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WHY BANKS CHOOSE TO TAKE EXCESSIVE RISK THAT LEADS TO DANGEROUS OUTCOMES?

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Abstract

Banks are fundamental in increasing competitiveness of small, open economies that have underdeveloped capital markets. However, when the same banks are encountered by the wrong incentives that lead to excessive risk taking the resulting outcomes are not only ruinous for their shareholders, but are also capable of disrupting the entire financial stability, even endangering regional economies. This article centres on both the institution specific internal governance related incentives for excessive risk taking and systemic incentives. In small, open economies, the most notable examples of the former category are weak internal control functions or poorly informed and insufficiently trained senior management, and inadequate compensation schemes. Systemic incentives for excessive risk taking, on the other hand, are arising from the specificities of legislative and regulatory framework and actions of external agents such as herding behaviour by peer-banks, biased bail out possibilities and regulatory arbitrage issues, high tolerance level of depositors and legislative deficiencies (limited liability of banks, tax shields for corporate debt). This article also looks at the resulting outcomes from excessive risk taking – whether the risk taking increased the shareholder value and what are the effects for the financial stability, direct and indirect costs to the taxpayers and local economy as a whole. The issues shown in this article are crucial for further development of the regulation for the banking sector, as well as for making future investment related decisions and formulation of banks' risk appetite frameworks. The analysis in the article is conducted by statistical and market analysis, literature review, document examination of prudential and supervisory regulation.

Key words: Latvia, systemic risk, bank risk incentives, economic agents, prudential regulation

JEL code: G21, G28, G41

INTRODUCTION

Banks normally act as pivotal financial intermediaries in economy. Therefore, their role should be accounted for when identifying financial soundness and stability of the country. Moreover, banks are particularly crucial in small and open economies for ensuring economic activities, financial decisions and risk-taking behaviour that has much larger impact on the country's financial stability.

Banks' activities, when driven by wrong incentives from internal factors, shareholders and other interested parties, can have an impact of larger scale, especially, when capital markets are underdeveloped, and the associated risks arise in the economy. To mitigate risks of inadequate banking behaviour that threatens financial instability it is of crucial importance to address the significance of the banking sector, analyse the incentives for excessive risk taking and evaluate the possible resulting outcomes of such decisions.

The research question of this study is whether the incentives for excessing risk taking by banks themselves are leading to higher value for shareholders and overall creating a justified and prudent systemic risk approach, given banks' own systemic importance in small, open economies with underdeveloped capital markets. The aim of this study is to identify incentives for excessive bank risk taking – both institution specific and systemic and outline the possible resulting outcomes from such decisions in the framework of small, open economy like Latvia.

THE HYPOTHESIS OF THE STUDY ARE AS FOLLOWS:

H1: The more stronger framework of corporate governance is established the more incentives of risk taking of the bank are mitigated.

H2: The inability to successfully mitigate systemic incentives for excessive risk taking in the banking sector creates vast opportunities with potentially disastrous consequences.

The methodology of the paper encompasses the content analyses of appropriate literature review, document examination of prudential and supervisory regulation, statistical and market analysis. The information sources used in the study cover inter alia journal articles, working papers, policy papers, regulator's yearly reports, financial data reports.

The novelty of this research lies in differentiating the institution specific and systemic incentives for excessive risk taking of banks in small, open economies, simultaneously assessing the resulting outcomes of such incentives. The research aims to fill the gap in the analyses of risky banking business that has disruptive outcomes given the specificities of those countries that have small and open economies with underdeveloped capital markets.

The main limitation of this research is availability of statistical data, publicly available information that allows to assess supervisors approach given bank specific riskiness in the capital market of Latvia and other factors relating to previous research in this field that stem from the differences between various economies.

The article is organised as follows – first part of the article is dealing with the importance of the banking sector in small, open economy both from the aspect of bank specific and systemic importance. Second part is devoted to the institution specific incentives while third section explores systemic incentives for excessive risk taking. Section four analyses resulting outcomes for excessive bank risk taking. Discussion, conclusions and proposals of the paper are addressed in the last paragraph.

RESEARCH RESULTS AND DISCUSSION

Importance of the banking sector

The very basic function of the bank is to ensure financial and risk intermediation. That also includes considering concentration aspect as banks take upon short-term liabilities, bundle them and later redistribute through lending and other financial products. However, as seen from the previous experience with the last global financial crisis, the golden rule of balance sheet is not always considered.

In small, open economies, where capital markets are often underdeveloped, one of the option for growth of the enterprises and other entities is credit financing from banks. Therefore, it is crucial for banks to lend while maintaining to be sound and stable and not to delve into excessive risk taking by wrong incentives. When banks increase their systemic importance and initiate into taking more power in the economy they can start to implement strategies to maximize their profits at the expense of the others more rapidly than they would in regular banking activities. This pattern of behaviour often occurs without any systemic background, as banks are still regular businesses that are aimed to increase shareholder wealth through many corporate governance related aspects, including risk management (Biondi and Graeff, 2017). It is in the nature of the banking business that bankers will always try to maximise their wealth at the expense of excessive risk taking (Fabricion and Brada, *et al.*, 2012). Such behavioural pattern can be seen not only at the micro, but also at the macro level (Contributions of each institutional sector to macroeconomic developments, Eurostat).

A stable and foreseeable banking system is a foundation stone for every country, but especially for countries that have small and open economies due to previously mentioned considerations. Some of the parameters of openness that also influence the stability of the banking sector are the trade imbalances, *de iure* and *de facto* barriers to moving funds between countries. All these are closely linked with international agreements and other aspects that stem from subjection to external legislation like World Trade Organization, European Union and Euro Area. Banks are mediators towards maintaining the overall balance while being the first ones to be flushed over during capital runs.

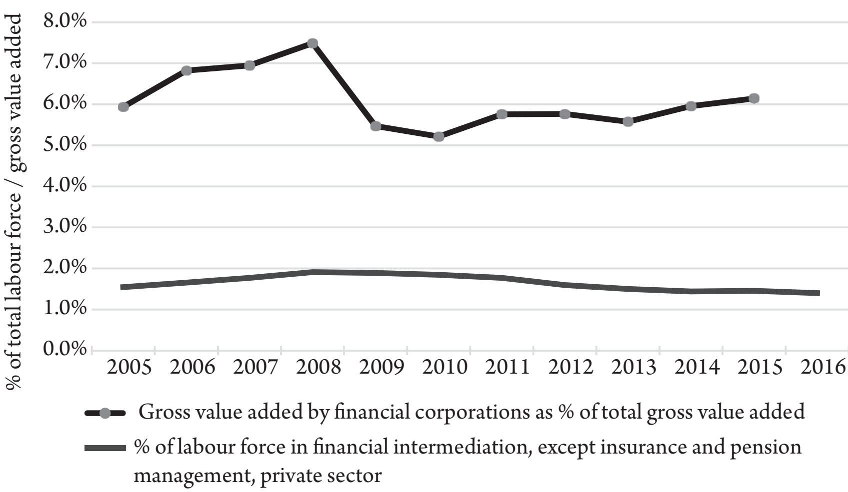
Nowadays banks can also serve not only as financial intermediaries, but also as creators of national wealth – through supply of specialised financial services, and joint ventures with technological enterprises. These "sudden" behavioural changes are mostly seen in small, open economies with highly developed technological background like Baltics (BNN, 2016), Nordic region and Hungary (KPMG, 2017).

As explored below on a case study of Latvia it is seen that the banking sector creates a significant part of Latvia's gross national income while employing comparatively less people in this sector – concluding that financial services sector is more productive than other sectors. As seen in figure 1 this sector in Latvia is becoming even more and more productive as the value produced increases while the share of labour force decreases.

Figure 2 shows that non-financial corporations are taking traditional debt from credit institutions (banks in the case of Latvia) to finance their needs of expansion and no other, more advanced credit sources like issued debt obligations, corporate bonds or preferred stocks.

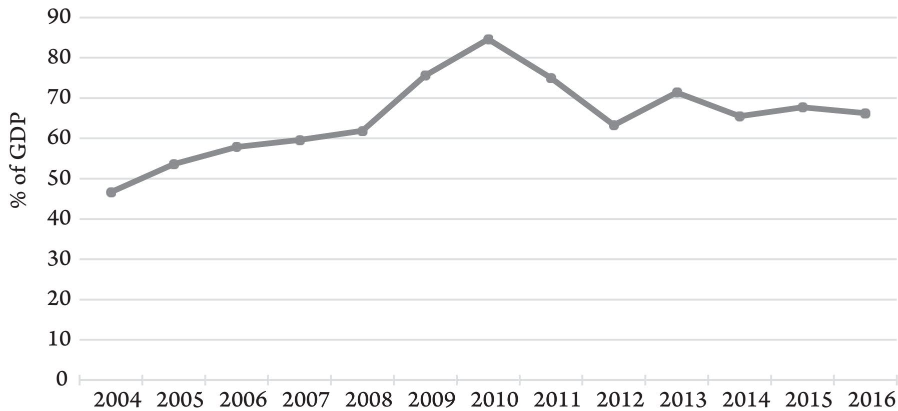
It is worth noting that Figure 3 displays the banking sector's importance from the market specific perspective when considering individual banks. Even when the number of banks in Latvia has varied over the years, the banking market structure of individual banks is still present in the means of competitiveness.

The authors measured the banking market density by the Herfindahl-Hirschman Index (HHI) and concluded that Latvia's banking market can be described as lightly to moderately concentrated (Figure 3). As proposed by the methodology of United States Department of Justice (2015) the HHI between 1500 and 2500 can characterise the market as moderately concentrated, but markets with HHI under 1500 can be defined as lightly concentrated. This allows one to conclude that Latvian banking market is dense, and the institution specific business decisions should have an impact not only on shareholders' wealth, but also on the perspective of systemic importance as denser banking market is bound to sustain systemically important institutions.



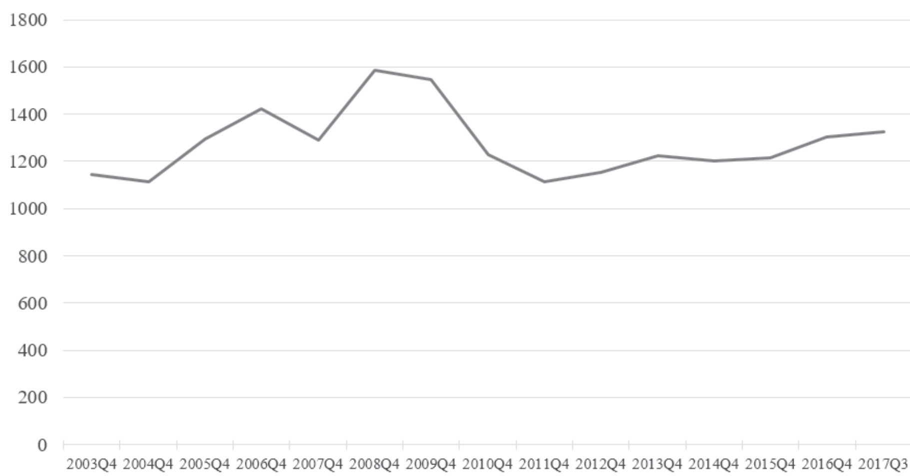
Source: Authors calculations based on data from Eurostat and Central Statistical Bureau of Latvia

Fig. 1. **Productivity in the financial sector in Latvia, years 2005–2016**



Source: European Central bank database

Fig. 2. **Debt excluding trade credit of non-financial corporations as a ratio of GDP in Latvia, years 2004–2016**



Source: Authors own calculations, the FCMC

Fig. 3. **Market concentration index (HHI) by bank asset size in Latvia, years 2003Q4–2017Q3**

All these figures also demonstrate the importance of banking sector in small, open economy like Latvia. Therefore, it is only reasonable to determine what are the driving factors for banks to take upon excessive risks that might not only lead to a single fall, but could steer into system wide shocks that spread through all economy not only nationally but regionally.

Institution specific incentives

When assessing risks, the bank specific view should be analysed from micro level. There are various factors that drive banks to acquire more risk as business evolves. These factors are similar to traditional business incentives as banks in general are still businesses that drive to foster shareholders wealth through many corporate governance related aspects such as profit, business growth and wages (Biondi and Graeff, 2017).

However, often money (or wealth) can lead to wrong incentives that may cause the shareholders to obtain false decisions that foster only business thinking which is not in the best interests of bank investors – depositors, who are mostly not with proper knowledge of financial economics. The agency theory enlightens this problem even more as the members of the management body – the main administrative and business steering body – often does not act with duty of loyalty than they should be acting according to international corporate governance principles (BCBS guidelines on the corporate governance principles for banks, 2015). This aspect also highlights the problems related to investor protection.

Because for the most riskiest aspects of the banking business there is a regulatory framework that mitigates the risks that may arise from those aspects given the task of the Regulator to maintain balanced systemic risks to protect not only the investors of the banks, but also to foster protection of minority shareholders which often balances out significant decisions of majority shareholders.

The most important regulatory framework for the banks in Europe, including Latvia, is the Capital Requirements Directive (CRD IV) (Directive 2013/36/EU, 2013) and Regulation (CRR) (Regulation (EU) No 575/2013, 2013). Other regulatory frameworks are binding as well, but CRD IV/CRR framework should be considered as the basic framework. The authors analysed that the regulatory framework, which is applicable to banks in Europe consists of major blocks that explains the focus of supervisory expectations. For example, Supervisory Review and Evaluation Process (SREP) constitutes of four elements – business model, governance and risk, capital and liquidity aspects – all that are accounted for prudent management of the banking businesses (ECB, 2016).

Regulatory aspects previously mentioned allow the authors to conclude, firstly, that mostly the decisions of majority shareholders are those that matter the most in every bank decisions (Chen and Lin, 2015; Luo and Li, *et al.*, 2015). Bankers will always try to maximize their wealth at the expense of excessive risk whether in risky assets that generally guarantees higher returns in short time period or in other profit generating aspects that are considered appropriate by the bankers themselves (Fabricio and Brada, *et al.*, 2012). These decisions stem from the business model choices and closely correlate with internal aspects – operating strategy, risk strategy, compliance with regulatory aspects and the level of doing so whether applying the bare accepted minimum or by stipulating the best practices that usually go beyond basic regulatory requirements (Barth and Caprio, *et al.*, 2002).

To outline the principles of banking management and thus risk taking that should be taken into account by the shareholders and the Regulator, the national legislation (mostly the Law on Commerce or similar legislation in other countries) are relevant as it differentiates between Two-Tier or One-Tier or other governance structures (liabilities, constraints of specific members of the management body, including structure) (The Law on Commerce, various Articles).

In Latvia, there is a Two-Tier structure, which means that management body is divided into two separate functions – supervisory function and management function (The Regulation on the Establishment of the Internal Control Framework, 2012). The supervisory board represents the shareholders' interests, supervises the management board and does not undertake the executive functions (the Law on Commerce Article 293).

There are clear rules that separate these two boards as it is internationally accepted standards that the same people should not engage into business decisions and at the same time supervise these decisions (European Banking Authority (EBA) guidelines on corporate governance, 2017). Nevertheless, this may occur in certain cases as small, open economies with certain national economic values hold banks that demonstrate power concentration with certain people that are promoted in significant directorships and decision-making process is mostly too concentrated to often be objective (The FCMC, 2017; Information about shareholders and members of the management body from Latvian commercial banks). The business decisions therefore might not fully be aligned with minority shareholders, and maybe are not in the best interests of investors and account for high-risk business. On the contrary, power concentration more effectively rules out agency problems that stem from members of the management body, which is also ruinous because materialistic incentives from members of the management body result in higher risks and ineffective risk management function in banks (Bushman and Davidson, *et al.*, 2018).

With underrepresented minority shareholders that would have any rights at the important decisions and insufficient corporate governance standards the information flows that would enhance prudent management of the bank are therefore non-existent. If the bank has the necessary policies and procedures that are required by the Regulation of the Establishment of Internal Control Framework (2012) then for the Regulator to check actual efficiency of these requirements is difficult or even impossible. If the senior management and the members of the management body do not act independently (they are unfit and improper for the directorship in practice) as they are supposed to be, and with no viable options to report non-compliance (reporting lines, *whistle blowing*) at the highest level of management – would relate to major issues with unsuitable staff that works only at the interests of majority shareholders.

It is notable that the banks of Latvia, whether they are Joint Stock Corporations (JSC), are not listed stock corporations and the liability of those banks are strictly limited to the regulation and criminal penalties that also foster irresponsible decisions of the shareholders. The stocks are owned by a small number of people that directs all the business by themselves, which carries numerous amounts of risk (majority shareholder problem discussed previously). It may be historical specificity that has kept these JSC unlisted and strictly owned by certain people.

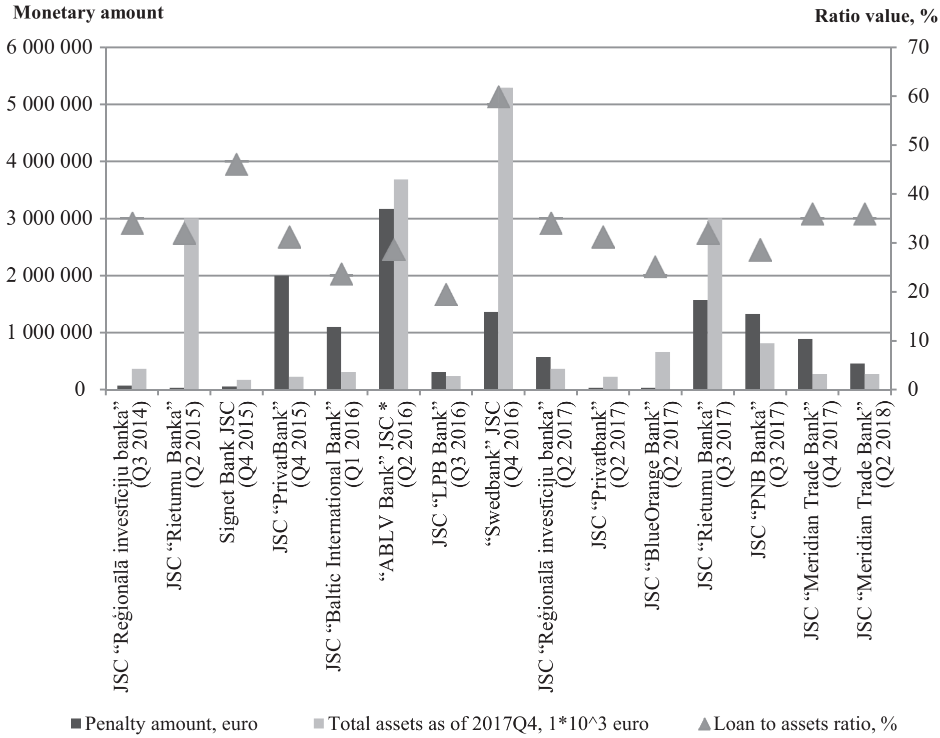
Staff suitability is also the issue in the case if the only shareholder (or majority shareholder as well) is a parent institution – factor may drive subsidiary to rely too much on parent institutions' group wide decisions and that is against the prudent management of the institution as a separate entity (EBA guidelines on corporate governance, 2017).

Excessive reliance on the parent institution has other downsides, for example, the risk that the bank will form a "shell bank" that is particularly gaining extra attention regarding Brexit plans and ECB response to strengthen Euro Area by stepping up with zero tolerance towards "shell bank" entities that do not have sufficient internal governance at the individual level (ECB, 2017). Stepping up to parent institution decisions that may not always be in the best interest of the subsidiary, is one of the most challenging risk-taking initiative of subsidiaries' staff that can lead to detrimental effects on the stability of subsidiary itself. Therefore, it is expected that group impact is very significant in every business decision.

A bank is deemed to undertake risks even with regulations present. It is expensive for the bank to establish adequate internal control system within its functions – risk management, compliance and audit functions, therefore the bank '*de facto*' will always try to reduce these compliance related costs (Noonan, 2015) that reduce the profit.

In addition, one of the largest risk-taking incentives for adding shareholders value is the dividend pay-out policy that always is the decisive driver for not using profit as capital strengthening tool, but as faster option to obtain dividends. These incentives also apply to the members of the management body and certain staff of senior managers that are classified as risk takers for the purposes of remuneration policy and pay-out rules (Regulation (EU) No 604/2014, 2014). This risk-taking incentive regarding remuneration is stronger in banks with the problem of power concentration of significant directorships as the management body and shareholders have too close personal incentives to approve inadequate compensation schemes and additional variable remuneration (bonus cap).

This allows one to conclude that the hypothesis that the stronger framework of corporate governance is established the more incentives of risk taking of the bank are mitigated. The authors assessed publicly available information from the FCMC on the amount of penalties that banks acquired given their faults on the internal control systems and the amount of fine that had to be paid and other agreements that had to be undertaken (see Annex 1, Table 1). Therefore, it is possible to confirm that the non-resident servicing banks that are generally more profitable are lacking the most requirements of the internal control system (Bojāre and Romānova, 2017).



Source: the FCMC

Fig. 4. **Monetary penalty statistics of Latvian banks by punishment date, total assets and loan to assets ratio**

As an example, the regulatory aspect just recently increased for Latvian banks as the Chairman of the FCMC declared (LETA, 2018) that non-resident servicing business is not an option for Latvian banking market anymore and should be winded down significantly. The extensive penalties (Annex 1, Table 1) confirms this fact. As Figure 4 shows, all banks that have received penalties regarding insufficient internal control systems and excessive risk taking are all oriented to non-residential clients (except one case of "Swedbank" JSC). By using the non-residential business type identification approach – the loan to asset ratio – the authors conclude that the correlation between receiving penalty and risky business model is evident. Similar approach was used by Jakobsons and Schaub (2014) in the means of identification of business models who divided Latvian' banking sector with the indicator loans to deposit ratio. As this indicator has the same correlation and trend as loan to assets ratio, overall it can be assumed as valuable business model identifier for research purposes.

Given recent scandals with banking business model choices that are unsustainable, the aspect of competitiveness in Latvia grows larger as banks with non-resident servicing business models struggle to find new market options, new business ways and new approaches in relatively small banking market (The Economist, 2018). This at the same time may lead to a new wave of excessive risk taking for some of those banks that fight for survival given recent regulatory activities. These decisions, however, will damage the shareholders' value and may threaten the investors and thus require additional supervisory approaches given historic cases.

Systemic incentives

While the previous section of the article described the institution specific incentives for excessive bank risk taking this section focuses on systemic incentives.

Analysing systemic incentives is a complex task due to existing linkages between actors and the prevalent market rules. As mentioned in the first section one of the main drivers for excessive bank risk taking are incomplete markets and contracts (Allen and Gale, 2006) that lead to banks using legislative loopholes.

An incentive that is important in the economy that is not only open and small, but also has relatively no power to set exchange rate, is appreciation of real effective exchange rate that leads to deteriorating trade competitiveness. This factor worsens the ability of enterprises to repay loans and other liabilities to banks and as a result bank asset value drops and possible liquidity and soundness risk arises. Therefore, banks are interested in maintaining a stable real effective exchange rate or limit their exposure towards enterprises in a particular market.

A market-defined incentive for banks to take excessive risk is the limited size of a market banks work in. The banking system in such particular small market is highly competitive (Beck, De Jonghe and Schepens, 2013) and to have high enough yields banks are encouraged to take upon excessive risks (Petrovska, 2017). In addition, the Regulator might push for increased capital buffers. For instance, if the Regulator sets a level of mandatory capital buffers too high (Allen and Gale, 2006) – banks are forced to increase the profitability of other assets that are not *frozen* – therefore increase their riskiness in the process.

A major drawback towards independence in the supervision of the banks is the aspect of the Regulator to act in line with the maximization of society's utility aspect over the competition with other regional Regulators that might arise given every country's individual interests. A Regulator in a small, open economy cannot create regulation in isolation from the rest of the region or even whole world because if rules are too strict the investors will choose to settle elsewhere. If the local Regulator is dependent on rules set by higher authority in a region (like Euro Area with European Central Bank foreseeing the whole region) the needs of the local Regulator can be diminished towards the needs for regulation of the largest member states.

The next systemic incentive for excessive risk taking by banks is the Regulator's preference for exact asset types like AAA bonds (Black *et al.*, 2016) that lead to scarceness of the exact asset types and increased demand for these assets that further lead to increased price. Besides not only Regulator's preference, but also peer bank preference for exact asset types from the same regions lead to correlated assets and excessive risk taking. This is especially pivotal in small, open economies with preferences relating to regional specificities. For instance, banks in Latvia prefer bonds issued by governments in Euro Area, US and Commonwealth of Independent States (CIS) (FCMC, 2018).

A recently observed phenomenon is banks engaging in financial innovation and close cooperation with *FinTech* and other technology enterprises. Moreover, while these innovations are not adequately regulated (Guerra *et al.*, 2013) a potential for excessive risk taking emerges as shareholder appetite for profits rises.

Another systemic incentive for excessive risk taking is the perception by banks that the Regulator will favour domestic or systemically important institutions (Garratt, Webber and Willison, 2012; Espinosa-Vega *et al.*, 2011) over other type of banks and therefore biased bailouts would occur. This leads to changes in behaviour to increase the bank's importance within the economy.

Due to tax shields, enterprises have a preference towards choosing corporate debt rather than equity when investing (de Mooij and Hebous, 2017). This leads to favouritism towards banks and in turn, banks choose to lend to enterprises in form of loans rather than option for other types of financial instruments to hold as their assets. Within the limited size of the domestic market, more risky loans are issued than in a market where banks are able to easily decline holding risky credit.

Excessive risk undertaking is further stimulated by behaviour of depositors. For instance, depositors in general are more lenient towards choosing banks to deposit funds if deposit insurance is in force (Laeven, Ratnovski and Tong, 2016). In addition, depositors are more careless for bank behaviour and their risk appetite when their domestic country is wealthy – high GDP per capita (Laeven, Ratnovski and Tong, 2016). When depositors do not sufficiently supervise banks with their deposits and withdrawals, banks tend to be more careless towards depositors and undertake riskier assets.

Another pressure for banks to take excessive risks is the prevalence of fixed rate deposits (Allen and Gale, 2006). That means that banks are forced to invest in projects that yield at least the rate promised for the deposits. However, the return of any investment project is not certain therefore banks have to take riskier projects to offset potential losses and repay depositors.

The herding behaviour by banks (Acharya and Yorulmazer, 2003) also promotes excessive risk taking especially when operating within a limited market. This behaviour leads to higher profits during the boom of the economy, but also shared higher losses during the bust. The limited size of market also plays a role as banks have to compete for the most profitable investment opportunities, sometimes at the expense of their soundness.

The final systemic incentive for excessive risk taking by banks is the prevalence of syndicated loans in the economy (Allen, Babus and Carletti, 2010). Syndicated loans tend to increase the overlap of the investment portfolios. Besides in a small economy usually few large enterprises are present therefore, banks compete with each other to finance these large enterprises and this increased competitiveness could lead to risks not evaluated.

Resulting outcomes

After the previous two sections with the exploration of the incentives for excessive risk taking by banks, this section conceptualizes the theoretical and empirical resulting outcomes of such behaviour.

The summarisation of bank specific aspects that are key risk-taking factors would be the cost reduction at the expense of compliance (Noonan, 2015). It can be assumed that banks engage in risky businesses to obtain more profit. In the case of small and open economy such as Latvia, the banks that focus on non-residential clients are those that are more profitable (Bojāre and Romānova, 2017). Moreover, the Regulator approaches these banks with higher regulatory requirements mostly in the area of capital buffers, liquidity and internal governance, but more notably in the field of anti-money laundering and terrorism financing risk management (the FCMC, 2017). Large monetary and other types of penalties prove that risky banking business models are ruinous for the economy, investors and other stakeholders and interested parties.

In the case of a level playing field with these banks – the same regulatory framework both for banks that service mostly residential clients and banks that serve mostly non-residential clients – the one and only resulting outcome for an individual bank would be its solvency issues as it would eventually engage in too risky business decisions and suffered ineffective risk management for the bank to maintain sound capital and liquidity levels (Hugonnier and Morellec, 2017). This will eventually damage the shareholders wealth. There would not be any backstop for minority shareholders as those would not be in the shareholder structure in the case of non-existent or weak minority shareholder protection. The dominance of majority shareholders would cast out groupthink and effective promotion of members of the management body would also be non-existent. The same problems apply with parent institution excessive dominance.

As for other outcomes that may result from excessive risk taking – financial difficulties such as the inability to repay deposits and other claims might arise, but in this case, the insolvency aspect will play its role. Every negative outcome and/or situation that relates to bankers' decisions sheds a dark light upon reputation and trust that is vital in banking business. The business has to be restructured or closed down if the risks are too large to manage and the Regulator would choose not intervene.

Any negative resulting outcome of the excessive bank risk taking will lead to losses of the investors and other interested parties not only in micro level, but will also have an impact in the macro level.

During times of turmoil, panic and runs on banking system occur even in the absence of direct linkage between bank in distress and other peers (Lau, 2011). Besides, in a small, open economy runs happen not only by individuals residing in the country, but also from global investors and these runs are more abrupt than would be in large economy. Inability to correctly evaluate assets leads to depressed asset value and possible bank insolvency (Diamond and Rajan, 2011).

A country's ability to fulfil obligations also play a role in triggering the bank runs especially when small, open economies have lower resistance towards mitigating shocks.

Excessive risk taking force banks to get creative in maintaining their profitability. Recent studies show that not only depositors, but also banks themselves try to expand in the usually non-regulated shadow banking business (Financial Stability Board, 2015) for maintaining their comparative advantage.

Due to the interconnectedness of a small, open economy, distress in one country easily spreads to the whole region. The consequences of excessive risk taking in a single market leads to the disruption of market functioning and distress in the whole region (Huang, Zhou and Zhu, 2012). Once the shock event emerges the freeze of credit sales starts. In addition, liquidity shortages and interbank linkages get broken (Laeven, Ratnovski and Tong, 2016).

Another outcome is the occurrence of the inefficient government bailouts when banks are in distress (Laeven, Ratnovski and Tong, 2016) from previous incorrectly evaluated risk. These funds usually come from taxpayer money that cannot be further invested in improving health, education, transportation or other needs of the society.

When the banking sector loses the confidence of investors due to previous excessive risk-taking defaults, fire sales and counterparty fear emerges (Garratt, Mahadeva and Svirydzenka, 2011). This leads to consolidation of the banking sector as only the strongest are able to raise funds and confidence.

Another outcome of excessive risk taking is a decrease in rating (Sy, 2009) for not only the bank in question, but also for all banks operating in the same market. The decrease in rating leads to an increase of the cost of borrowing.

The overall cost of borrowing increases (Acharya and Yorulmazer, 2003) as lenders are more suspicious towards the whole sector even if excessive risk taking was evident only in few banks.

Overall, it can be concluded that there are various negative outcomes from excessive risk-taking incentives.

Discussion of results

As it is seen from the previous sections, the banking sector as a whole plays an important role in not only providing funds for development of the economy, but also collects and distributes various risks. Besides, nowadays banks also take part in creation of a nation's wealth and invests in innovative economy by joint ventures with technological enterprises.

Another point worth discussing is that recently bank specific incentives to take upon activities with questionable reputation by having improper anti-money-laundering standards have been penalised by Regulator, at least in Latvia (Annex 1, Table 1). These incentives are often difficult to manage as they result from bank specificities regarding ownership status, structure and overall attitude towards business decisions.

The systemic incentives are seen to be arisen from an incomplete and small market itself. Therefore, the role of a fair Regulator and a legislative framework is crucial both from micro and macro level perspective.

Some incentives have more ruinous consequences than others. The results of this study show that mostly all incentives have progressed over time. That leads to the thought that also the Regulator has to adapt faster towards mitigating and controlling the incentives. The authors have also found that the factor of a small, open economy plays a determinative role in monitoring incentives. Not only banks have to implement strategies based on regional market specificities, but also the Regulator has to adapt as well. A single Regulator cannot set stricter rules than the neighbouring countries' Regulators for their particular markets as then, due to the free movement of capital (or at least easily), the banks will choose to re-settle over in neighbouring markets since the regulatory level playing field cannot be met in practice. The regional competitiveness over funds, clients and even amiability of the Regulator have started to play a definite role. This all leads to the limited Regulator's power to act independently and in a timely manner.

CONCLUSIONS

1. To steer bankers from pure profit making to prudent business management the corporate governance framework has to be strengthened by various factors in which, among others, sound risk culture and effective internal control system that facilitates long-term interests of investors plays an important role. There are various requirements that have to be met for a bank given its nature and importance in any economy. Especially in a small, open economy like Latvia.
2. In small, open economies with certain national and cultural aspects, there are problems with correct shareholder representation through management body members. The dominance of majority shareholders is present. This enables problems regarding the prudent decisions on behalf of the bank and abstraction from own personal business decisions more effectively.

3. Not mitigating incentives (bank specific or systemic) will lead to systemic events with catastrophic effects. However, if these incentives will not be controlled (and worst – penalised) by an outside party (be it the Regulator, global market participants or even depositors) the probability of risk realisation increases.
4. Some of the incentives have more ruinous consequences than others do. Therefore, the mitigation process should be firstly directed towards those with most disastrous consequences.
5. Due to regional competitiveness in mitigation (or leniency towards mitigation) of incentives takes place constantly, the implementation of Regulatory strategy has to be independently evaluated and fairly adjusted over time.
6. Incentives have progressed over time and are business cycle and regulatory framework dependant.
7. Overall, the hypotheses set out in this study were confirmed. Particularly that strong internal governance framework enables more prudent and sound risk-taking behaviour in a bank, that leads toward minimising negative resulting outcomes. Systemic incentives are more difficult to minimise as they arise from various agents and market structure as such, but have a potential of disrupting the entire banking system.

PROPOSALS & RECOMMENDATIONS

1. To the Regulator – stricter oversight of financial innovations and shadow banking sector. Simultaneously evaluate the necessary intervention. In addition, to have strict supervisory approach regarding bank specific risk taking that is often a starting point for every ruinous decision and outcome. Carry out supervisory review and evaluation process for every bank regardless of its size and systemic importance;
2. To fiscal and monetary policy makers to introduce a financial transaction tax for transactions that promote systemic risk in order to create "systemic event" fund;
3. Banks must look for opportunities to diversify their investment portfolios (both in terms of sector of national economy and in terms of services provided) in order to avoid excessive asset correlation and dependency between assets of mutual investment portfolios;
4. Banks must introduce in practise the best practices in their institution regarding internal governance related aspects, prudent capital and liquidity management, careful consideration of business model and its decisions. The shareholder structure should always be considered as groupthink phenomenon should not be dominant;

5. To the Regulator and banking system agents – implementation of continuous monitoring of current and newly developing incentives;
6. To other researchers – the institution specific view in bank related research should be analysed closely with systemic perspective view (micro and macro levels).

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Annex I

Table 1. **Monetary and other penalties of Latvian banks since 2014**

BANK	*DATE OF PUNISHMENT*	*PENALTY (EUR)*	*REASONING*
JSC "Meridian Trade Bank"	25.05.2018.	**455 822**	Overall insufficient internal control system. Mostly in the AML risk management area
JSC "Meridian Trade Bank"	14.11.2017.	**889 651**	Insufficient internal control system in the credit risk area
JSC "NORVIK BANKA"(currently JSC "PNB Banka") JSC "Rietumu Banka"	21.07.2017.	**1 324 667** **1 566 604**	The FCMC in cooperation with USA FBI investigated that both banks have not complied with regulation in the field of AML and internal control systems. Investigation concluded that the internal control system was not efficient given banks' business model.
JSC "Baltikums Bank" JSC "Privatbank" JSC "Reģionālā investīciju banka"	27.06.2017.	**35 575** **35 575** **570 364**	JSC "Baltikums Bank" and JSC "Privatbank" lacked certain provisions in the field of AML that was discovered as part of international investigation. JSC "Reģionālā investīciju banka" lacked compliance with crucial internal governance aspects additional to provisions in the field of AML therefore the penalty additional to monetary fine consisted with requirement to invest ~ 2.8 million euro in strengthening internal control system framework in fore coming year.
JSC "Swedbank"	23.11.2016.	**1 361 954**	Bank settled an agreement for monetary fine and additional activities to strengthen the internal control framework that had some major issues regarding AML and other aspects (know your client).
JSC "Latvijas pasta banka"	25.07.2016.	**305 000**	The investigation regarding the publicly available research of National Bank of Moldova (Kroll report) about activities in the banks of Moldova in 2012 and 2013 that concluded into penalty for the Bank regarding aspects in the field of AML and inefficient internal control framework.
JSC "ABLV Bank"[1]	26.05.2016.	**3 166 682**	The FCMC settled an agreement with the Bank and Head of AML Officer (Aleksandrs Pāže) for a monetary fine additional to further enhancement of internal control system that had serious errors regarding aspects of AML. This settlement requested the Bank to invest additional 6.5 million euro to strengthen its internal control system.
JSC "Baltic International Bank"	09.03.2016.	**1 100 000 (The bank), 25 000 (CEO)**	The bank lacked crucial details regarding the AML risk management and endangered the bank to excessive risks. The bank agreed to strengthen its internal control system in the field of AML risk management.
JSC "TRASTA KOMERCBANKA"	03.03.2016.	**License suspended**	The bank was previously fined regarding similar problems therefore the license suspension that was made by the FCMC and ECB was an outcome. Banks' shareholders were not able to raise capital and comply with regulatory requirements for some time. The bank was already working with significant losses and the chosen business model was not sustainable.

[1] 12.06.2018. The FCMC permits JSC "ABLV Bank" to implement voluntary liquidation due to un-repairable fallout of negative reputation risk after public suspicions' of faults in the AML area.

BANK	*DATE OF PUNISHMENT*	*PENALTY (EUR)*	*REASONING*
JSC "PrivatBank"	11.12.2015/ 14.12.2015.	**2 000 000 (Bank), individual penalties for management board members – 96 449 (CEO); others – 25 869, 15 411 and 7607**	Critical faults in the field of AML risk management led to the suspension of the management board additional to monetary fine for each of them and the bank itself. The investigation regarding the publicly available research of National Bank of Moldova (Kroll report) about activities in the banks of Moldova in 2012–2014 was also taken into account. Further work regarding the enhancement of the internal control system and also the management of AML risks are taking place.
JSC "Bank M2M Europe" (currently JSC "Signet Bank")	27.11.2015.	**55 000**	Faults in the management of AML risks and shortcomings in the internal control system led to penalty.
JSC "Rietumu Banka"	15.05.2015.	**35 000**	Shortcoming in the field of AML risk management (know your client) and insufficient internal control system led to penalty.
JSC "Reģionālā investīciju banka"	04.07.2014.	**70 000**	Insufficient non-residential client investigation but the bank led to serious faults that were crucial for the penalty. The requirement to strengthen the internal control system was made for the bank in upcoming years.

Source: the FCMC