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Bank Governance: what do we know, what should we do?

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ABSTRACT:

This paper addresses the questions of whether available empirical evidence supports the hypothesis that bad corporate governance in banks was a principal cause of the Global Financial Crisis and the types of regulatory responses regarding bank governance which have resulted. It reviews what we know about bank governance, assesses key features of regulatory (and other) initiatives suggested, and concludes by considering whether contemporary approaches to thinking about bank governance are suitable.

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1. Introduction

Various definitions of corporate governance can be found in the literature, but most share a common theme of specifying it as the set of relationships between stakeholders and decision makers in the organization designed to facilitate the achievement of the goals of the organization. In one of the most widely cited articles on corporate governance Shleifer and Vishny (1997) commence by asserting that it "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment", thus focusing purely on agency problems. Because, as Macey and O'Hara (2003) note, complete contracts to cover every possible future contingency cannot be written, decision making responsibilities, incentive structures, and monitoring arrangements are put in place to deal with the agency problems which result. Since then broader, multi-disciplinary perspectives have come to the fore, as outlined by Filatotchev and Boyd (2009) reflecting recognition of a wider range of stakeholders and the role of internal organizational arrangements and processes and cultures. [1]

Although corporate governance has been a dominant theme for the last two decades for academic research, business, and policymakers, there was relatively little explicit attention paid by researchers to corporate governance in banks prior to the Global Financial Crisis (GFC). Macey and O'Hara (2003) noted that despite the increasing attention being paid to corporate governance generally "very little attention has been paid to the corporate governance of banks".

There had also been a relatively limited regulatory focus on bank corporate governance by regulators. In the Australian context, Davis (1999) notes that the "Wallis Inquiry…paid relatively little explicit attention to governance issues, although several of its recommendations … have implications for governance mechanisms and structures". APRA, however, released a draft prudential standard on board composition for ADIs in November 2001 and the subsequent draft of prudential standard APS 510 *ADI Governance* in May 2005. The focus of this standard was primarily upon board

[1] This is reflected in a focus on Board characteristics in supervisory approaches and in much recent empirical literature in contrast to the Shleifer and Vishney survey which pays scant attention to boards of directors and emphasizes legal protections and concentrated interests of financier stakeholders (owners, creditors) as mechanisms for resolving the agency problem between financiers and managers.

characteristics and structure. This was also the principal focus of the guidance note produced by the Basel Committee (1999) and updated subsequently (Basel Committee (2006)). In New Zealand, attention to bank governance also included significant directors' liabilities for misleading disclosures (Bollard (2004)), consistent with a perceived need for stronger governance in a less prescriptive regulatory environment.

The GFC has spawned extensive regulatory interest in bank corporate governance, although Mulbert (2010) reviews official studies of the GFC and argues that bank corporate governance failures did not feature as an explanation for the crisis for a year or more after its onset – following which this became a key issue for regulators. The current conventional wisdom is summarized as follows by researchers from the World Bank. "If there is one lesson from the current crisis— a lesson consistent with the Asian financial crisis—it is that corporate governance matters. The central irony of the governance failures in this crisis is that many took place in some of the most sophisticated banks operating in some of the most developed governance environments in the world." (Ard and Berg (2010)). This has led to a regulatory and supervisory focus upon improving governance in financial institutions reflected in the G20 Leaders Statement that "[m]ore work is required to restore the soundness and enhance the transparency of banks' balance sheets and markets; and improve the corporate governance and risk management of financial firms…" G20 (2010). There has been a range of initiatives and suggestions forthcoming relating to risk governance, remuneration, board arrangements, and shareholder rights and duties.

This paper asks the questions of whether available empirical evidence supports the hypothesis that bad corporate governance in banks was a principal cause of the GFC and whether that evidence provides a foundation for the types of regulatory initiatives in train. It also asks the question of whether contemporary approaches to thinking about corporate governance in banks are well founded.

Section 2 of the paper briefly reviews why bank corporate governance may be special, and considers whether bank ownership and organizational structures conform to the model which underpins much current thinking. Section 3 reviews empirical studies which have addressed features of bank corporate governance and section 4 focuses upon studies of banker remuneration which has been a particular topic of interest and study. Section 5 looks at empirical work and official views on whether bad corporate governance in banks was a principal contributor to the GFC. Section 6 looks at the various changes to corporate governance requirements proposed and their merits. Finally section 7 considers whether contemporary approaches to bank corporate governance are appropriate given the characteristics of modern financial sectors and banks. In particular, the disjuncture between legal control rights and economic interests, high allowed leverage and financial safety nets, inherent complexity and opaqueness (both internally and externally), and limited liability arrangements suggest that an alternative perspective may be appropriate.

2. Is Bank Corporate Governance Different?

The European Commission (2010, p4) argues that "the rules of corporate governance within financial institutions must be adapted to take account of the specific nature of these companies", specifically mentioning the role played by supervisory authorities as implicit representatives of stakeholders such as depositors and (in the event of failure) taxpayers. This is well recognized, as are the special features of banks which create specific governance issues and prompt regulation. Davis (1999) notes difficulties posed for external monitoring by bank opaqueness, the increasing level of internal delegation of decision making responsibility (and risk taking) within modern banks, and the free rider problem induced in private sector monitoring by official regulation and supervision. Levine (2004) also emphasizes the relevance of opaqueness, including the complications it creates in trying to design incentive structures to align management interests with those of shareholders (or other stakeholders). He also notes the adverse effect which government regulation of bank takeovers and concentrated ownership may have on pressure for improved governance – in addition to the effects of the "safety net". Macey and O'Hara (2003) argue that a Franco-German approach to corporate governance should be taken in the case of banks which extends fiduciary duty of bank directors and management to a broader range of stakeholders (particularly depositors) as opposed to the US approach which focuses on obligations to shareholder/owners. Similarly the European Commission (2010) argues that corporate governance in financial institutions should involve directors, shareholders and management assuming a greater level of responsibility.

Much of the analysis of bank corporate governance is addressed from a perspective of banks as limited liability profit maximizing, stock-market listed, companies with diffuse owners and with the agency problems generated by the division between owners and managers ameliorated by shareholder elected boards of directors and the market for corporate control. This is a narrow perspective which, while possibly applicable to large banks in a number of major countries, ignores significant historical and contemporary geographic characteristics of banking. Fashioning governance requirements based on that perspective avoids the prior question of whether that organizational structure is the most appropriate for good bank governance.

There is a diversity of bank ownership structures around the world. They range from publicly listed companies (which may have widely held or concentrated ownership) to private family owned companies to mutual or cooperative structures to government ownership. Moreover, legal structures may involve banks as subsidiaries of holding companies, or as parent companies in their own right with other financial or non-financial subsidiaries. In the US for example bank (or financial) holding companies have become the norm for large banks – on which most of the bank governance literature has been based. Partnership structures were also common in investment banking until recently, as, historically, was double or unlimited liability of bank shareholders.

Caprio, Laeven and Levine (2007) provide information on ownership structures of publicly traded banks for a sample of 244 large banks from 44 countries as at December 2001. Notably, widely held ownership structures are not common, with only Australia, Canada, Ireland, Norway, UK, USA and (to a lesser degree) Japan having widespread ownership predominating. A situation of a controlling family holding was more common internationally than widespread ownership, while State control was also frequently observed.

Because Caprio, Laeven and Levin restrict their sample to the ten largest publicly traded banks in each country, they exclude fully government owned banks and mutual or cooperative banks which are also significant. Moreover, as Taboada (2008) notes, there has been a substantial wave of bank privatizations around the world in recent decades. He finds for a sample of around 800 banks, that there is no significant difference between common law versus civil law countries in terms of ownership concentration (domestic, government, foreign blockholders) but that there is greater domestic blockholder and less government blockholder concentration in developed versus emerging markets (using data for 1995, 2000, and 2005).

In the Asian region, Fan and Wiwatanakantang (2006) provide information on ownership of 59 leading banks in Indonesia, Korea, Malaysia and Thailand. Around 70 per cent of banks have a controlling shareholder, and while the relative importance varies across the countries, around one third are government controlled, one third foreign controlled and 10 per cent family controlled.

Governance arrangements also differ across countries. In some countries banks have a dual board structure involving a supervisory board and an executive board. Ferreira, Kirchmaier and Metzger (2010) examine characteristics of boards of 740 large banks from 41 countries. They find that the importance of independent directors increased in the years prior to the GFC, but that for many countries outside the USA the extent of director independence is less. Countries with two-tier boards, and those in which courts have powers to remove directors have less independent directors.

Partly missing from the mainstream literature on ownership and governance structures in banks is recognition of the importance of cooperative and mutual institutions in the sector, and the particular characteristics of these institutions. In Europe for example, cooperative banks are a significant part of banking markets, as Table 1 shows. Fonteyne (2007) notes that the voting rights structure and the intergenerational wealth transfer implicit in such cooperative (or mutual) structures raises particular problems for governance – in particular opportunities for management empire building and for attempts at expropriation. He notes that while these organizational forms may have worked well for small community based institutions for which they were designed, they may be subject to shortcomings when those institutions become large and complex, and that the absence of a market for corporate control for such entities also weakens governance incentives. The absence of owner-depositor agency conflicts is also relevant for potentially reducing incentives for excessive risk-taking.

Table 1: Cooperative Banking in Europe

	Selected European Countries: Cooperative Bank sector share	
Country	banking assets (2003)	Retail deposits
Austria	35.6	20-50
Finland	15.9	20-50
France	24.1	50-100
Germany	10.3	5-20
Greece	0.6	0-5
Italy	14.9	20-50
Netherlands	26.7	20-50
Portugal	3.5	5-20
Spain	3.9	5-20

Source: Fonteyne (2007)

3. *Studies of Bank Governance*

Empirical studies of bank governance prior to the GFC are relatively few, although there are numerous studies not focusing on governance but still based on an agency perspective which examine "bank" incentives for risk taking due to the financial safety net. Simpson and Gleason (1999) is one of the early empirical governance studies examining whether board attributes are relevant for performance. In this case, for a sample of approximately 300 US banks, the only characteristic (measured in 1989) found to be related (negatively) to probability of subsequent financial distress (measured at 1993) was CEO – Chairman duality. It is suggested by the authors that a CEO who is also Chairman, is better able to withstand shareholder incentives for higher risk-taking which is contrary to the CEO's private interests. This result is supported by Pathan (2009) who studies 212 large bank holding companies for the period 1997-2004. He finds that bank risk (measured using both stock price data and Z-scores) is negatively related to CEO-Chairman duality and positively related to "strong" boards as defined by small boards and those with few restrictions on shareholder voting power. But having more independent directors appears to lead to lower risk-taking. Pathan and Skully (2010) use the same sample to analyse determinants of board structure such as size, composition (independent directors), and CEO-Chairman duality. Larger, diversified, banks have larger boards, more external directors, more likelihood of CEO-Chairman duality. They conclude that “to the extent that bank board structure adapts to its unique competitive environment, it suggests that uniform rules or guidelines to reform board governance could prove counter-productive.”

Offsetting the risk reduction benefits of CEO-Chairman duality, Pi and Timme (1993) find (for a sample of 112 US banks in the late 1980s) that duality reduces performance as measured by return on assets and cost efficiency. Adams and Mehran (2003) examine 35 large US bank holding companies over the period 1986-1999. They find that, compared to manufacturing firms, bank boards are larger, have more committees, make less use of stock-options in CEO compensation, and that CEO ownership stakes are lower and institutional shareholdings are lower. They note, however, that their empirical work suggests relationships found between board characteristics and firm performance in other industries is not necessarily replicated in the case of banks.

de Andres and Vallelado (2008) undertake a cross country study of the role of board characteristics using data on 69 banks from US, UK, Canada, Spain, France and Italy for 1995 to 2005. Bank performance (measured by Tobin’s Q, ROA, or shareholder return) is found to have an inverted U relationship to board size (with the peak occurring at around nineteen directors) while having more outside directors is also associated with improved performance. Caprio, Laeven and Levine (2007) also provide cross country evidence. Based on the assumption that higher market valuation (proxied by Tobin’s Q ratio) is an indicator of better governance, their empirical work leads to the conclusions that concentrated ownership is consistent with good governance, as is minority shareholder protection provisions, but that stronger regulation or supervisory powers does not improve governance once ownership concentration is controlled for. Laeven and Levine (2008) also find that concentrated ownership leads to higher risk taking, consistent with the standard agency problem perspective. They also note that bank risk taking depends upon the interaction of regulation and governance structures, such that the diversity of ownership arrangements around the world suggests that “one size fits all” regulation is not appropriate. For example, deposit insurance does not appear to induce moral hazard in the form of higher risk taking unless there is a single large equity owner.

Crespí, García-Cestona and Salas (2004) is one of the few studies which compares governance for different types of banks. They find that cooperative savings banks (Cajas) in Spain perform on average no worse than commercial banks, but that there is more evidence of governance reactions via CEO replacement in commercial banks, (and more use of friendly mergers for savings banks) following poor performance (measured using ROA). DeYoung (2007) finds from an examination of US Community Banks that the link between financial performance and governance indicators varies depending on the organizational and ownership structure of the bank. For example, CEO cash bonus salary component and existence of a management succession plan were significant positive influences on performance in "Subchapter S" banks (which are small, with few shareholders and tax incentives to have a high dividend payout ratio), but not at publicly traded community banks.

What, tentative, conclusions might be drawn from this literature? Independent directors appear to be beneficial (both for performance and limiting risk taking); concentrated ownership leads to closer alignment with shareholder goals (although whether that is socially desirable is another matter); CEO-Chair duality might reduce risk-taking. But the evidence is mixed, suggests there is no unique best governance structure, and is largely based on US bank-holding company data – which may limit its more general applicability.

4. Studies of Banker Remuneration

Banker remuneration has attracted considerable attention since the GFC and led to a range of regulatory proposals internationally (see Douglas (2010). It is of particular interest because aligning executive incentives via remuneration structures with those of particular stakeholders may influence bank risk taking and performance.

Studies of banker remuneration essentially fall into two categories. One group examines the determinants of remuneration (such as bank size, link to past performance) and its composition (role of incentive components such as option grants etc.) The other looks at whether compensation arrangements affect risk taking by, or performance of, the bank.[2]

[2] A number of earlier studies of (primarily US) banker remuneration are discussed in Fahlenbrach, Rüdiger, and René M. Stulz, 2010, Bank CEO incentives and the credit crisis, *Journal of Financial Economics* In

Ang, Lauterbach and Schreiber (2002) examine remuneration arrangements at 166 US banks from 1993-1996 and find that CEOs have a larger performance-contingent pay component than less senior executives, and a higher sensitivity of remuneration to bank performance. Cornett, McNutt and Tehranian (2009) find for the largest 100 US bank holding companies that during the period 1994-2002, greater pay-performance sensitivity of CEO compensation was associated with more earnings management, but also with more independent boards which tended to moderate the extent of earnings management. Ang, Lauterbach and Schreiber (2001) in a theoretical study argue that performance related pay for top executives induces greater internal monitoring by them of subordinates (enhancing performance) as well as aligning their interests with owners, but that regulation such as minimum capital adequacy requirements reduces the sensitivity of the performance-pay relationship. John, Saunders and Senbet (2000) develop a model of bank management incentives which implies that the structure of banker remuneration should be incorporated into deposit insurance pricing (and supervisory actions) to offset incentives to undertake risk-shifting actions (higher leverage, more risky investments) to the detriment of depositors and/or the deposit insurance fund.

Bliss and Rosen (2001) examining a sample of large US banks over 1986-1995 find no difference in the link between CEO remuneration and growth in bank size via merger or non-merger means, which may induce merger activity if that is an easier path to growth, They also find that larger share ownership by bank CEOs tends to reduce the incidence of acquisition activity (consistent with adverse effects on CEO wealth from poor acquisitions reducing takeover incentives). Anderson, Becher and Campbell (2004), examining 330 large bank mergers from 1990-1997 conclude that the post-merger increase in CEO remuneration is related to expected gains from the merger (measured via announcement stock price effects) and involves a shift towards longer term compensation – suggesting that mergers are not necessarily an easier path to growth for CEOs. The inference they draw, that the market for corporate control works effectively in banking, is consistent with the results of Becher (2000) which found that the 558 bank mergers

Press, Accepted Manuscript.. Significant changes in the structure and level of banker remuneration following financial deregulation (a phenomenon of interest in its own right) make these studies of less current relevance.

studied over the period 1980-1997 had, on average, positive wealth effects (although previous studies surveyed had mixed results).

John, Mehran and Qian (2010) argue that the sensitivity of the CEO performance-pay relationship should decline as leverage increases (to reduce incentives for risk-shifting from equity to debt) and increase with the intensity of outside monitoring (which allows for closer alignment of interest with owners while limiting potential for risk-shifting). Using an index of outside monitoring (based on subordinated debt and regulatory data) they find support for these hypotheses for a sample of US bank holding companies over the period 1993-2007.

A number of studies have examined whether bank executive compensation is linked to risk taking by those institutions. Cheng, Hong and Scheinkman (2010) use residual compensation in excess of that explained by institution size as a measure of CEO risk-taking incentive, and find that it is a predictor of subsequent institutional risk taking. However, they do not find that their results can be explained by standard corporate governance indicators, but are more related to measures of shareholder short-termism (stock turnover and institutional ownership) suggesting that characteristics of executive remuneration generating risk taking behavior may be more driven by shareholder clientele objectives.

Chen, Steiner and Whyte (2006) examine compensation in US banks following deregulation of the early 1990s and argue that increasing use of executive stock options occurred and was associated with increased risk taking by banks. (In 1992, options accounted on average for around 17 per cent of total CEO remuneration for banks in their study, and had increased to almost 50 per cent in 1999. In Europe, Nestor Advisors (2008) found that, on average, for the largest 25 banks salary accounted for 24 per cent, annual bonuses for 37 per cent and long term incentive rewards for 40 per cent of CEO remuneration). Chen, Steiner and Whyte (2006) used four stock price related measures of risk (stock price volatility, idiosyncratic risk, beta, and stock price return sensitivity to short term interest rates), and other factors controlled for included bank size, leverage and diversification. Accumulated option holdings appear to have a closer relationship with the measures of risk-taking than the option share of annual remuneration.

Fahlenbrach and Stulz (2010) examine whether alignment of CEO incentives with those of shareholders, through remuneration arrangements, was relevant in explaining differential bank performance in the GFC. They find no evidence that better alignment led to better performance as measured by bank stock price movements, and argue that CEOs apparently took risks which were *ex ante* in shareholder best interests, but turned out to be *ex post* value destroying – including of their own wealth.

However, Bebchuk, Cohen and Spamann (2009) analyze the compensation of top executives at Lehmann and Bear Stearns and note that substantial amounts ($1 billion plus) of remuneration were cashed out over the eight years prior to failure. Hence, even though senior executives in those firms "lost" substantial amounts at the time of failure, their net wealth gain relative to eight years earlier was still substantial. They argue that this is consistent with remuneration arrangements encouraging risk taking – despite the ex post losses which were incurred.

Bebchuk and Spamann (2009) analyze banker remuneration arrangements, arguing that the ability of executives to access short term remuneration gives incentives to take risks which may involve longer term effects. This is aggravated by the linking of remuneration to equity returns which are a highly leveraged claim on bank assets, and thus not forcing enough attention of bank executives on the potential downside faced by depositors and other creditors. The leverage effect is further exaggerated if a holding company structure exists with bank executives having remuneration linked to shares in the holding company which itself is leveraged. They argue that regulatory requirements which attempt to align executive remuneration with that of bank shareholders is not necessarily socially optimal given the incentives of bank shareholders to encourage risk taking in the presence of a financial safety net (or inability of other creditors to adequately discipline excessive risk taking). Rather regulation of remuneration should be designed to affect risk taking incentives of bank executives, and perhaps is better linked to returns to all the bank stakeholders than to shareholders.

For the former six main US Investment Banks Nestor Advisors (2009) found that remuneration was strongly aligned with long-term shareholder interest, but questioned whether this was in fact appropriate for systemically important financial institutions (SIFIs).

Chaigneau (2010) develops a formal model of socially optimal bank CEO remuneration in circumstances where alternative risky strategies can be taken and where deposit insurance/guarantees protect depositors and creditors from loss, and finds that structuring remuneration to align CEO incentives with shareholders is not optimal. As he notes “to the extent that the preferred strategy of the bank's shareholders is not socially optimal, then it is generally not socially optimal to let them set the incentives of bank CEOs”

From this review of (a relatively small part of) the literature on banker remuneration, the following conclusions can be drawn. First, there has been an increase in the role of performance related pay in banking over past decades. Second, performance related pay aligns management incentives with those of bank shareholders and may encourage greater risk-taking. Third, such alignment is not necessarily socially optimal, particularly in the presence of a financial safety net, and this can provide a rationale for the setting of regulatory parameters, such as deposit insurance premiums or capital requirements, to take into account characteristics of bank management remuneration arrangements. But, it is worth noting, while some studies may control for board characteristics in examining the relationship between remuneration and bank risk-taking, they do not generally cast much light on the important question of the relative roles of boards and executives in determining bank risk taking.

5. Bank Governance and the GFC

Interest in bank governance has increased significantly in the wake of the Global Financial Crisis (GFC) reflecting a prior comment by Levine (2004) that “[b]anking crises dramatically advertise the enormous consequences of poor governance of banks.” In the case of the GFC, those consequences were substantial as illustrated by data presented by Ladipo and Nestor (2009) for the ratio of the share price at the trough (Feb 2009) to its peak (Jan 2008) for the 25 largest banks (by initial market capitalization) in Europe. The highest ratio is 48 per cent, for 9 of the 25 banks the ratio is over 20 per cent, and there are 8 banks with a ratio below 10 per cent.

But as cautioned by Davies (2003) it is important to distinguish between failures of management and failures of governance. Financial institutions can get into difficulties because decisions which turn out to be poor ones are made by boards and executives operating within a good corporate governance structure.

Academic Studies

Beltratti and Stulz (2009) consider differences in performance of 98 large banks internationally to ascertain whether they can be attributed to different regulation, governance, or balance sheet characteristics. They do not find that poor governance, as measured by the Corporate Governance Quotient (CGQ score), explains poor performance during the GFC, and instead attribute differences in performance to balance sheet structures – where banks with boards more aligned with shareholders took ex-ante value adding positions which with hindsight exposed the banks to significant losses.

Adams (2009) compares the governance structures of banks with those of non-banks, focusing on standard indicators of governance characteristics such as board independence, board size, CEO remuneration etc. The data is for large financial and non-financial companies in the USA. While there are some differences in governance characteristics there is no clear evidence that they indicate that governance is worse in banks. When Adams compares banks which received TARP funds with those that did not, she finds that TARP recipients had larger and "busier" (more outside directorships) boards, and with more CEO incentive pay. The first two characteristics are generally thought to be consistent with poorer governance and consistent with the perception that TARP recipients, by virtue of requiring assistance were less well governed. The latter characteristic is consistent with higher risk taking by CEOs. However, TARP recipients were also characterized by having more independent boards – which Adams suggests may, in this case, indicate poorer governance in that independent directors may not have had adequate financial sophistication to assess risk taking by banks. Lower remuneration of directors at banks may also support this conclusion. A conclusion is that independence (and absence of conflict of interest) requirements for directors may have adverse effects on bank governance, particularly if legal liability is onerous.

Erkens, Hung and Matos (2009) examine the role of governance in the GFC using data for 296 of the largest financial firms from 30 countries. They find that financial firms with greater institutional ownership took more risks, and that greater board independence appears to lead to quicker reaction to bad outcomes. These responses, possibly reflecting reputational concerns of independent directors, include CEO turnover and capital raisings even though such raisings may be inconsistent with the best interests of current shareholders. While apparently at variance with the results of Adams (2009), both these studies highlight an important role for independent directors and the need for them to have adequate financial skills.

Official Views

The view expressed by Walker (2009) appears to be widely accepted. "The fact that different banks operating in the same geography, in the same financial and market environment and under the same regulatory arrangements generated such massively different outcomes can only be fully explained in terms of differences in the way they were run. Within the regulatory framework that is set, how banks are run is a matter for their boards, that is of corporate governance."

Ard and Berg (2010), from the World Bank, argue that many of the problems of the GFC can be traced to flawed implementation of good governance principles and excessive short term remuneration, and note that these were most apparent in some of the supposedly largest and most sophisticated financial institutions globally. They suggest four key areas have been identified: (a) risk governance (including information, assessment capacity, management and systems failings – including identifying and internally pricing risk-taking appropriately); (b) remuneration and incentive alignment (c) board professionalism; and (d) shareholder engagement.

In its Green Paper, the European Commission (2010) argues that "it is clear that boards of directors, like supervisory authorities, rarely comprehended either the nature or scale of the risks they were facing". The OECD, concludes that "the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance" (Kirkpatrick (2009)) emphasizing particularly failures in risk management systems and remuneration structures. The Basel Committee highlights "insufficient board oversight of senior management, inadequate risk management and unduly complex or opaque bank organisational structures and activities”. BCBS (2010)

Given these perspectives, it is particularly interesting to examine the results of Senior Supervisors Group (2009) November 2008 survey of twenty of the largest global financial firms, asking them to self assess their practices to industry standards proposed by industry and supervisory reports during that year. Their self evaluation against assessment topics saw all twenty grading themselves as fully aligned on governance roles and responsibilities, governance policies, governance internal coordination and communication. Eighty per cent or more graded themselves similarly on governance practices involving risk committees and role of the chief risk officer, and on risk disclosure and transparency and liquidity risk monitoring and planning and funding and reserve management. Where self assessment indicated least alignment was in areas more related to internal risk management practices, including inclusion of liquidity risk in transfer pricing, monitoring, mitigation and close-out practices for counterparty risk, stress testing, and dealing with new products.

6. Policies and Proposals

Regulatory and supervisory interest in bank governance arrangements has been building for a decade or more. The Basel Committee (2006) provides a list of corporate governance principles for banks (updating an earlier, 1999, document) and guidance to supervisors in assessing bank corporate governance standards. This has been further supplemented by a Consultative Document released in 2010 BCBS (2010), Their approach to corporate governance draws on the OECD approach which identifies a range of stakeholders, but also emphasizes internal processes including independent oversight, line management supervision, and independent risk, compliance, and audit functions. The 2006 Basel (eight) principles relate to Board member qualities, determining strategy and corporate values, ensuring suitable accountability, management and oversight structures, use of audit and compliance resources, compensation policies consistent with long term goals, transparency and disclosure, and knowledge of structure. It argues that supervisors should review governance arrangements, particularly that they give suitable acknowledgement to protection of depositors. As Mülbert (2010) notes the notion of governance implicit in the Basel Committee Principles is a broad notion which incorporates internal organizational structures, rather than the narrower shareholder focused one which emphasizes relationships between senior management, boards of directors and shareholders.

Comparison of Principles set out in the 2010 and 2006 Basel Committee documents (which are summarized and matched in Appendix 1) provides some interesting insights. In its 2010 Consultative Document BCBS (2010) the number of principles for good bank corporate governance has been expanded from 8 to 14. Of the eight 2006 principles, all can be found explicitly reflected (albeit with some changes in emphasis) in the 2010 document (although the references in principles 2 and 3 to communicating values and enforcing lines of responsibility etc *throughout the organisation* do not appear). There are three new principles relating to risk management responsibilities, structures and processes, one new principle relating to the Board's responsibility with regard to its own processes and practices, and two focusing on Board responsibilities and arrangements within group structures and where special purpose vehicles or operations in particular overseas jurisdictions create particular risks. Notably, there is no mention of a Board responsibility for the "living wills" requirement that some supervisors are in favour of.

Notably, the number of entries under the role of supervisors has fallen from 6 to 5, although there is an element of "tougher language" involved. While it is possible to "map" the 2006 items into corresponding elements of the 2010 set, there are some differences, such as a greater emphasis on coordination across jurisdictions. It is also asserted (item 4) that supervisors should require and enforce action when governance shortcomings are observed rather than determining suitability of practices and advising. What is particularly noticeable, however, is the absence of the second item in the 2006 list that "[s]upervisors should consider corporate governance as one element of depositor protection".

Regulatory responses have been proposed in each of the four areas of risk governance, remuneration, board professionalism, and shareholder engagement identified by Ard and Berg (2010). The recommendations of the UK Walker Review fall into these categories, and provide a useful framework for identifying issues commonly addressed elsewhere.

Risk Governance: The Walker Review proposed that banks should have specialised board risk committees, an empowered Chief Risk Officer, use appropriate external specialists, ensure acquisitions are subject to detailed risk committee scrutiny, and provide detailed risk reports in Annual Reports. These suggestions are reflected in the Basel 2010 principles, while risk reporting has been required for several years under the required Basel 2 disclosures. But what is particularly striking about the importance attached to this area is that enhanced risk management systems have been the focus of regulatory and bank attention for a number of years with large banks spending hundreds of millions of dollars in preparing for qualifying for the Advanced Internal Ratings Based approach in Basel 2.

Remuneration: The Walker Review proposed that bank board remuneration committees should set an overarching structure for bank remuneration policies and be responsible for setting remuneration and performance objectives of "high end" managerial employees. Disclosure of remuneration for high end employees should occur, those employees should be expected to build up an appropriate shareholding in the bank, and deferral of incentive payments should be a primary risk adjustment mechanism, and some form of shareholder vote on remuneration should be required. "In order to increase awareness and attention, it can be considered good practice that remuneration policies and implementation measures are submitted to the annual meeting and that there are procedures that enable shareholders to express their opinions." OECD (2010, p12). The G20 endorsed "the implementation standards of the FSB aimed at aligning compensation with long-term value creation, not excessive risk-taking" G20 (2009). In March 2010 the Financial Stability Board (2010) produced a report on progress internationally in implementing the principles on remuneration (which can be grouped under headings of governance of compensation, alignment with prudent risk taking, effective oversight by supervisors and stakeholders) which its predecessor the Financial Stability Forum had previously developed.

In some countries, the authorities have taken specific action on banker remuneration, in response to public concerns about taxpayer support for troubled banks being used for bankers' bonuses. In the US, the Dodd–Frank Wall Street Reform and Consumer Protection Act passed in July 2010, bank shareholders are provided with a relatively weak "say on pay" right through requirements for a three yearly vote on remuneration. This followed legislation in 2009 to limit executive salaries at banks receiving assistance under the Troubled Assets Relief Program (TARP) – perhaps inducing more rapid exit of large banks from that program. In the UK, the FSA introduced a remuneration code (reflecting the FSF principles) in August 2009 for banks, building societies and broker dealers, following earlier Government budgetary tax imposts on bonuses. The European Union issued the Capital Requirements Directive (CRD 3) in July 2010 involving deferral requirements for bonus pay, share-linked compensation requirements, and requirements to ensure that variable compensation is reduced when firm performance is poor.

Board professionalism: The Walker Review proposed that non-executive directors (NEDs) should be well briefed, supported, be able to devote adequate time (at least 30-36 days p.a. for NEDs of major banks and the Chairman's role requiring 2/3 time), provide an adequate spread and depth of expertise, and subject to appropriate "interrogation" by experts appointed by the supervisor prior to appointment. The Chairman and Senior Independent Directors have special responsibilities for ensuring challenge and leadership, and the board should have appropriate performance evaluation. The OECD (2010) argues that director shortcomings were particularly important in causing the GFC, with relevant issues including inadequate input from NEDs, insufficient diversity of directors, incomplete understanding of risks taken.

Many prudential regulators have in place "fit and proper" requirements for directors of financial institutions, but these focus primarily upon good standing etc rather than expertise. The OECD (2010) suggests that "such tests should extend to the technical and professional competence of board members, including general governance and risk management skills."

Within this context the OECD (2010) notes that market or stakeholder discipline to deal with conflicts of interest may be particularly significant for large financial institutions, reflecting their complexity and opaqueness. This was most apparent in the case of the Goldman-Sachs case where structured products (CDOs) were manufactured to best fit the preferences of a particular client wishing to take a short position on mortgage backed securities, and which were then sold to other clients. This issue also was significant in the

"Volcker" proposal (incorporated in the Dodd-Frank Act in the USA) to ban banks from engaging in proprietary trading, with both issues highlighting the difficulties of maintaining adequate "Chinese Walls" within financial institutions.

Shareholder Engagement: The Walker Review recommended that boards should be aware of the composition of shareholders, that institutional investors should be required to exercise their Stewardship role.

7. An Assessment

This paper commenced by noting that the corporate governance problem arises from the agency problems faced by suppliers of funds to business enterprises and that organizational structures and various control rights and monitoring devices are developed because complete contracting is not possible. It also noted that much of the corporate governance literature and focus has moved onto other issues, such as board size, composition, processes, which largely take as given the organizational structures and control rights in existence. The discussion thus rarely addresses the important prior question of whether the institutional /organizational structures and allocations of legal rights which have emerged are indeed suitable for achieving good governance.

Some part of the current discussion about regulatory change is related to inducing or forcing changes in institutional structures – but generally premised on concerns about financial stability rather than governance, even though various proposals can have significant governance implications. For example, suggestions for requiring separation of "utility" (commercial) banking from "casino" (investment) banking would have significant implications for governance arrangements. If nothing else, it would reduce the likelihood of remuneration structures perhaps suitable for one type of activity (such as the high-powered incentives in investment banking) being spread throughout the institution into other activities (commercial banking) where they are perhaps less suitable. More generally, such institutional separation (and different remuneration structures) may induce self-selection by managerial employees into institutions where their personal risk appetites better match those of the institution.

Another example of potentially fundamental change lies in proposals for requiring banks to issue “contingent capital” in the form of hybrid debt instruments which convert automatically into an equity stake should a set of pre-specified adverse outcomes occur for the bank. Investors in those instruments will expect some control or decision rights, with implications for the power of ordinary shareholders. For example, a requirement that holders of contingent capital have the right to elect one or more board members could be envisaged.

But these changes, involving relatively minor modifications to control rights, miss an important implication of the agency problem for suppliers of funds relating to banks. Shareholders in banks are very much minority suppliers of funds to banks, and legislative and regulatory systems have allowed owners of these institutions to exploit limited liability (arguably excessively) through high leverage. Limited liability, one of the great capitalist system innovations, brings benefits by enabling entrepreneurs to undertake risky ventures without exposing their entire wealth to loss. But it also enables those same entrepreneurs to expose the wealth of other non-equity investors to loss, while protecting the non-invested part of their own wealth from loss. It was not always so, with numerous examples in banking history of bank shareholders having double or unlimited liability[3]!

This ability for leverage and undertaking actions which expose funds provided by creditors to loss would be of little concern if those creditors were capable of assessing the risk involved and acquiring some decision or control rights which protected their position. Banks, themselves, do so when lending to companies. But this is hardly the situation applicable in the case of depositors, who are often poorly informed (and comforted by perceived government protection) and where further (equal priority, potentially diluting) deposits can be raised by the bank without prospectus or need for approval by existing depositors. Arguably, there is a fundamental flaw in the governance arrangements for banks whereby the dominant providers of funds (depositors) have no control rights in the form of “voice” and can exercise influence only by “exit”. In this regard, the deletion from responsibilities of supervisors in the Basel Committee’s 2010

[3] Esty, B, 1998, The Impact of Contingent Liability on Commercial Bank Risk Taking, Ibid.47, 189-212. finds, in a study of US banks between 1900 and 1915 that stricter liability rules reduce bank risk taking.

document that "[s]upervisors should consider corporate governance as one element of depositor protection" seems a retrograde step.

But there is a potentially more significant flaw in the conventional analytical approach to corporate governance which envisages shareholders as long-term owners of banks and effective controllers of the organisation. Modern stock markets have facilitated the use of "exit" rather than "voice" as a means for equity investors to exert influence, and with share-turnover rates often exceeding once per year it is difficult to interpret shareholders as long-term owners exercising control rights. Here, with two exceptions, there is a disjunction with regulatory approaches, which seem to place no importance on shareholders having a role in corporate governance. The Basel Committee's suggested fourteen principles, for example, do not mention shareholders except in principle fourteen where they are treated equivalently with depositors and other stakeholders. Boards are treated as effectively self-perpetuating entities with composition determined by use of nominating committees, perhaps influenced by regulators (through fit and proper requirements), but with limited scope for effective shareholder influence.

The two exceptions mentioned are worth noting. One relates to the common use of maximum shareholding limits, which reduces the potential for a dominant shareholder which some studies (eg Caprio, Laeven and Levine (2007)) find is associated with better performance (but also higher risk-taking). The second is the attempts to get institutional investors such as fund managers to exercise a "stewardship" role on behalf of their clients as the ultimate shareholders in the bank. But as the European Commission (2010) notes, short-termism of institutional investors, the free-rider problem for shareholder activism, lack of effective shareholder power, and inadequate disclosure to enable informed decision making, are all factors which create complications.

Whether these issues should lead to an empowerment of depositors in governance arrangements (such as having a right to representation on the Board), or whether director's obligations should be legally respecified to place a fiduciary duty to depositors ahead of shareholders (as occurs in the case of Australian life insurance companies and their policyholders), are questions which have not been seriously addressed.

Also potentially relevant is the argument advanced by Sarra (2009) that the growth of financial derivatives has weakened the correspondence between stakeholders' legal control rights and economic interests on which traditional approaches to corporate governance is based. Shareholders and creditors can hedge their economic exposures using (respectively) equity and credit derivatives with third parties taking on such exposures but with no control rights. Alternatively, third parties may have contracts with stakeholders which effectively give them control rights in some circumstances, meaning that directors and managers may not know who are the ultimate stakeholders for whom they are operating. Where derivative transactions change incentive structures, monitoring by large creditors or shareholders which provide externalities in governance arrangements to other "free-rider" stakeholders may no longer exist. Sarra argues that the traditional approach to corporate governance (and corporate law) assumes control rights reflect incentives to monitor due to economic interest, and that without the latter, control rights can involve moral hazard. He suggests that responses to these developments should include disclosure of economic interests acquired in derivative transactions,

Whether we know enough about how to design banker remuneration arrangements is also unclear – particularly since it is not clear what types of incentives they should be aiming to generate. Alignment with (even long term) shareholder interest is not obviously socially optimal in the presence of a financial safety-net. Attempting to "cap" bankers' pay in response to populist demands is a forlorn task, and perhaps there is merit in investigating imposing some form of "downside" risk whereby individual wealth is at risk so as to induce appropriate risk aversion and prudence. (Requiring remuneration to be taken in deferred partly paid shares, could be one option). Ideally such incentive structures might also lead to decisions to divest particular activities into institutions which operate outside the financial safety net.

A global approach to implementing internationally common regulatory arrangements and governance principles and standards, such as has been adopted through the Basel Committee and the Financial Stability Forum, may also be missing an important perspective. Quite significant differences occur in ownership structures around the world. The impact of regulation will depend upon its interaction with private governance arrangements, and different governance arrangements may be appropriate for different types of ownership arrangements, such that a “one size fits all approach” is not appropriate. More generally, much of the empirical research evidence on bank governance stems from the US where studies are typically conducted on Bank Holding Companies (BHC) raising the question of whether this particular organizational structure involves idiosyncratic governance characteristics. As Adams and Mehran (2004) note BHCs “often have a complicated hierarchical structure through their ownership or control of banks, lower level BHCs and other subsidiaries. Each of these subsidiaries is separately chartered and therefore has its own board”. They conclude that “the role of the board may be different in holding companies.” In this regard, if pronouncements by multinational agencies lead to uniform international governance principles and practices, the general approach to corporate governance regulation of “comply or explain” may be more appropriate than a “comply or else” approach such as suggested regarding higher capital requirements for banks with governance arrangements not preferred by regulators.

BHCs have become the dominant form for banking organizational structure in the US reflecting growth of interstate activities and an increasing range of activities. This prompts an important question: have large, modern, financial institutions become too complex and large to be adequately governed? Risk management is particularly critical[4] and as Davis (1999) noted “[t]he changing nature of employee and management activities within financial firms, away from traditional activities such as transaction processing and toward decision oriented activities in a deregulated environment, gives rise to greater potential for risk and outcomes not expected or desired by other stakeholders in those firms.” This has been aggravated by complex corporate structures. As noted by Senior Supervisors Group (2009) “A key lesson of the crisis, drawn by both firms and supervisors, was that complex corporate structures hindered effective contingency funding”.

In this regard, Blundell-Wignall, Wehinger and Slovik (2009) advance the view that banks should be required to adopt a non-operating holding company (NOHC) structure in order to achieve a separation of commercial banking from investment banking which still

[4] Surprisingly, given that risk taking and management is one of the key economic functions of banking, Nestor Advisors, 2008. *Board profile, structure and practice in large European Banks: A comparative corporate governance study*. found that only 44 per cent of the Boards of the 25 largest European banks by market capitalization had a specialized Risk Committee.

allows economies from use of common shared services. Dedicated subsidiary governance arrangements, together with separate capitalization, may improve governance and ease some of the difficulties in supervising and dealing with resolution of SIFIs. In Australia, Macquarie Bank restructured in 2007 into a NOHC structure, providing an interesting potential case study to assess the merits of such a structure.

A further issue worth examining is whether the joint-stock form is preferable to mutual or collective style structures for operation and governance of particular banking activities. These latter institutions remove the depositor-owner agency problem (since they are one and the same) but potentially involve greater management-owner agency problems, with this incentive structure consistent with lesser risk taking as Esty (1997) finds in a study of the US savings and loan sector. While it may be argued that their decline in importance in recent decades is a reflection of market forces weeding out inferior, non-competitive, organisational structures, their demise can also be traced to other, less sanguine, factors. Regulators have tended to be antipathetic towards them, and regulatory requirements to build capital reserves has made them ripe for expropriation via demutualisation.

8. Conclusion

There is much ongoing research, and regulatory action, on bank governance. But there is relatively limited evidence that knowledge gained from empirical studies, or from theory, has underpinned regulatory proposals and approaches. That perhaps reflects a lack of clear guidance from empirical work, and the focus of regulators on boards and internal arrangements rather than a focus on the nature of the underlying agency problems which the organizational structures found in modern financial institutions generate.

Theoretical studies, which recognize the interaction of the financial safety net and governance, suggest that some more fundamental issues involving organisational structure warrant addressing. And these issues have assumed even greater importance following government responses to the GFC which have undermined whatever perceptions previously existed about absence of implicit government guarantees of important financial institutions. How should control and decision rights be allocated amongst providers of finance in highly levered, implicitly government-supported, financial institutions? What restrictions on the range and mix of financial activities in such institutions might generate socially optimal governance arrangements? To whom should boards of directors have primary fiduciary duties? What contingent liabilities should stakeholders in failed financial institutions have? How should regulatory requirements (capital adequacy, deposit insurance premiums etc) be amended to take into account differences in "governance" characteristics across financial institutions? These are the sorts of questions warranting further attention.

APPENDIX 1: The Basel Bank Corporate Governance Principles

BCBS 122 February 2006

Principle 1
Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.
Principle 2
The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation.
Principle 3
The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.
Principle 4
The board should ensure that there is appropriate oversight by senior management consistent with board policy.
Principle 5
The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.
Principle 6
The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.
Principle 7
The bank should be governed in a transparent manner.
Principle 8
The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (i.e. "know-your-structure").

APPENDIX 1 (cont.): The Basel Bank Corporate Governance Principles

BCBS 168 May 2010

Principle 1
The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The board is also responsible for providing oversight of senior management. (BCBS 122 #2)
Principle 2
Board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank. (BCBS 122 #1)
Principle 3
The board should define appropriate governance practices for its own work and have in place the means to ensure such practices are followed and periodically reviewed for improvement.
Principle 4
In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.
Principle 5
Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board. (BCBS122 #4)
Principle 6
Banks should have an independent risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board.
Principle 7
Risks should be identified and monitored on an ongoing firm-wide and individual entity basis, and the sophistication of the bank's risk management and internal control infrastructures should keep pace with any changes to the bank's risk profile (including its growth), and to the external risk landscape.
Principle 8
Effective risk management requires robust internal communication within the bank about risk, both across the organisation and through reporting to the board and senior management.
Principle 9
The board and senior management should effectively utilise the work conducted by internal audit functions, external auditors and internal control functions. (BCBS 122 #5)
Principle 10
The board should actively oversee the compensation system's design and operation, and should monitor and review the compensation system to ensure that it operates as intended. (BCBS 122 #6)
Principle 11
An employee's compensation should be effectively aligned with prudent risk taking: compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment. (BCBS 122 #6)
Principle 12
The board and senior management should know and understand the bank's operational structure and the risks that it poses (ie "know-your-structure"). (BCBS 122 #8)
Principle 13
Where a bank operates through special-purpose or related structures or in jurisdictions that impede transparency or do not meet international banking standards, its board and senior management should understand the purpose, structure and unique risks of these operations. They should also seek to mitigate the risks identified (ie "understand-your-structure").
Principle 14
The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants. (BCBS 122 #7)

APPENDIX 1 (cont.): The Basel Bank Corporate Governance Principles

The Role of Supervisors

BCBS 122 Feb 2006

1. *Supervisors should provide guidance to banks on sound corporate governance and the pro-active practices that should be in place.*
2. *Supervisors should consider corporate governance as one element of depositor protection.*
3. *Supervisors should determine whether the bank has adopted and effectively implemented sound corporate governance policies and practices.*
4. *Supervisors should assess the quality of banks' audit and control functions.*
5. *Supervisors should evaluate the effects of the bank's group structure.*
6. *Supervisors should bring to the board of directors' and management's attention problems that they detect through their supervisory efforts.*

BCBS 168 May 2010

1. *Supervisors should provide guidance to banks on expectations for sound corporate governance.(BCBS 122 #1)*
2. *Supervisors should regularly perform a comprehensive evaluation of a bank's overall corporate governance policies and practices and evaluate the bank's implementation of the principles. (BCBS 122 #3)*
3. *Supervisors should supplement their regular evaluation of a bank's corporate governance policies and practices by monitoring a combination of internal reports and prudential reports.(BCBS 122 #4)*
4. *Supervisors should require effective and timely remedial action by a bank to address material deficiencies in its corporate governance policies and practices, and should have the appropriate tools for this. (BCBS 122 #2)*
5. *Supervisors should cooperate with other relevant supervisors in other jurisdictions regarding the supervision of corporate governance policies and practices. The tools for cooperation can include memorandum of understanding, supervisory colleges and periodic meetings among supervisors (BCBS 122 #5).*

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