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Corporate governance issues for banks. A financial stability  
perspective

by

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**DISCUSSION  
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A FINANCIAL STABILITY PERSPECTIVE**

**by**

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\* Comments by P. Van Cayseele and C. Van Hulle have been appreciated greatly. The remaining errors are the author's own responsibility.

# **CORPORATE GOVERNANCE ISSUES FOR BANKS. A FINANCIAL STABILITY PERSPECTIVE**

**Prof. Dirk Heremans**

## **INTRODUCTION**

Corporate governance is being challenged by increasingly fluid and global market places. Recently, accounting scandals and the corporate crisis involved have moved the corporate governance debate to the forefront of public policy.

In the aftermath of these crises, financial institutions and banks in particular, are expected to play an active gatekeeper role monitoring the behaviour of their corporate clients<sup>1</sup>. This evolution necessarily brings into focus the corporate governance of the monitoring banks themselves, as it also evolves within the rapidly changing financial landscape.

The major issue to be addressed in this contribution is whether corporate governance principles specifying the organisation of the relationships within the corporation are homogenous to all firms. Specifically the question is whether the (optimal) corporate governance design for non-financial firms is to be extended to the banking firms as banks are subject to financial regulation reflecting the overall concern for stability of the financial system.

This question is approached first by investigating the specific characteristics of banks, how these specificities affect agency problems for banks as well as the functioning of the governance mechanisms put in place in order to cope with agency distortions. It appears that corporate governance tends to focus on equity governance, whereas for banks debt agency problems are also a serious concern if only as the result of a very high debt to equity ratio in financial intermediaries (see Dewatripont and Tirole, 1994).

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<sup>1</sup> See Blommestein, 2006, or Degryse and Van Cayseele, 1999.

Next, taking a banking stability perspective the relationship between risk taking by banks and governance structures are further explored. Trade-offs between equity governance and debt governance for banks affect the choices for specific governance mechanisms, but also the broader debate on the appropriateness of different corporate governance systems.

Third, after evaluating ownership structures, functioning of the board of directors and remuneration systems with respect to their impact on bank's risk taking, an attempt is made to outline an adapted corporate governance model for banks

Finally, the framework for the conceptualisation of these issues awaiting further empirical evidence, is extended briefly to non-bank financial institutions. It is also used for a brief (critical) assessment of some recent EU legislative initiatives w.r.t. corporate governance.

## **1. CORPORATE GOVERNANCE: WHAT IS SPECIFIC FOR BANKS?**

Corporate governance arrangements specify the distribution of rights and responsibilities among different participants in the corporation and spell out the rules and procedures for making decisions in corporate affairs. Through this structure the company objectives are set and the means provided for attaining those objectives and for monitoring performance (see OECD 1999).

According to an extensive and ever growing economic literature the modern corporation is to be approached as a “complex web or nexus of contractual relationships” facing “agency problems” in its organisation.

Traditionally the focus is on “equity governance” i.e. the conflicts of interest between owners and management, and/or between controlling and minority shareholders. The challenge is to constitute an efficient monitoring structure for these conflicting interests.

This, however, may be too limited a view with respect to the general corporate finance problem, i.e. raising finance efficiently. Corporate finance includes both equity and debt.

Corporate governance mechanisms may have to be set up in a way that limit agency distortions also in raising debt, i.e. for debt governance<sup>2</sup>.

Banking firms constitute a “web or nexus of contractual relationships” and hence face also agency distortions in raising finance efficiently. The issue to be further investigated is whether these agency problems w.r.t. the conflicts of interests and the scope of stakeholders involved present special characteristics for banks compared to non-financial firms. To what extent does this affect existing corporate governance arrangements? Should they be designed differently for banks?

### **Bank Characteristics and Agency Distortions**

Banks present several specific characteristics that may affect agency problems. Banks are highly leveraged firms, i.e. with a very high debt to equity ratio on their balance sheet. An important part of their debt consists of highly liquid demand deposits. Their assets to the contrary being illiquid, the maturity mismatch involves substantial risks for their debt holders.

The nature of their products and services, as well as of their claimholders differs from non-financial firms. Bank products are of a fiduciary nature and bank balance sheets are notoriously opaque for investors. The quality of the loan portfolio is difficult to evaluate and financial products become increasingly complex. Information asymmetry problems are very serious, making it difficult to monitor the behaviour of banks. Moreover, the multitude of debtors, i.e. small depositors, are non experts in monitoring. Hence, banks rely critically on depositor confidence<sup>3</sup>. The situation is different in non-financial companies, where debtholders have generally more incentives and expertise in monitoring. Moreover, in non-financial companies debt is mainly in the hands of a few specialised debtholders. The main creditors are often banks themselves which have the necessary expertise and power to play a disciplining role in case of financial distress.

Banking, moreover presents systemic externalities raising special concerns for bank solvency and financial stability. The threat to the stability of the financial system depends

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<sup>2</sup> With the focus no longer on equity governance, i.e. only on shareholders value, corporate governance may be approached within an even broader view of the stakeholder society. Corporate governance is then defined as the design of institutions that induce or force management to internalise the welfare of all stakeholders (Tirole, 2001). This broader scope, however, will not be explicitly pursued in this contribution.

<sup>3</sup> For a survey see e.g. Llewellyn, 2004.

on the occurrence of negative disturbances and the presence of negative externalities such that economic shocks have a system-wide character. Traditionally systemic risks find their origin predominantly in banking problems. Banks are subject to many shocks as they face different types of risk such as liquidity, credit, market and operating risks. Moreover, the banking system contains powerful propagation mechanisms that can amplify small initial shocks as they are much more interconnected than is the case in other sectors of the economy. Bankruptcy of one institution may easily spill-over to others and endanger the whole financial system. Whereas traditional contagion mechanisms of runs by depositors on banks in trouble may no longer apply in a world where depositors benefit from deposit insurance, these domino effects are more likely to occur at the wholesale level, in particular through the interbank market. The greater reliance on interbank financing may decrease the probability of individual bank failure, but increases the probability of total collapse. Real economic activity may severely be disrupted as money production is at the core of the banking system. It is a special commodity with a vital payments function in the economy. The wider macroeconomic distortions in case of bank's distress explain the special concern for banking and financial stability<sup>4</sup>.

The question then arises whether these specific bank characteristics create specific corporate governance concerns for banks compared to non-financial firms?

Hence, we address the two standard types of agency distortions relating to equity governance, but introduce also a third one concerning debt governance, which may be of particular importance to banks.

*Type 1: Management control bias: conflict between shareholders and management.*

Conflicts of interest arise in firms due to the separation of ownership and (management) control as stressed originally by Berle and Means (1932). With external finance by equity holders managers earn less than the full return on their effort. Hence, their incentives to exert effort may be too low and they have an interest in pursuing their private interests. Dispersed shareholders face a free rider problem and have little incentive to monitor managers. Excessive managerial power then amounts to the expropriation of (dispersed) shareholders by management.

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<sup>4</sup> See Heremans, 2003 for a further analysis of systemic risks in Europe in the context of a single financial services market and a consolidating financial sector.

As financial products are very information intensive, i.e. opaque and of a fiduciary nature due to market imperfections and information asymmetries characterising the financial sector, it becomes even more difficult to control management in the banking sector<sup>5</sup>.

*Type 2: Expropriation of minority shareholders: conflicts between controlling and minority shareholders.*

Controlling blockholders may have incentives and the power to pursue their own private interest in companies. Through transactions which are not conducted at arm's length, especially within group structures, they may shift wealth to other members, thereby abusing small (more dispersed) shareholders.

The incentives for controlling owners to expropriate corporate resources, however, very much depend on their cash flow rights as will be further argued below.

As financial products are very opaque and the balance sheets of banks very complex, inside transactions are more difficult to control by small shareholders. Moreover, they lack the incentives and also the necessary expertise to do so. Hence, type 2 agency problems may become more serious.

*Type 3: Risk shifting to debt holders: conflicts between shareholders and creditors*

Shareholders have convex claims on the income of the firm, while debtholders' claim are concave (see J. Tirole, 2006). Equity holders earn the residual income i.e. all the upside potential and only a limited downside loss. Hence, they have an incentive to engage the firm in taking (excessive) risk. In fact these risks are shifted to debt holders who are only entitled to a fixed contractual payment.

This moral hazard problem certainly is more serious in the financial sector compared to other sectors in the economy. The high proportion of debt in total liabilities and the resulting high leverage of banks, facilitates risk shifting by shareholders. The opportunities for risk shifting are also larger given that the debt holders are dispersed and non-experts compared to the monitoring by creditors in non-financial firms<sup>6</sup>.

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<sup>5</sup> See Devriese, Dewatripont, Heremans, Nguyen, 2004, p. 97. Shareholders have the right to take decisions, i.e. formal control. They, however, may not have the ability to take decisions i.e. real control, as it typically requires prior information about the consequences of potential decisions. Shareholders dispersion, moreover, reduces shareholders incentives to acquire information and therefore to exercise real control.

On the other hand, it has been argued that high leverage confronts managers with the threat of illiquidity which may constrain and incentivize them. As this may apply to non-financial firms, it may be questioned whether the available safety nets providing liquidity for banks do not eliminate these market forces. See Tirole, 2006.

<sup>6</sup> Debt in a higher leveraged firms resembles equity in a modestly leveraged one. Debt holders become basically also residual claimants at all income levels, see Tirole, 2006..

Moreover, favouring (excessive) risk taking by banks, i.e. the type 3 agency distortions, may have systemic externalities when it leads to banking failures which eventually endanger the stability of the whole financial sector. Hence, compared to non-financial firms, type 3 agency problems are a more serious concern for banking firms.

### **Corporate governance mechanisms and banking regulation**

In order to contain the different types of agency distortions several mechanisms are operative affecting the power and the incentives of the different parties involved in modern corporations. Specific mechanisms are additionally provided for banks and the whole financial sector through extensive financial regulation and supervision.

The basic governance mechanisms as they apply to all firms mainly address equity governance problems and may be distinguished as follows:

- (i) legal intervention: Formal control is guaranteed to the equity owners by corporate law. This may operate directly through shareholder democracy, or indirectly through the board of directors as a specialist monitor of management.
- (ii) market discipline: Monitoring by interested parties such as shareholders, creditors, clients, rating agencies and financial analysts depends on their incentives to monitor and their ability to do so. It requires information disclosure and transparency to be further based on the legal setting of accounting and audit standards.
- (iii) also self regulation (soft law) in the form of codes of conduct being a more flexible instrument may provide the necessary “checks and balances” to contain agency distortions<sup>7</sup>.
- (iv) the ultimate market discipline is the market for corporate control being subject to take-over legislation.

The banking sector, moreover, is subject to specific regulatory and supervisory intervention by the financial authorities. Traditionally the goals of financial regulation and prudential supervision are double. The emphasis has been upon the stability of the financial system thereby protecting depositors and other creditors against the risk of loss as a second objective. Concerns for competition, transparency of financial markets and integrity in the conduct of business as a third objective are of a more recent date.

The main objectives of regulation remain to monitor type 3 agency problems, i.e. to avoid excessive risk taking by banks and thereby shifting the risk to depositors and other

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<sup>7</sup> Tirole, 2006, argues that such codes educate the general public and may help the corresponding practices to enjoy network externalities inherent in familiar institutions.



creditors. In this respect the regulatory and supervisory authorities are to be seen as corresponding to the need for a representative of the depositors. In view of the specific debt governance problems they “mimic” the role taken by debt holders in non-financial firms (see Dewatripont and Tirole, 1994).

The need for such a strong depositor representative is especially great for banks as deposit insurance and lender of last resort facilities are being provided in order to avoid systemic risk through selffulfilling panics. Such safety nets affect the risk behaviour of banks: deposit insurance weakens the incentives for depositors to monitor bank risks, and bail-out practices may increase risk incentives for shareholders. Hence, in order to limit this moral hazard behaviour, extensive prudential regulation had to be introduced relying mainly upon capital adequacy requirements. Capital not only provides a buffer against losses, it also reduces risk incentives as more of the own funds of the banks are at stake (see Heremans 2000). The effectiveness of these regulations is constantly being challenged. Recently it has led to the design of better risk-adjusted capital requirements, but also the enhancement of market discipline in the Basel II proposals<sup>8</sup>.

The question arises, however, whether the higher level of regulation for banks compared to non-financial firms has not removed the need for other governance mechanisms to deal with the agency distortions within banks?

It appears that regulatory oversight is not a substitute, but rather a complement to corporate governance (see Adams and Mehran 2003).

Hence, financial regulators increasingly acknowledge the importance of corporate governance. Structural deregulation in the financial sector has gradually eliminated activity restrictions that limited competition, but improved stability by containing the possibility of contagion in the banking sector. Hence the potential for spill-overs between business lines and for conflicts of interest and agency distortions have increased. Additional sources of contagion are created within larger financial conglomerates, which by their sheer size present also systemic risk ramifications.

There are also limitations to the effectiveness of prudential regulation as is recognised in the Basel II design of capital requirement. It allows the use of internal models of risk

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<sup>8</sup> The high burden of regulation on banks is often being criticised. Recently also evidence has been presented that it may have negative affects on bank development and valuation, without evidence that it promotes bank stability. Policies that empower private monitoring, however, have a positive effect. See Caprio, Lavaert, Levine ,2003..

management as banks through their credit monitoring have better information than the supervisors on the true risks of their clients. These internal bank models are to be reviewed and validated by supervisors putting heavy pressures on supervisory resources. Moreover, the supervisory review of the organisation of risk management is becoming very complex as banks are using increasingly sophisticated risk-management instruments to better fine-tune their own risk preferences. Hence, supervisors have to rely more heavily on the existence of sound governance principles and practices within banks. The organisation of these procedures is heavily dependent on the specifics of the corporate governance of banks (See Devriese e.a. 2004).

More generally, the regulatory and supervisory function mainly aiming at debt governance is facilitated by sound corporate governance structures with respect to risk taking in banks<sup>9</sup>. Hence the question to be explored next: How do corporate governance arrangements w.r.t. relationships between shareholders, directors and managers affect debt governance problems?

## **2. CORPORATE GOVERNANCE SYSTEMS AND DEBT GOVERNANCE**

The corporate governance debate is usually underpinned by efficiency concerns for equity governance as will be documented first. A banking stability perspective, however, brings debt governance issues to the forefront and raises several questions that go beyond the usual efficiency debate.

Are corporate governance arrangements w.r.t. shareholders structures, management incentives and the composition of the board of directors that apply for non-financial firms also appropriate for the functioning of banks? As banks are particularly vulnerable to excessive risk taking, it has to be investigated how these different corporate governance arrangements affect the incentives and the power of the parties involved in banking to assume (excessive) risk. The analysis of these corporate governance elements may also cast some new light in the broader debate on the relative merits and disadvantages of the main corporate governance systems.

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<sup>9</sup> Financial regulators increasingly acknowledge the importance of corporate governance. In Belgium this issue is already for decades addressed by the Agreements on Bank Autonomy to be concluded between financial authorities and banks.

### **Equity governance systems**

Type 1 equity governance problems, i.e. excessive managerial power, are addressed by several corporate governance mechanisms:

- (i) an active market for corporate control disciplining management;
- (ii) the board of directors acting as a monitoring specialist of management;
- (iii) performance linked contracts to remunerate and incentivize management;
- (iv) shareholding activism restoring shareholders democracy, i.e. real power for shareholders.

These governance mechanisms are representative for the Anglo-American outsider system. As it is characterised by dispersed ownership, type 2 agency problems of expropriation of minority shareholders are avoided. Type 1 problems of excessive managerial power, however, become more serious and have to be curbed by the above mechanisms. The effectiveness in reality, however, of the market for corporate control is to be questioned. Moreover, for banks the take-over market tends to be less active. Hence the role of the board of directors becomes all the more important.

Agency problems and the mix of governance mechanisms to remedy them, are different in the Continental European insider system. Due to concentrated ownership stock exchanges are less active, limiting seriously the operation of the market for corporate control. Type 1 agency problems, however, are less serious as big blockholders have the power and the incentives to better monitor management within the board of directors. Blockholders' monitoring substitutes for performance linked pay, which as a result tends to be more restricted on the European continent.

A new concern, however, is the high potential for type 2 agency problems. Majority shareholders have the power to extract wealth from the firm thereby harming the minority shareholders. In order to curb type 2 agency problems regulatory procedures may be introduced e.g. intragroup transactions are to be supervised by independent directors in the board. Hence, governance mechanism such as the composition of the board of directors and shareholding activism to control this become important in this insider system.

### **Governance Systems for Banks and the Corporate Governance Debate**

An increasing amount of research documents the occurrence in the real world of the different corporate governance systems for industrial companies. For banks, however, the empirical evidence remains limited.

From a recent study of the ten largest publicly listed banks in 44 countries, using 10 percent of the voting rights as a threshold for control, the following picture emerges (see Caprio, Laeven, Levine 2003):

- (i) only 25 percent of the banks are widely held, so that the type 1 agency problems inherent in the Anglo-American outsider system are not so prevalent. At the country level, in only 8 out of 44 countries the majority of the large banks has a dispersed ownership.
- (ii) The dominant model obviously is that of concentrated ownership corresponding to the Continental European insider system. More than half of the time the controlling shareholder is a family, and in 14 percent of the cases it is the State. It is even so in 21 out of 44 countries that all banks have a controlling owner.

On the occasion of many studies for nonfinancial firms, from which a somewhat similar overall picture emerges, the predominance of blockholders has been heavily criticised<sup>10</sup>:

- (i) It is claimed that the Anglo-American system is superior in raising finance efficiently for the company. Dispersed shareholdings allowing for a large free float and liquidity, better tune in to the increasing role of financial markets due to globalisation and the growing importance of institutional money in the external financing of companies.
- (ii) Also the power of controlling blockholders to expropriate the minority, i.e. to create type 2 agency problems is claimed to be a barrier to attract external market finance.

The latter argument, however, should be further qualified according to a distinction to be made between voting rights and cashflow rights:

- (i) When control rights significantly exceed cashflow rights, incentives may indeed become very much distorted to the disadvantage of small investors. This may be achieved by various technologies separating cashflow rights from voting rights such as trust offices, preference shares, cross-ownership and pyramidal cascade structures of holding companies (see Devriese e.a., 2004).
- (ii) Expropriation moreover requires costly transactions such as setting intermediary companies, taking legal risks etc. (see La Porta e.a., 2002). Hence, when cashflows rights increase, incentives for controlling owners to expropriate resources from the

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<sup>10</sup> Among the many contributions, see in particular La Porta, Lopez de Silanes, and Schleifer, 1999.

company decrease as it involves a greater reduction in their own cashflows (see Caprio e.a., 2004).

In this respect, the same study for the ten largest publicly traded banks in 44 countries provides a somewhat mixed picture. Controlling owners hold on average 35,75 percent of the control rights with a lower but still substantial amount of 27,45 percent of the cashflow rights. In 15 out of the 36 countries where the blockholders dominate, the difference between control and cashflow rights is larger pointing towards potentially larger type 2 agency problems<sup>11</sup>.

It follows that for a more adequate approach of the agency distortions, the controlling ownership model should be differentiated according to two sub-categories:

- (i) the non-levered or straightforward controlling ownership model. It applies when cashflows rights are substantial and largely correspond to voting rights.
- (ii) the levered controlling ownership model. It emerges when technologies have been set up separating cashflow rights from voting rights. This may be achieved by differential voting rights and cross-shareholding, but as it appears in practice mainly by cascades of holding companies in a pyramid structure<sup>12</sup>.

Family ownership of public firms, being the main fraction of concentrated shareholdings, is mostly of the non-levered type and may reduce agency problems has as been found recently for US firms (see Anderson and Reeb, 2003).

Whatever the broader debate on governance systems and arguments in favour of external equity financing, for banks these may carry less weight given their high leverage and larger access to debt financing. Arguments against the widely dispersed shareholdings model may have relatively more relevance for banks:

- (i) The shorttermism of stock markets is increasingly being criticized especially in periods of turmoil in stock markets. The obsession with liquidity and short term results, in particular when induced by short term performance linked options for management, may have unintended consequences in destroying long term value. Long term value creation for all shareholders requires long term commitment i.e. stable investors<sup>13</sup>.

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<sup>11</sup> See Caprio, Laeven, Levine, 2003. These 15 countries comprise mainly Spanish or Portuguese language countries, and also Switzerland, Sweden and the Netherlands.

<sup>12</sup> The available evidence for banks is still limited. For an application to Belgium, see Devriese, Dewatripont, Heremans, Nguyen, 2004. In a wider study for nonfinancial firms, the difference between control and cashflow rights is mainly attributed to pyramid structures (fully 26 percent of the firms that have an ultimate owner are controlled through pyramids), and only to a limited extent explained by differential voting rights and cross-shareholdings, see La Porta, Lopez de Silanes, Schleifer, 1999.

<sup>13</sup> According to Becht and Mayer, 2001, the insider model is perceived as conducive to activities with long realization periods, whereas the outsider model benefits short term investments requiring greater flexibility.

- (ii) The trade-off between investor liquidity and investor commitment may have special relevance for banks as only long term players are good monitors. Investors who can easily exit by reselling at a fair price, have little incentive to create long run value improvement. The illiquidity that large investors face, enhances the quality of monitoring (see J. Tirole, 2006). This argument carries more weight for banking firms which notoriously are facing high monitoring costs.
- (iii) The stability of shareholders may also be important to complement regulatory capital in the case of undercapitalisation, or even to bail-in ailing banks, which may prove to be more difficult when shareownership is widely dispersed. Finally, whatever the merit of this banking stability perspective for the efficiency of equity governance, it is important to further explore this stability perspective for debt government issues.

### **Debt governance and risk attitudes**

Conflicts of interest between debtholders and shareholders with respect to risk taking exist in every firm, but type 3 agency problems of risk shifting are raised to a new dimension in the banking context (see Macay, O'Hara 2003). Given that banks are in the business of risk trading with a high debt-to-equity ratio, and that depositors protected by deposit insurance have no incentives to monitor these risks, they have more opportunities and incentives to engage in (excessive) risk taking.

These debt governance problems are further to be analysed as a function of the risk incentives of the different parties involved in the corporation.

Incentives for risk taking crucially depend on the opportunities to diversify risk. Portfolio theory distinguishes between systematic or market risk on the one hand, and non systematic (idiosyncratic) or firm specific risk on the other hand. The latter may be diversified away in a portfolio allowing for a higher return on investment. It follows that parties who are more diversified have an interest in more risk taking by the firm. They have an interest in taking more firm specific risk as they can diversify it away in their wealth portfolio.

In a typical firm managers are intrinsically more risk averse than shareholders:

- (i) they stand to lose invested specific human capital and, in some cases, invested wealth if the firm goes bankrupt
- (ii) managers tie up all their human capital in the firm, so their degree of diversification is limited

Hence, managers care about the total risk of the firm being the sum of systematic and idiosyncratic risk.

Whereas this applies when managers receive a fixed compensation scheme, things may change when they start receiving performance-based pay. With regard to the cash flow effect managers then face a trade-off between:

- (i) future cash flows generated by specific human capital invested in the firm
- (ii) and additional cash flows generated by increased performance resulting from risk taking.

When remuneration is linked to share prices, and especially when managers are paid with stock options, whose value can be very sensitive to the volatility of the underlying stock, managers may receive high incentives to take substantial risk to increase the value of their stock options.

Also for shareholders the outlook for risk taking incentives for shareholders depends upon risk diversification opportunities.

A typical financial investor is a diversified shareholder caring only about systematic risk. He has an interest in more risk taking by the firm as the firm specific risk is diversified away in his equity portfolio.

Things may be different for strategic investors with concentrated shareholdings. Big block holders being generally less diversified have less risk appetite as they care about total risk including firm-specific risk. With levered control, however, as is the case in pyramidal groups, diversification is more likely and hence also the risk incentives increase.

In this respect, risk taking is also going to be influenced by the identity of the controlling shareholder. Different owners as e.g. a family, an industrial firm, an other financial institution have different opportunities to diversify their wealth. Hence, they have also different attitudes towards risk<sup>14</sup>. They differ moreover in their information, expertise and monitoring capabilities (See Devriese e.a. 2004).

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<sup>14</sup> Founding families represent a unique class of shareholders that hold poorly diversified portfolios. See Anderson and Reeb, 2003.

### **Debt governance and corporate governance systems for banks**

The next step is to relate the risk incentives for the different parties involved to the different corporate control systems.

Shareholders of widely held companies, a system representing about 25 percent of the large banks, will be diversified. They have incentives for (excessive) risk taking at the expense of debtholders, but they have only formal and no real control to do so. Real control resides with managers, who have no such incentives unless remuneration depends substantially on high powered options. Hence, type 3 agency problems are solved by management control in banks.

Management control, however, is in contrast to traditional corporate governance recommendations for nonfinancial firms. It reintroduces type 1 agency problems. The governance system then faces a difficult trade-off as governance mechanisms that operate to curb managerial power have negative side-effects on debt governance:

- (i) an active market for corporate control for banks is not conducive to bank stability
- (ii) promoting shareholder activism giving real control to diversified shareholders may increase risk incentives
- (iii) performance linked pay may induce managers to take excessive risk

To balance these conflicting interests, the role of the board of directors becomes all the more important, as will be further investigated.

In the controlling ownership models shareholders acquire real control by holding substantial voting rights. It is easier for them to push management to engage in excessive risk taking and in risk shifting at the expense of debt holders. In order to avoid this, the regulatory and supervisory authorities have intervened to put more power with respect to the banking function in the hands of management by so-called bank autonomy arguments<sup>15</sup>.

Type 3 agency problems, however, are not only a question of power, but also of incentives depending upon the degree of wealth diversification of the controlling owners.

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<sup>15</sup> To this end in Belgium the Commission for Banking, Finance and Insurance concludes with controlling owners agreements on the Autonomy of Bank Management.



Families, controlling 39 percent of the large banks, generally are poorly diversified and cannot be expected to be risk loving. Eventually also the 14 percent of the large banks that are state-owned may be assumed to have a similar attitude. Hence, half of the controlling owners are non-diversified what may largely correspond to the straightforward big blockholders, for whom also type 2 problems may be less acute. It follows that on the whole the straightforward controlling ownership model presents less trade-offs between equity and debt governance problems. Moreover, the absence of an active market for corporate control favours banking stability. Also, with majority shareholders in real control, there is less need for highly performance sensitive pay for management thereby reducing also their incentives for excessive risk taking.

The question, arises, how these trade-offs are affected by imposing management control for this group of companies as is done by the so-called bank autonomy agreements. It may not do much to improve type 2 agency problems nor type 3 agency problems, but does it not introduce type 1 agency distortions?

The remaining group of well-diversified controlling blockholders may largely correspond to the levered controlling owners, for whom voting rights and cash flow rights are widely divergent. Levered controlling ownership presents very difficult trade-offs between equity and debt governance. Imposing management control for the levered control group may help to avoid type 3, as well as type 2 agency distortions.

### **3. BANKS IN NEED OF AN ADAPTED CORPORATE GOVERNANCE MODEL?**

#### **What ownership structures?**

An overall picture of the impact of different ownership structures on agency distortions is presented in table 1. The signs in the table reflect both the power (p) and the incentives (i) of the parties in real control. A negative sign for both power and incentives is a necessary condition for the agency distortion to occur within the given ownership structure.

It follows that for all ownership structures trade-offs between the different agency problems are to be made. Type 1 distortions are best dealt with by controlling ownership.

Dispersed ownership avoids type 2 problems. For these two standard equity agency problems the final outlook depends on the relative weights accorded to them.

Compared to nonfinancial firms, for banks type 3 debt distortions carry more weight. The overall outlook then is such that levered controlling ownership presents more agency distortions. It may explain why this ownership structure is often singled out and criticized in the corporate governance debate.

The comparison further depends upon the availability of corrective governance mechanisms and their effectiveness. With financial regulation and supervision effectively dealing with debt governance problems, the relative weight shifts more to type 1 and type 2 equity governance problems. Also the availability and effectiveness of other corrective mechanisms of corporate governance will affect the choice.

*Table 1: Ownership Structures and Agency Problems*

Ownership Structure \ Agency Distortions	Type 1		Type 2		Type 3	
	Management Control Bias		Expropriation Minority Shareholders		Risk Shifting to Debt Holders	
	p	i	p	i	p	i
1. Dispersed Ownership	-	-	+	+	-	+/-
2. Levered Controlling Ownership	+	+	-	-	-	-
3. Straightforward Controlling Ownership	+	+	-	-/0	-	+/-

- negatively or + positively affects agency distortions

Some of these mechanisms such as performance linked remuneration for management may change the whole picture. It is an important mechanism to balance the separation between management control and ownership (type 1) in case of dispersed ownership. The effectiveness of highly performance linked pay is, however, more and more disputed as option schemes may induce shorttermism in management behaviour and give incentives for excessive risk taking (type 3) to which banks are especially vulnerable. In the controlling ownership system, however, the effects of remuneration systems for management are less of an issue.

In view of the potential conflicts of interest and the different trade-offs between various corporate governance mechanisms, the operation and the composition of the board of directors becomes all the more important as corporate governance mechanism for banks.

### **Conflicts of interest and independency of directors**

The board of directors besides giving strategic guidance to the company is mainly a monitoring specialist. Its balancing role very much depends on the power, the composition of the board determining who is in real control, and upon the incentives of the various types of directors involved.

Conflicts of interest leading to agency problems very much depend upon the incentive structures of the directors involved. To deal with type 1 agency distortions a director should be independent from management (type 1 independency). In this respect independent directors in the board are seen as an important preserve against the opportunism of management. Type 2 agency problems prescribe that a director should be independent from controlling shareholders (type 2 independency). Independent directors are needed to act as delegated monitors for minority shareholders.

In order to deal with type 3 debt agency problems a new prudential definition of independence for directors is to be developed. A director who has no (or minimal) shareholdings in the company and receives no (or limited) performance linked remuneration is financially independent from the firm and will be rather risk-averse (given also his director's liability). He is type 3 independent, and has no conflict of interest to act as a delegated monitor for debtholders. Things may become different when a director's remuneration is very much linked (e.g. through options) to the stock prices of the company. Also when he holds a sizeable amount of equity of the firm in a diversified equity portfolio, he may have an interest in risk taking.

For a director, who is also a controlling owner, risk incentives will depend upon his degree of diversification. As already argued above a straightforward controlling owner is more likely to be non-diversified than a levered controlling blockholder of the pyramidal type (see Devriese e.a. 2004). Type 3 independency is especially important for banks as it has been argued that directors have fiduciary duties not only to shareholders but also towards debtholders (see Macey and O'Hara 2003).

A director who is independent on all three counts has incentives to act as deligated monitor simultaneously for all shareholders, and in particular also for minority shareholders and for debtholders.

### **Composition of the board of directors**

Agency distortions are not only a question of incentives, but also of real power. The other condition for agency distortions to occur is that the directors who are facing conflicts of interest are also in real control. This very much depends on the composition of the board of directors.

Condition to deal with type 1 problems is a majority of type 1 independency in the board. In this respect the widespread practice to control management is to have a majority of non-executive directors in the board. This, however, is not a sufficient condition. All or at least a larger number of these non-executives should be independent from management, so that there is a clear majority of type 1 independent directors in the board.

Potential type 2 agency distortions are to be monitored by a majority of type 2 independency in the board. Hence, a sufficient number (not necessarily a majority) of non-executive directors should be independent from the controlling shareholders, so that they together with management constitute a majority in the board.

In order to avoid type 3 distortions especially relevant for banks, the additional condition is a majority of type 3 independency. This majority may be constituted by

- (i) management executives, depending upon their remuneration systems
- (ii) non-executive directors with non financial links to the company, the only link being their position as independent director
- (iii) eventually also non-executive directors being major shareholders, but being financially non-diversified.

As the respective majorities of independents, i.e. which no conflicts of interest do not necessarily overlap in the three instances, the picture as to the required composition for the whole board may become rather complex. It will also differ among the main corporate governance systems as they face different agency trade-offs.

When the composition of the board would be a mere reflection of the ownership structures, then the same outcomes as given in table 1 would apply. Obviously a different composition is needed for the board in order to balance the agency distortions.

Within the dispersed ownership model independency of non-executive directors becomes the main issue. A majority of non-executive directors is necessary, but not sufficient. This

majority should be really independent from management (type 1). Given that highly linked performance remuneration is likely for management, these non-executive directors should have no such remuneration to keep them type 3 independent<sup>16</sup>.

Also levered controlling ownership faces important independency issues for non-executives. A sufficient number of them should be independent from the controlling shareholders, so that together with management they constitute a type 2 majority in the board. At the same time they should be financially independent from the firm (type 3) e.g. by not receiving highly performance sensitive pay. Should management receive such highly performance linked pay, then the number of these independent directors should be larger to guarantee a majority for type 3 independency.

Finally, for the straightforward controlling ownership model independency issues are less important. When cash flow rights are substantial and approach voting rights, type 3 problems may be mitigated also by non-executive directors who represent the blockholders in the board. To monitor type 2 problems, however, a sufficient number of the non-executive directors should also be independent from the controlling shareholders.

### **EU legislative initiatives on the board of directors**

Finally, some recent legislative initiatives in the field of corporate governance may be critically examined, by comparing them with our conceptual exercise on the appropriate design of the board of directors.

As to the appropriate composition of the board of directors a recent EU Recommendation preconises quite generally to look for an appropriate balance so that no small group i.e. management, nor non-executives can dominate decision making in the board. This recommendation becomes more specific for the composition of the specialised committees advising the board: the majority of their members should be “independent”. Independency is related to agency problems as the principle is advanced that these directors should be “free of conflicts of interest” such as to impair their judgement<sup>17</sup>. Looking, however, into the more specific criteria, to be distinguished into functional, family and economic independency, it appears that they are largely confined to equity governance. Type 3

<sup>16</sup> A majority may convey formal control, but real control will only be achieved when they behave independently depending upon nomination procedures, their expertise, reputation etc.

<sup>17</sup> EU Recommendation 15 February 2005 on the role of non-executive or supervisory directors and on the Committees of the Board.

independency is not specifically addressed, raising questions for the governance of firms potentially subject to important debt agency distortions<sup>18</sup>.

With respect to remuneration systems the EU Recommendation of 2005 is limited to the “independent” directors. An important criterium to qualify as independent is that they obtain no share options or other performance related pay from the company. For the other non-executive directors and also for management the issue of highly performance linked pay which may create type 3 agency problems is not addressed<sup>19</sup>. Specifically for the banking sector, however, the Basle Committee on Banking Supervision already pointed out prudently that the need for equity based compensation for management is not as strong in banking as in other industries<sup>20</sup>.

#### **4. FURTHER IMPLICATIONS FOR CORPORATE GOVERNANCE POLICIES**

As the conceptual exercise has demonstrated that governance principles and optimal governance arrangements are not homogenous to all firms when taking into account type 3 debt agency problems, broader implications may be derived.

##### **Application to other financial institutions**

First, debt agency problems are important not only for banks, but also for other financial institutions. As different types of financial institutions present specific agency distortions, the (different) corporate governance implications have to be further explored.

The specific characteristics of financial institutions that affect agency problems are to be distinguished as follows:

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<sup>18</sup> The Belgian Corporate Governance Law of 2 August 2002 and the Belgian Corporate Governance Code Lippens are liable to the same criticisms.

<sup>19</sup> In Belgium the Code Lippens recommends for all non-executive directors that no performance linked pay should be given to them. For management, however, it is stated more vaguely that an appropriate portion of the remuneration is to be performance linked in order to compensate for individual performance. Specifically for the banking sector the CBFA advises for non executive directors not to link their remuneration to short term performance.

<sup>20</sup> Basle Committee on Banking Supervision, 1999.

- (i) leverage, i.e. high debt to equity ratios not only apply to banks but also to insurance companies. Liquidity and maturity mismatch risks are, however, less of a problem for insurance companies.
- (ii) the nature of products and services, as well as of the claimholders presents similarities but also important differences<sup>21</sup>. Insurance products are also of a fiduciary nature and often opaque. For bank depositors, however, exiting by liquidating their deposits is much easier than is the case for insurance policy-holders. Hence, the latter have more incentives to control their company ex-ante. Also the moral hazard problems involved are less as policy-holders do not benefit from the same safety-nets as depositors<sup>22</sup>.
- (iii) systemic externalities are not to be excluded in the insurance sector, but the risk of their occurrence tends to be much smaller, and also their consequences for the real economy are less severe.

Whereas, equity governance problems may be largely similar for banks and insurance companies, their debt governance problems may be different requiring a different corporate governance design. Similar analysis have to be pursued for other types of financial institutions.

In the same vein financial regulation and supervision having to cope with the same conflicts of interest and agency distortions, has traditionally been organised separately for banks, insurance companies and securities firms. Recently, however, this institutional set-up of the regulatory and supervisory architecture is being challenged due to structural deregulation and cross-sectoral mergers of banks, insurance companies and securities firms. Hence, also the appropriate corporate governance design of these financial conglomerates is becoming an even more complex matter in need of further investigation.

### **Evolution of corporate governance and take-over bid legislation in the EU**

Finally, the analysis raises further questions as to the evolution of corporate governance systems in Europe.

Harmonisation of corporate governance is a long standing controversial issue in Europe. Corporate law is often considered to be an essential part of national economic and social traditions. Hence, harmonisation measures have been held up on grounds of the subsidiarity principle. The achievement of the single European market, however, very much relies upon the removal of legal barriers requiring an European approach to

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<sup>21</sup> See Heremans, 2000.

<sup>22</sup> See Van Cayseele and Heremans, 1994.



corporate governance. In the recent internal market approach it is attempted to solve this by minimal harmonisation, i.e. mutual recognition complemented by essential standards at the EU level<sup>23</sup>. In the same vein the EU Commission came to the conclusion that there is no need to expend energy on the development of a Corporate Governance code applicable to companies in the EU<sup>24</sup>. When recognising that corporate governance needs not to be homogenous between countries, should the same principle not be extended in order to differentiate also among different sectors in the economy?

In this respect also the adoption recently of the 13th EU Directive on Take over Bids may raise some eyebrows. The directive aims at offering European business greater legal certainty with regard to take over bids while protecting the interests of shareholders<sup>25</sup>. In particular in order to protect minority shareholders these EU minimum guidelines force someone, who as a result of his acquisition obtains control of a company, to make a bid on all other outstanding shares.

The question necessarily arises whether this obligation in the directive, will not have major consequences for corporate governance systems in Europe? Will the major listed companies not have to converge to the Anglo-American dispersed shareholders model? Will it not amount to adopting the UK system requiring a mandatory bid on all shares whenever a control threshold of 30 percent has been reached?<sup>26</sup> It appears that in the U.K. 90 percent of the twenty largest non-financial companies, and 83 percent of the ten largest banks have no shareholder holding more than 10 percent of the voting rights<sup>27</sup>.

The directive has been presented as a component of the Financial Services Action Plan. Interestingly the broader implications for the whole corporate governance set-up have not been addressed properly. It is questionable whether it is good governance practice to introduce such important choices for corporate governance through the back door of EU financial market integration. Moreover, whereas the directive deals with equity governance issues, debt governance concerns are not addressed. Hence, the question whether particular

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<sup>23</sup> See Lannoo, 1999 and Commission of the European Communities, November, 2002.

<sup>24</sup> See EU Commission, January, 2002.

<sup>25</sup> See European Parliament and Council Directive 2004/25/EC of 21 April 2004.

<sup>26</sup> This threshold guarantees a free float of at least 70 percent. Financial investors are attracted by the greater liquidity and the absence of type 2 agency distortions. It should boost the development of the single European capital market and also the overall competitiveness of the European market by promoting corporate restructuring. The functioning, however, in practice of the market for corporate control as a disciplining mechanism on management for type 1 agency problems may be questioned.

<sup>27</sup> Similar figures apply to the U.S. see e.g. Caprio, Lavaert, Levine, 2003 and also La Porta, Lopez-de-Silanes, Schleifer, 1999.

prudential concerns for financial stability should not be taken into account? Are they best served by applying these principles indiscriminately to the banking sector?

More generally, the directive may raise further questions as to legal coherence of the whole corporate governance set-up<sup>28</sup>.

## CONCLUSION

It may be questioned whether the principles specifying the relationships within the corporation are to be extended as such to the banking firm. Compared to non-financial firms banks present specific characteristics, i.e. high leverage, fiduciary products, a multitude of small claimholders, systemic externalities w.r.t. financial stability. These specificities affect agency distortions and are also the basis for specific financial regulation and supervision. As corporate governance is a necessary complement to regulatory and supervisory intervention, it should be approached not only from a point of view of profit maximisation but also from the perspective of financial stability.

Compared to non-financial firms, in particular debt governance distortions may arise, as banks are particularly vulnerable to excessive risktaking. Hence, the need to investigate how different corporate governance arrangements that apply to non-financial firms, affect the incentives and the power of the parties involved in the banking firm to assume (excessive) risk.

It follows that the usual criticisms on the predominant blockholders' model for banks should be further qualified. Whereas they apply to levered controlling ownership with complex structures such as pyramids, however, straightforward controlling ownership by non-diversified shareholders however, might provide an important governance mechanism. It may also explain the predominance of family ownership in the banking sector. Moreover, the analysis of risk attitudes of the parties involved in the banking firm, introduces a new prudentially relevant definition of independence for directors. It has

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<sup>28</sup> Also path dependency and legal complementarities within national corporate governance systems make shifts in corporate governance models not very obvious. See Schmidt and Spindler, 2002.

important implications as to the appropriate composition of the board of directors for banks, an issue which has to be approached in a more systematic way.

The conceptual framework taking into account risk attitudes and financial stability implications, is to be further extended to explore the corporate governance design for other financial institutions. It may also serve to critically examine some recent initiatives w.r.t. corporate law and corporate governance codes.

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