CHARACTERISTICS OF THE CORPORATE GOVERNANCE OF BANKS

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Abstract

This paper analyses the corporate governance of banks. The banking sector industry is somewhat unique because it is simultaneously consolidating and diversifying. We study the specific characteristics of banks in the view of the current economic framework and the implications of these characteristics for the governance of banks. We focus on the following characteristics of banks: the capital structure, the equity ownership, the approach to disclosure, the stakeholder groups, the competition as a mechanism of corporate governance, the increased regulation and supervision in the banking sector. Banks respond to risks and increased regulation through specific operations as governance control mechanisms. The paper concludes with the importance of corporate governance of banks for the adequate functioning of economies.

Key words: corporate governance, banking, regulation and supervision, stakeholders

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Introduction. Importance of banks and their governance

The topic of governance of banks has been approached to a lesser extent than the governance of non-bank firms. Banks' governance is a subject of particular importance and challenges because of the role of banks in economy and the current regulatory environment. Most authors agree that extended research is necessary.

Significant attention has been given to the role of banks in the corporate governance of other firms. The importance of this role and the role of banks in economy explain the particularities of their corporate governance. Previous research focuses on the following two areas: the specificity of banks and their increased regulatory environment. These two aspects shape the governance framework of banks, which differs from other firms. Visentini (1997) states that the observed forms of corporate governance of banks emerge in the course of their operations as entities having to respect the private interest of owners, on the one hand, and the public interest in the overall stability of the system, on the other hand.

Previous literature analyses the implications of banks' specific attributes on their corporate governance framework. Two aspects are emphasised: greater opaqueness and greater regulation. Whether these attributes have a weakening effect on the traditional corporate governance mechanism is a matter debated by most research papers on the subject.

Banks have a critical position in the development of economies due to their major role in the running of the financial system. The banking industry is somewhat unique because it is simultaneously consolidating and diversifying (Koch and MacDonalds, 2002). Banks have a major role in the functioning of firms, contributing to the formation, increase, monitoring and allocation of their capital and stimulating productivity growth. As a result, they have a major role in the governance of other firms. These responsibilities increase the importance and complexity of banks' own governance.

The importance of banks to the stability of the financial system places them in a particular position of the agency-principal framework. The agency problem is more complex. The principal is represented by a range of claimants whose protection is more profound.

We study the specific characteristics of banks in the view of the current economic framework, the implications of these characteristics on the governance of banks and banks' responses to risks and increased regulation as governance control mechanisms.

Capital structure

An aspect that distinguishes banks from other firms is their capital structure, which is unique in two ways (Macey and O'Hara, 2003). Firstly, banks have little equity relative to other firms and receive 90% of their funding typically from debt. Bond holders and depositors provide the rest. Second, banks hold illiquid assets that often take the form of loans without maturity. Banks have liabilities in the form of deposits that they issue to creditors or depositors, thus creating liquidity for the economy.

A mismatch between deposits and liabilities may cause a collective-action problem among depositors. This can cause the failure of a bank, with externalities effects. Consequently, the liquidity function may create problems in the governance of banks. High loan growth raises bank capital requirements, as regulators consider most loans to be risky assets. One regulatory measure against such risks is the deposit insurance, which is considered successful in achieving what had been a major objective of banking reform for at least a century, namely the prevention of banking panics[2].

Banks react to these risks through different mechanisms. Different size banks pursue different strategies. Small- to medium-size banks continue to concentrate on loans but seek to strengthen customer relationships by offering personal service. Large banks

[2] Macey and O'Hara (2003), based on Friedman and Schwartz (1963)

respond through securitisation, a process of converting assets into marketable securities (Koch and MacDonald, 2002). These strategies reflect banks' governance control.

Equity ownership

As with all publicly-owned firms, the diffuse and concentrated ownership of banks are aspects that influence their governance mechanisms. Diffuse ownership can effectively exert corporate control directly through their voting rights and indirectly through electing the board of directors. Information asymmetries are an impediment for shareholders and debt holders to exert control over management. In the case of banks, due to their opaqueness, diffuse shareholders and diffuse debt holders find it difficult to exercise control. This situation is managed by more concentrated ownership and increased regulation.

Concentrated ownership enhances firms' control and monitoring of its activity through a better flow of information. Large shareholders and large debt holders are more effective in exercising their rights, thus having more control over management. This context should theoretically lead to better governance of firms. In practice, evidence shows that large shareholders may exploit their interest in the firm, thus undermining its governance.

Generally, banks have a concentrated equity ownership, which makes it more difficult for small equity holders to exert influence over the management of banks. Controlled ownership by large investors may also affect the interest of debt holders – either diffuse or concentrated – and on other stakeholders, leading to a more complex corporate governance environment for banks.

A legal system that prevents large shareholders controlling a bank from taking advantage of the small and diffuse stakeholders has the potential to stimulate good corporate governance.

Transparency and disclosure

Transparency is one of the main principles of corporate governance. This principle is applied to a lesser extent in the banking sector. The opaqueness of banks is factored by their sensitive operational environment: loan operations to individuals, to large entities and to governments, capital funding of firms, banks' interaction with Central Banks and governments.

Notwithstanding the lack of transparency, shareholders and other stakeholder groups do not generally complain about the non-compliance with this governance principle. One explanation is that the risk of banks' failure is not as high as the risk of non-financial firms' failure. It is often argued that banks are "too large to fail", in reference to the major stakes that governments have in these entities. In addition to funding the economy, banks also perform in a political context, which enhances the gravity of a potential failure. As a result, entities such as states and prudential supervisory bodies dominate the banking sector in order to minimize the risk of failure.

Literature presents different points of view with regard to the transparency of banks. Levine (2004) examines the implications of opaqueness for the governance of banks by diffuse equity holders and diffuse debt holders. Opaqueness may help controlling holders to exploit their stake, to facilitate the manipulation of loan operations and compensation packages. This comes at the expense of the long-run health of the banks, their diffuse shareholders and their diffuse debt holders. The opaqueness of banks may weaken market competitive forces, affecting the efficiency of the securities market. All stakeholders are negatively affected, including diffuse shareholders, customers and governments. Morgan (2002) states that "banks appear to be among the more opaque industries, but not the most opaque one". Macey and O'Hara (2003), based on a statement by Furfine (2001), argue the notoriously opaqueness of banks' balance sheet and the effects of the technology on the difficulty of monitoring banks by traditional regulation and supervision. Flannery et al (2002) consider that special government supervision can enhance banks' transparency.

Governments impose strong regulation on the banking system, by restricting the concentration of bank ownership. This is to avoid the concentration of power and control of banks, thus enhancing disclosure.

Improving the flow of information through increased disclosure enhances market discipline. This is the rational behind the third pillar of the Basel Capital Accord. The Basel Capital Accord proposes disclosure of capital adequacy and risk exposure and assessment by banks. This is designed to allow markets to have a better picture of the overall risk position of the bank and to allow the counterparties of the bank to price and deal appropriately. The importance of market discipline for a sound financial system is supported by the Basel Committee on Banking Supervision: "Supervisors should encourage and pursue market discipline by encouraging good corporate governance and enhancing market transparency and surveillance"[3].

Corporate governance context for banks: Stakeholders

From a generic perspective, banks are viewed as any firm with a broad range of stakeholders. In the case of banks, the group of claimants includes shareholders, who contribute to the formation of capital, as well as other categories who have a direct interest, such as: creditors, employees, general public, governments and regulators.

Referring to corporate governance models and viewing a comparison between the Anglo-American and the Franco-German models, Macey and O'Hara (2003) note the strange fact that paradigms of corporate governance differ on the basis of national boundaries rather than on the basis of the indigenous characteristics of the firms being governed. The Anglo-American corporate governance approach focuses on the interests of maximizing

[3] The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy that national supervisory authorities are now working to implement through domestic rule-making and adoption procedures. Pillar 1 of the new Basel Capital Accord refers to the minimum capital requirement. Pillar 2 refers to the supervisory review process; it complements the minimum capital requirement of pillar 1 and looks at a bank's internal procedures to manage and control risk. Pillar 3 strengthens the role of market discipline. For the original Basel II document, see Bank of International Settlements (BIS) publications.

shareholder value, while the Franco-German model considers the interests of all stakeholders.

In the case of banks, the two authors find a hybrid approach, in which most firms are governed according to the US model, while banks are governed according to the Franco-German paradigm. The governance of banks is targeted at the interest of its shareholders, employees, creditors, local communities, customers and regulators.

There is a significant public dimension to the banking firm. In the banking context, depositors' savings and government interests are at stake (Macey and O'Hara, 2003). When the social costs of an outcome exceed the private costs of an outcome, there is a negative externality effect. In this case the failure of a bank can influence the functioning of the entire banking system. The positive externality effect is also acknowledged: good individual performance improves the health of the banking system, which benefits all stakeholder groups.

In this context, the corporate governance model argues that shareholders are not the exclusive beneficiaries of fiduciary duties. Non-shareholder constituencies claim fiduciary duties from management, in certain circumstances requesting higher protection than the duty performed in relation to shareholders. The special nature of banking requires that management duties are more extensive than those of other directors. Managers function in the light of two distinct sets of interests: one is the private interest internal to the firm and the other is the public interest external to the firm. From the banks' governance perspective, the agent seeks that behaviour beneficial to the firm's interest does not compromise the public interest (Ciancanelli and Gonzales, 2000).

Mechanisms of corporate governance: product competition and takeovers

Shleifer and Vishny (1997) analysed solutions for solving the problems of banks' corporate governance. One solution is competition, referring to product competition and takeovers. The two authors conclude that product competition, although being the most powerful force towards economic efficiency, can not solve the problem of corporate governance. Analysing the takeover element, the two authors consider it as a second corporate governance mechanism only in the US and the UK markets.

Koch and MacDonald (2002) identify five forces of change in the banking sector, which transform the structure of markets and institutions: deregulation, financial innovation, securitisation, globalisation and advances in technology. The latter factors actually represent responses to regulation.

Levine (2004) analyses the effects of opaqueness on the competition in the banking sector. The opaqueness of banks can weaken competitive forces, affecting product competition and the takeover activity. The author observes that product market competition is less frequent in the banking sector due to the personal relationships that banks establish with their clients.

Regarding the takeover activity in the banking sector, Schoenmaker (2005), based on Walter (2003), presents empirical research on cross-border mergers and acquisition of financial institutions. Research shows that, between 1996 and 2000, the bulk of financial restructuring occurred on an in-sector and domestic basis. For Europe, cross-border intra-European mergers and acquisitions amounted to 29% of the European total. These figures differ considerably across sectors. The banking sector amounted to 17% of the total figure. According to Walter (2003), these figures possibly suggest somewhat different economic pressures at work. Schoenmaker debates whether the low percentage of cross-border activity in the banking sector reflects the abuse of national provisions, formally based on current legislative EU banking framework in a protectionist manner.

Among the 15 EU former member countries, the cross-border penetration in Luxembourg and Sweden is higher than the average. As at 2003, Luxembourg had a share of foreign banks in total assets of 94% and Sweden of 59%[4]. The extent of cross-border penetration is greater in the newly acceded EU countries than in the 15 former EU countries. The

[4] Source: ECB (2003)

new EU member states have a share of foreign banks in total assets between 60-100%. They also have a higher degree of concentration than in the euro zone (Lannoo, 2005). Hostile takeovers are rare in the banking sector, due to stricter regulatory requirements.

The decrease in product competition and the tension present in the cross-border takeover activity may stimulate competition for good governance of banks. Supervisory practices could be further developed via benchmarking based on best practices (Schoenmaker, 2005).

Increased regulation and supervision

The need to streamline the structure of the financial regulation and supervision and the requirements to adapt this structure to market developments led to reforms in the financial sector and, particularly, in banking. The increase in regulation in the banking sector took place during the second half of last decade.

Given the importance of banks for the economic development and their political context, the banking sector is more regulated than other sectors across all countries. The regulatory framework is not homogenous. In some countries, state intervention is more significant than in other countries.

Most governments restrict the concentration of bank ownership, which is a major corporate governance control mechanism. There are restrictions set on the ability of outsiders to purchase a substantial percentage of bank stock without regulatory approval (Levine, 2004). Restrictions on corporate control may improve corporate governance in cases where banks are controlled by shareowners who use their concentration power for their own interest and in the detriment of small stakeholders.

Central Banks have a significant role in regulating the banking system. According to Healey (2001), the involvement of Central Banks in their lender of last resort role and monetary policy objectives has led them to be intrinsically interested in the stability and general health of the financial system. Concerns over the moral hazard that might result from the emergency assistance and the potential cost of financial instability in turn led Central Banks to take a closer interest in the behaviour of individual banks. Often, but not always, this resulted in the Central Banks supervising and, if necessary, regulating the banking system.

Regulation in the banking industry is enhanced by the intervention of international supervisory bodies, such as World Bank, International Monetary Fund, US Federal Reserve, and Central European Bank (ECB). In Europe, the ECB founded a Banking Supervisory Committee, by which supervisors would inform the Eurosystem as soon as any problems in the banking system arise (ECB, Annual Report 1999).

The pros and cons of moving supervision to the European level have been extensively debated in the literature. Prati and Schinasi (1999) argue that national authorities are not well placed for managing a crisis involving pan-European banks. As pan-European banking groups emerge, supervisors with national orientations are less likely to be able to assess bank soundness and systemic risks in an adequate manner (Schoenmaker, 2005). Prati and Schinasi (1999) conclude that the ECB should assume a more ambitious role in crisis management.

Centralisation of supervision may help preserve financial stability in an integrating European system (Schoenmaker, 2005). Nevertheless, there is a strong case for decentralisation. In this regard, Padoa-Schioppa (1999) draws a relevant picture of the Italian banking system:

- Small banks are supervised by the respective regional branch of Banca d’Italia;
- National Banks are supervised by the respective branches, but key-decisions are taken at the headquarters of Banca d’Italia in Rome; and
- Pan-European banks are supervised by a group of national supervisors working collectively in a multilateral mode as a single consolidated supervisor.

Centralisation in the EU banking legislation illustrates a tendency towards a "one-size fits all" approach. Corporate governance tends to avoid a "one-size fits all" approach, because the governance context is largely based on social, political and economic differences. We state that centralisation, especially when enhanced by strong regulation, may create pressure on the governance of banks. Fostering market discipline by introducing mechanisms for prompt corrective action is a viable solution for sustaining governance.

Previous literature debates whether increased regulation hinders corporate governance in the banking sector. Authors often raise the question as to whether increased market control mechanisms, as opposed to stronger regulation, support better governance in the banking sector. Ciancanelli and Gonzales (2000) argue that commercial banks are distinguished by a more complex structure of information asymmetry arising from regulation. Regulation limits the power of markets to discipline the bank. Does the fact that regulators are among the principles in the agency-principal relationship enhance the complexity of banks' governance?

Banks respond to tight regulation through mechanisms such as financial innovation, securitisation, globalisation and new technologies. We consider that these responses, if managed adequately, may have stimulating effects on the governance of banks.

Conclusion. The importance of banks' sound corporate governance

Given the significant role of banks at macroeconomic and firm levels, their corporate governance context is of major importance.

At a macroeconomic level, good corporate governance of banks enhances its credibility, having positive effects upon economic development. On the contrary, weak governance of the banking system that overlooks the interests of its stakeholders has negative implications for the entire economic system.

Looking at the level of firms, sound governance of banks increases the efficiency of their funding mechanisms, which has a positive effect on the governance mechanisms of firms funded by banks.

There is a rolling effect of the corporate governance mechanisms of banks, as systems that influence the performance of all entities in the economic system. Sound governance of banks will be transmitted to the governance of firms, which enhances productivity and efficiency of the economy as a whole. Poor governance of banks may have critical effects on economies.

The environment in which banks operate has an increased level of risk due to the complexity of the financial environment and the trend in decentralisation. Good governance of banks sustained by a proper regulatory environment and proper directors' duties have a critical role in monitoring risks.

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