's role as stakeholder is in the event of dissolution of the bank. In this case, the Superintendence of Banks will register the working liabilities, except for the directors' "in order to proceed with the exclusion of assets and deposits in accordance with the regulation established thereon,"¹⁵⁷ thus protecting the workers of the intermediary who are important stakeholders of the same.

In detail, the first order obligations established by the Monetary and Financial Law are:

- a) Private sector's current-account, on-demand, savings and time deposits, excluding operations with other financial intermediaries and tied deposits;
- b) Cash orders, including foreign trade pre-payments, collections, and tax withholdings, drafts, transfers through contracts;
- c) Judicial deposits;
- d) Labor liabilities; and
- e) The price owed for the technical assistance that may be hired by the Banking Superintendency charged to the dissolving entity, to ex-

151. *See id.* at art. 5.

152. *Id.* at art. 37.

153. OECD, *supra* note 66, at 48.

154. *Id.*

155. Ley No. 183-02 at arts. 60, 61.

156. *Id.*

157. PELLERANO & HERRERA, *supra* note 96, at 24.

clude privileged obligations.¹⁵⁸

In addition, the second order obligations cited by the law are: "a) Public sector's current-account, on demand, savings and time deposits; b) Obligations with the Central Bank; c) Obligations with financial brokerage institutions; [and] d) Tax liabilities of the dissolving entity."¹⁵⁹

The first order obligations will be transferred to one or more solvent financial intermediaries in the market through a securitization process "that would make these assets into a non attachable, autonomous capital, subject to the service of the profit-sharing emitted."¹⁶⁰ The transfers made by the Superintendence, in any of its forms, do not require the consent of any of the debtors, creditors or any other claimants,¹⁶¹ thus the Superintendence acts as the legal agent of those entities. Finally, the residual balance will be available to satisfy the credit of the workers that was not transferred during the dissolution process, and then other privileged obligations.¹⁶² Moreover, the depositors will have access to the reserve at the Central Bank; their deposits will be fulfilled up to the cap of five hundred thousand Dominican pesos, per person, or 30 percent of the privileged obligations.¹⁶³

Additionally, the law states that the voluntary dissolution of the bank will only proceed after the intermediary has proven that it has returned all of the deposits and debt due, and after the approval of the Superintendence of Banks and the Monetary Board.¹⁶⁴ In sum, the dissolution process of banks does take into account various stakeholder interests, with shareholders bearing most of the losses and the other stakeholders represented by an active regulator.

E. DISCLOSURE AND TRANSPARENCY

In addition to the above principles, the corporate governance framework needs to ensure the timely and accurate disclosure of all material information regarding the corporation, in particular, information on the financial, governance ownership, and performance of the entity.¹⁶⁵ The OECD Principles emphasize that "[a] strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders' ability to exercise their ownership rights on an informed basis."¹⁶⁶

Thus, disclosure and transparency are means for stakeholders to exercise their rights in order to balance the agency problem, and as such, are important mechanisms in the prevention of bank crises. But they are

158. *Id.*

159. *Id.*

160. *Id.*

161. Ley No. 183-02 at art. 63(i).

162. *Id.* at art. 63(j).

163. *Id.* at art. 64(c).

164. *Id.* at art. 65(b).

165. OECD, *supra* note 66, at 22.

166. *Id.* at 49.

only as effective as what is done with the information they provide, and that rests in the hands of stakeholders.

Based on the need to inform stakeholders, the OECD Principles highlight the need for both external and internal annual audits, specifying that the external auditors are accountable to the shareholders and the company.¹⁶⁷ The work of auditors informs management, shareholders, and stakeholders of the real situation of the company, and in effect, will enable proper market monitoring of the banks because it will balance the information asymmetries at the heart of the agency problem and banking crises.

Furthermore, pillar three of the new Basel accord "also addresses corporate governance concerns by focusing on transparency and market-discipline mechanisms to improve the flow of information between bank management and investors," and align their objectives.¹⁶⁸ It "contains the first detailed framework of rules and standards that supervisors can apply to the practices of senior management and the board for banking groups."¹⁶⁹ Disclosure is key to informed stakeholders that would effectively represent their interests and control the risks that the agency problem entails. Moreover, the working group on corporate governance of the Basel Committee considers transparency and disclosure to be the mediums to effectively inform stakeholders of the real situation of the bank and ensure protection of their interests.¹⁷⁰

In the Dominican system, Law 183-02 establishes general requirements for internal controls, such as "Up-to-date Administrative Policies"¹⁷¹ and internal manuals and procedures, in order to coherently evaluate credit-worthiness and comply with rules governing anti-money laundering and other illicit-activities.¹⁷² Additionally, the law establishes that intermediaries must implement processes that efficiently and accurately measure and manage risk,¹⁷³ and other internal controls that clearly define the responsibilities and proper ethics of those who work in the entity.¹⁷⁴

Section V of title III of the Dominican Monetary and Financial Law is titled "Of Financial Transparency."¹⁷⁵ It states that banks must disclose the investments they may make in other entities and related services.¹⁷⁶ The Superintendence of Banks will keep a register of these activities.¹⁷⁷ Moreover, all financial intermediaries have the obligation of docu-

167. *Id.* at 22.

168. Alexander, *UK Corporate Governance and Banking Regulation: The Regulator's Role as Stakeholder*, *supra* note 35, at 1016.

169. *Id.* at 1014.

170. BASEL COMMITTEE ON BANKING SUPERVISION, *supra* note 144, at 15.

171. PELLERANO & HERRERA, *supra* note 96, at 17.

172. Ley No. 183-02 at art. 55(a).

173. *Id.* at art. 55(b).

174. *Id.* at art. 55(c).

175. *Id.* at art. 51 (translated by the author).

176. *Id.*

177. *Id.* at art. 41(a).

menting their operations in a regulated form and are to keep them for a minimum of ten years after the cancellation of the operation.¹⁷⁸ The law further establishes some minimum information that will have to be disclosed regarding credits and loans.¹⁷⁹ Furthermore, the Superintendence of Banks will establish a system of risk information that will require the mandatory participation of all the regulated entities.¹⁸⁰ They will provide information regarding their debtors, classifying them in a homogenous manner in order to create the database.¹⁸¹

The law also requires that the financial intermediaries publish their financial statements, and in a visible form, display the offered interest rate, the annual calculations of expenses and commissions that apply to the different operations conducted by the bank, the offered exchange rate, and the price of all services they offer to the public,¹⁸² in order to protect the intermediaries' customers. Nevertheless, it does not contain special stipulations regarding the information that should be made available for employees as recommended by the OECD.¹⁸³

F. RESPONSIBILITIES OF THE BOARD

The sixth section of the OECD Principles refers to the board of directors, stating that "[t]he corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders."¹⁸⁴ "[T]he board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation."¹⁸⁵

For this reason, the board is the corporation's nerve center where all stakeholders' interests meet and are directed to control management from excessive risk taking. Thus, "boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities."¹⁸⁶ As previously addressed, these principles are consistent with the recommendations made by the Basel Committee's working group on their consultative document on corporate governance. In fact, the purpose of the consultative document is "describing the roles of the board of directors and senior management in managing risk and underscoring the need for banks to set strategies for their operations and establish accountability

178. *Id.* at art. 51.

179. *Id.*

180. *Id.*

181. *Id.* at arts. 56(a)-(b).

182. *Id.* at art. 53.

183. *See* OECD, *supra* note 66, at 53.

184. *Id.* at 58.

185. *Id.*

186. *Id.*

for executing these strategies.”¹⁸⁷

Because of the importance of the board of directors to the corporation, it is logical that the persons elected as members of the board must fulfill the minimum threshold standards established by law.¹⁸⁸ These requirements prohibit the following persons from becoming members of the board: anyone who happens to work for the government administration; anyone who has been a director or administrator of a financial brokerage entity that had its operation permit revoked, been sanctioned, or rescued; or persons that are insolvent or have been convicted of financial crimes.¹⁸⁹ As such, these requirements are consistent with the international standards that mandate that the shareholders and managers’ be fit and proper to carry out their duties and responsibilities in the company. In fact, the law expressly requires that at least 40 percent of the members of the board of directors be professionals with experience in the financial sector, or persons with accredited economic, financial, or entrepreneurial experience.¹⁹⁰

But Law 183-02 fails in that it does not outline or enumerate specific responsibilities to the board of directors, or hold them to a specific standard of conduct. Rather, the law lists express penal norms regarding the sanctioning of directors and other company executives for breach of the law, and/or acting in their own interest.¹⁹¹ In this specific aspect, the Dominican system is lacking in the implementation of a specific standard that the board of directors will be held to in order to ensure accountability, which is essential for the protection of the stakeholders.

V. CONCLUSIONS AND RECOMMENDATIONS

The 2003 bank crisis in the Dominican Republic is an example of how costly these banking catastrophes are, especially in developing countries. This cost makes it necessary for authorities, the markets, and all those affected to attend to the prevention of future failures, because as stated by Barth, Caprio, and Levine, banking policies have a direct effect on the living standards of society.¹⁹²

Therefore, it is logical to assume that the failure of a bank is much more disastrous than that of any other corporation because banks have more stakeholders, as they are at many times “the main depository for the economy’s savings.”¹⁹³ This is consistent with the consequences of the Dominican banking crisis where the losses accrued to 25 percent of the country’s GDP, becoming a heavy burden on taxpayers and society as a whole.

187. BASEL COMMITTEE ON BANKING SUPERVISION, *supra* note 144, at 2.

188. *See* Ley No. 183-02 at art. 38(f).

189. *Id.*

190. *Id.*

191. *See generally id.* at arts. 66-72, 80.

192. BARTH, CAPRIO & LEVINE, *supra* note 35, at 2.

193. Arun & Turner, *supra* note 35, at 3.

Furthermore, many of intermediary's stakeholders do not have the means to protect their interests from excessive risk-taking by management or are unable to do so even if provided with the proper information, which in turn has deeper consequences than the agency problem. These deeper consequences derive from the findings of studies that have identified the principal-agent problem as one of the main causes of recent banking crises.¹⁹⁴ Therefore, controlling the agency problem should be on the top of the list of priorities in the management of risk and prevention of future bank crises.

The first step in controlling the agency problem is to recognize that banking corporate governance is different than the governance that is to be applied to other types of industries. The reason for this distinction is that banks have to attend to the different stakeholder interests, including the general public. Thus, in banks there is no single agency problem, but rather a wide range of relationship problems that can take place. These include shareholders, creditors, taxpayers, claimants, managers, employees, suppliers, customers, and the regulator in representation of the public interest. The regulator plays a dual role as the developer of policies and agent of the public interest, and as such, must be considered a stakeholder and be vested with the authority to cooperate with banks' boards of directors in order to develop the adequate mechanisms to control management's risk taking. This is consistent with the cited experts, as well as the OECD and the Basel Committee standards.

After the crisis in 2003, it is in the interest of the Dominican Republic to ensure that it has the adequate mechanisms to prevent future bank crises. A corporate governance system that takes into account the interests of stakeholders is the first step in that direction. In this respect, the OECD Principles of Corporate Governance are highly regarded as very influential in shaping today's corporate governance standards,¹⁹⁵ and as such, are an effective measurement for the existing banking corporate governance framework in the Dominican Republic.

The Dominican monetary and financial regime describes the existence of three authoritative entities, all with supervisory power over financial intermediaries. Therefore, if the regulator is a stakeholder of banks, then in the Dominican system it may only express its interests through supervision. It does not work with the entity to develop adequate internal controls, except during the approval of the entity for operation when it revises the submitted documents, during the regularization process as monitor, and during the dissolution of the intermediary. In this respect, the recommendation made by the International Panel of Experts to designate a responsible authority to work individually with each financial intermediary,¹⁹⁶ is to be highly regarded. But it will only be as effective

194. Alexander & Dhumale, *supra* note 35, at 6.

195. Alexander, *UK Corporate Governance and Banking Regulation: The Regulator's Role as Stakeholder*, *supra* note 35, at 1017.

196. GUZMAN ET AL., *supra* note 2, at 38.

as the political independence exercised by the regulator and the soundness of the general political environment.¹⁹⁷

Moreover, on the issue of the rights of shareholders and other stakeholders, the Dominican framework does include provisions for the protection of their interests. The right for shareholders to be continually informed of the company is contained in the Dominican Commercial Code, while Law 183-02 protects minority shareholders from not being allowed to participate in shareholder meetings. Nevertheless, a possible reform could include the participation of shareholders in the development and application of the remuneration policies for directors and executives, in order to limit the information asymmetries on this respect, as well as specific ways through which shareholders can hold the board accountable for their actions.

Furthermore, the law also includes depositors and other creditors as stakeholders entitled to receive information on the bank's liquidity and solvency problems, sanctioning non-compliance to this obligation. Additionally, Law 183-02 contains rules on the information that needs to be available for customers, which is consistent with the fact that informed stakeholders are better prepared to protect their interests. Finally, the Superintendence steps in to handle the regularization and dissolution of the bank in protection of the public interest, defending those stakeholders that are less able to exercise their rights.

In conclusion, the Dominican banking corporate governance regime does take into account the interests of the various stakeholder groups. But the regulator's role is one-sided, limited to the supervision of the intermediary instead of having the power to cooperate and ensure adequate internal controls and an effective representation of the public interest. Moreover, specific standards with which to measure the board of directors and its obligation to uphold the interests of the different stakeholders must be included in future reforms of the monetary and financial law. These additions to the role of the regulator will not eliminate risk intrinsic to the financial market,¹⁹⁸ but it is a step in taming it in order to prevent the recurrence of the catastrophe of 2003.

197. See generally Viviano De León, *Montás Afirma Presiones desde Palacio Crearon Crisis Bancaria*, LISTIN DIARIO (Dom. Rep.), June 9, 2006, <http://images.lis-tindiario.com/ediciones/2006/06/090606/cuerpos/ciudades/ciu5.htm> (remarks made by the current technical secretary to the president regarding the lack of political independence of the monetary and financial authorities during the last presidential term).

198. Lastra, *supra* note 19, at 82.