The Corporate Governance of Banks – Lessons Learned from the Financial Crisis

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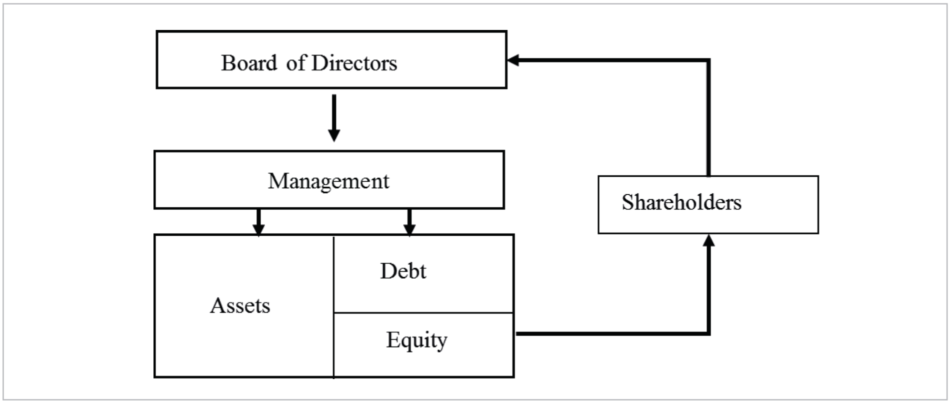
List of Abbreviations

ABS	Asset Backed Securities
CDS	Collateralized Debt Obligation
EBA	European Banking Authority
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSM	*European Financial Stabilisation Mechanism*
EIOPA	European Insurance and Occupational Pensions Authority
ESCB	European System of Central Banks
ESFS	*European System of Financial Supervision*
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EMU	European Monetary Union
FSB	Financial Stability Board
IMF	International Monetary Fund
KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich
MBS	Mortgage Backed Securities
NCB	National Central Banks
OECD	Organisation for Economic Co-operation and Development

1. Introduction

Until the outbreak of the financial crises in 2007 the intellectual debate concerning corporate governance often focused on only two issues. On the one hand (first issue) we discussed the problem, if corporate governance should focus exclusively on protecting the interests of equity claimants, or whether corporate governance should instead expand its focus to deal with the problems of other groups, called stakeholders. On the other hand (second issue) we began with the assumption that corporate governance has to protect exclusively equity claimants, and attempts to specify ways how banks can better safeguard those interests.[1] It is very interesting to compare the Anglo-American model of corporate governance and the Franco-German model of corporate governance.

Figure 1: Anglo-American model of corporate governance

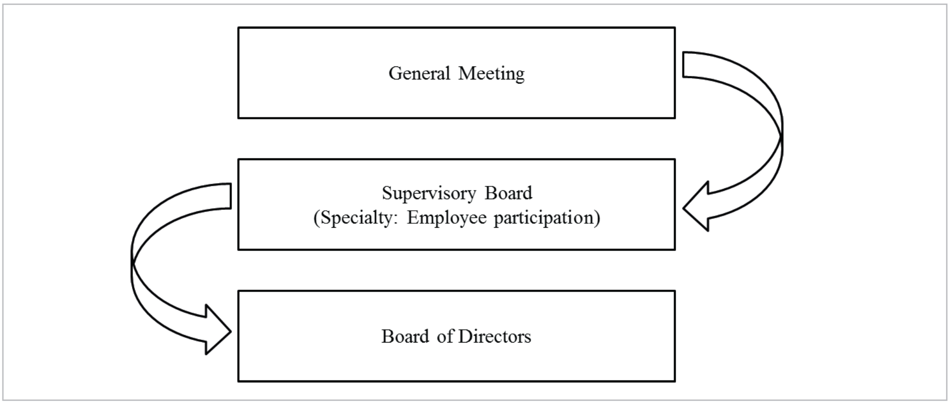


Source: Butler, 1997

Both models differ in its treatment very much. The first model takes the view on maximizing the shareholder value, in contrast to the second model, like in Germany implemented, which considers corporations and banks to be "industrial partnerships".

1 See Macey, J.R., O'Hara, M., 2003.

Figure 2: Franco-German model of corporate governance



Source: Own representation based on Welge, Eulerich, 2012

The interests of long-term stakeholders, like other corporations, banks and employees, should be taken into account. Like we know, the Anglo-American and the Franco-German model prefer different solutions to the core problems of corporate governance.

We know the subsequent criticism of German company organs:

- General Meeting
  - Often insufficient and low quality of content
  - Abuse of the right to ask questions
  - Strengthening the chairman rights, less speakers and limited speaking time
  - Problem of order voting rights at general meetings

- Supervisory Board (control function)
  - Involvement in the decision-making process is insufficient or too late
  - Strengthen the advisory role KonTraG
  - Enhance professionalism and therefore quality
  - Fewer seats per council member

- Board of Directors
  - Collective principles are too cumbersome
  - The Anglo-American presidential system is more flexible
  - Effective cooperation and quick decisions

In this context it is not my part to philosophy further about the differences between the Anglo-American vs. the Franco-German model, shareholder value maximization vs. interests of stakeholders. In any case, I think, we need (additional to the general standards

of corporate governance for listed firms) specific approaches, solutions and standards for banks, particularly for systemically relevant banks.
But at the end, the most quoted definition of corporate governance was: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer & Vishny, 1997).
Scandals and corporate failures in US and Europe have led to a renewed interest in research of corporate governance and some legal reforms (e. g. The Sarbanes-Oxley Act of 2002).
The financial crisis in 2008 has shown that risk, transparency and rules of good governance require particularly attention. Analyzing the causes of the financial turbulences, many reports of scientists and authorities identified important deficiencies, especially concerning the corporate governance of Banks.
Totality of legal rules and other recommendations related to good and accountable corporate management, e. g. accounting rules, internal and external audit bodies, board and management work, the role of the owners: shareholder vs. stakeholder, improve the transparency. Later on, we started to look on the management of public enterprises, development banks, saving and loan associations, credit unions, public institutions, authorities in our scientific work.
In all debates we used a common definition for Corporate Governance, for the Code of Conduct (guidelines) for a good /appropriate business management.

→ Internationally referred to as rules for "Corporate Behavior"

Like mentioned before, the objectives were:
- Increase transparency for shareholders in relation to the management.
- Strengthen the confidence of shareholders and all other stakeholders.

2. The role of banks and what is different in banks?

There is no doubt that banks exert a strong impact on economic development of firms and of the GDP in a macro-economic framework. Corporate governance of banks becomes more and more crucial for growth and development. After the crisis a new discussion started about the relationship between corporate governance approaches and the stability of banks, of the banking market and in any case about the impact on the national banking systems. We are living in a European banking market! In this discussion we see two contrasting views: First of all, non-financial firms and banks are (and have to be) influenced by the same core corporate control mechanisms. But on the other hand, banks need specified corporate standards.

To answer the fateful question: Are banks special concerning corporate governance, we have to discuss the debate more general. Eugene Fama wrote the famous article, "What's different about banks?" already in 1985. The answer to this question has a strong impact on the decision which financial regulation arrangement should be chosen.[2]
Because of banks exert a strong impact on economic development; the corporate governance of banks becomes more crucial for growth and development in national and international context.

There are two contrasting views: non-financial firms and banks are influenced by the same core corporate control mechanisms vs. specificity of banks.
Long before the current financial crisis we learned there are two special features of banks because they work less efficiently: opaqueness and regulations.[3] Opacity means, difficulties to monitor bank managers. We know partly strong informational asymmetries in the money and capital markets, especially in the credit market. That is why banks are difficult to value, in the contrast to non-financial firms. State interventions seem to increase opacity. The banking industry is one of the most regulated sectors of industry. Most of the countries increased banking regulation because of systemic risks and to protect depositors, look on Basel II and Basel III. International Accords serve to strengthen market discipline: preventing excessive risk-taking through regulation. Against this, we should ask the question: How to create better incentives for appropriate behavior of top management and market participants?

What we can consider are two conflicting views in literature:

- Specificity of banks: common mechanisms of corporate governance are not equally valid in banking corporate governance of banks regulated by authorities in place of private monitors; traditional argument: opacity.
- The same core corporate control mechanisms that influence the governance of non-financial firms also influence bank operations; prudential regulation vs. introduction of incentives for appropriate behavior.

2 See Polo, 2007.
3 See Capriom Leaven, Levine, 2007.

3. Corporate Governance and risk management

Risk is an important element which occurs in banks much more than in every other organization or company. Special risks must be managed effectively in order to guarantee a long term success (market risks, credit risks, interest rate risks, currency risks, operational risks etc.). The phrase "risk management" refers a particular management function, which came up first in the early 1950s.
Today the risk management process is more holistic than just dealing with physical risks like at the beginning in insurance companies. In general we can see an enterprise-wide approach, including threats like governance failure and breaches of corporate social responsibility, e. g. unethical behavior, which might harm the firm's reputation (do we need whistle blowing systems?). Trust and reputation are one of the most important assets of a bank.

Because of to two special features, corporate governance of banks work less efficient: opaqueness & regulation (Caprio & Levine, 2002).

- Opacity:
  - Difficulty to monitor bank managers
  - Informational asymmetries: banks are more difficult to value than non-financial firms are
  - State intervention seems to increase opacity but also to reduce it

→ à improve governance in banking by reducing bank opacity

- Regulation:
  - Systematic risk & depositor protection
  - "lenders of last resort" / "safety net" moral hazard
  - Basel II: market discipline preventing excessive risk-taking through regulation vs. creation of incentives for appropriate behavior

Shortcomings of governance (inside of banks) in risk management contributed to the crisis. Financial markets and high sophisticated financial products seem to be very complex and intransparent from a non-professional perspective, which is the reason why we do not wonder. But after the crisis we find out, there were also a lacks of risk understanding by actors of the risk management chain, this is incredible until today. Even board members of European bank (not only banks form US, Ireland or Island, but also German and Swiss banks) did not fully understand the risk of certain transactions, e. g. derivative products (ABS, MBS, CDOs, which came from the US over London and Dublin in the European markets). In some financial institutions, there was neither an effective supervision regarding the constraints of the risk strategy nor a proper defini-

tion of the risk appetite.[4] Furthermore we found out: one major feature of the recent banking crisis has been played by liquidity risk. The de Laroisiére –report said: the misunderstanding of the interaction between credit and liquidity and the supervision authority's negligence to review banks in terms of financial leverage, reactions as a last consequence were major failings.[5]
That is why in our research we have to define the governance of banks much more complex than before. In general we can distinguish two side of the topic, with many different, very special aspects:

- Internal governance of a bank (Structure of the board, process of risk management, compensation systems, social incentives etc.).
- External governance of the banking system (legal framework, standards, restrictions, regulations etc.).

Concrete we have to look how OECD Principles and national Codices are implemented, how corporate governance is related to the behavior of risk taking, profitability and stability, bank valuations, pricing of stocks, merger and so on. Very interesting are case studies between banks in different countries (comparing corporate governance reports). The corporate governance culture and national standards in emerging markets and in transition economies ask questions to solve problems, to give recommendations how to improve and how to implement those. Which western model should be favored, do countries need own, very special solutions according to the development stage of their banking system, according to the national culture of business? We can see special corporate governance cultures in private, in cooperative and in public banks too.

Research about banking suggests that strong shareholder protection laws increase firm valuations:

- Investors pay more for equity when legal institutions effectively protect their rights.
- Investor protection laws provide the tools for small shareholders to stop large shareholders from expropriating bank resources.

However, banks are very complex and opaque. Investor protection laws alone may not provide a sufficiently powerful corporate governance mechanism to small shareholders. Furthermore, bank regulations may suppress standard investor protection laws.
The impact of investor protection laws on banks may differ from their impact on non-financial corporations?

4 See European Commission, 2010a.
5 See The de Larosière Group, 2009.

4. Risk taking and executive board composition

After all this experiences, it seems to be very interesting to have a look on the ownership structure of banks:

- Ownership structure is an additional mechanism for using corporate control.
- Banks are generally not widely hold, only about 25 % are widely hold (i.e. they do not have a shareholder that owns at least 10 % of the voting rights).
- The controlling shareholder of a bank is in most of the cases a private major shareholder, while the state is the controlling owner of banks in one-fifth of the time.
- Stronger legal protection of shareholders is positively connected with countries having more widely held banks.

Another research approach should be mentioned concerning corporate governance in banks. In my mind, a very interesting paper was published currently in Germany. It explained how socioeconomic characteristics of executive teams affect corporate governance in banking. Exploiting a unique dataset of the Deutsche Bundesbank, scientists show how age, gender, and education composition of executive teams affect risk taking of financial institutions.[6] They found out, that the socio-economical composition of a company's board is highly relevant for economic and social policy. What are the key results? First, younger executive teams increase risk-taking. Second, board changes that result in a higher proportion of female executives also lead to a more risky conduct of business. Third, if board changes increase the representation of executives holding Ph.D. degrees, risk taking declines.
What we have to learn from that? I am not sure, maybe this could be a topic for our discussion after my official contribution.

Main conclusions should be:

- Qualified board oversight and robust risk management is important.
- The OECD Corporate Governance Principles in these key areas need to be reviewed.

We should not forget, risk models failed due to technical assumptions, but the corporate governance dimension of the problem was how their information was used in the organization structures of banks. Attention has focused on internal controls related to financial reporting, but not enough on the broader context of risk management

- The financial turmoil has revealed severe shortcomings in risk management practices.
- CDO exposure far exceeded the firms understanding of the inherent risk.

6 See Berger, Kick, Schaeck, 2012.

5. Compensation structures – how to improve models for banks?

In 2007/2008 many financial institutions have collapsed or were bailed out by governments because of greedy risk taking in the years before. The crisis of international banks reached its peak in September 2008 when the investment bank Lehman Brothers failed. As a result of this we could see a collapse in confidence in the most areas of banking.

The debate about the compensation of bank managers was (and is) an important part in the whole corporate governance discussion after the crisis. Several studies claimed that the executive compensation systems of investment banks and other big banks in the past had been the trigger for the excessive risk taking. The bonus payment structures of much banks were often linked or even encouraged through the generation of short term revenues and therefore long term risks (so called tail risks) haven't been taken into consideration during the decision making process.[7] After the crisis of private and public banks, the incentive structures of the top management got into the focus of the public and the regulators.

Corporate Governance should be focused on responsibility, long term orientation, value-enhancing corporate management and supervision. In this understanding we have to lead an intensive debate due to:

- Changing landscape of management and supervision of enterprises due to globalization and greater influence by institutionalized shareholders
- Changing demands of international shareholders
- "Professional shareholders" (Pension funds etc.) have a greater impact on management.

Finally there are still the following aims:

- Sustainable increase of the firm value for all stakeholders
- Accounting to international standards to raise transparency
- Intensive Investor Relations through more frequent analyst and investor meetings
- Management compensation according to increase in shareholder value

In 2009 the Financial Stability Board (FSB) published "Principles for Sound Compensation Practices" to reduce incentives toward excessive risk taking that may arise from the structure of compensation schemes.[8] The board of directors of major financial firms must actively monitor the compensations system's design, operation and functioning. The compensation of staff engaged in financial and risk control has to be independent of the business areas they oversee.

7 See London Summit 2009, UBS annual report 2009.

8 See Financial Stability Board (2009).

The main points of the FSB – Principals are:

- effective governance of compensation,
- effective alignment of compensation with prudent risk taking,
- effective supervisory oversight and engagement by stakeholders.
- Now we can see selected types of salary regulations in European banks:
    - Taxes on bonuses (variable compensation),
    - wage limits (cap the compensation payments).

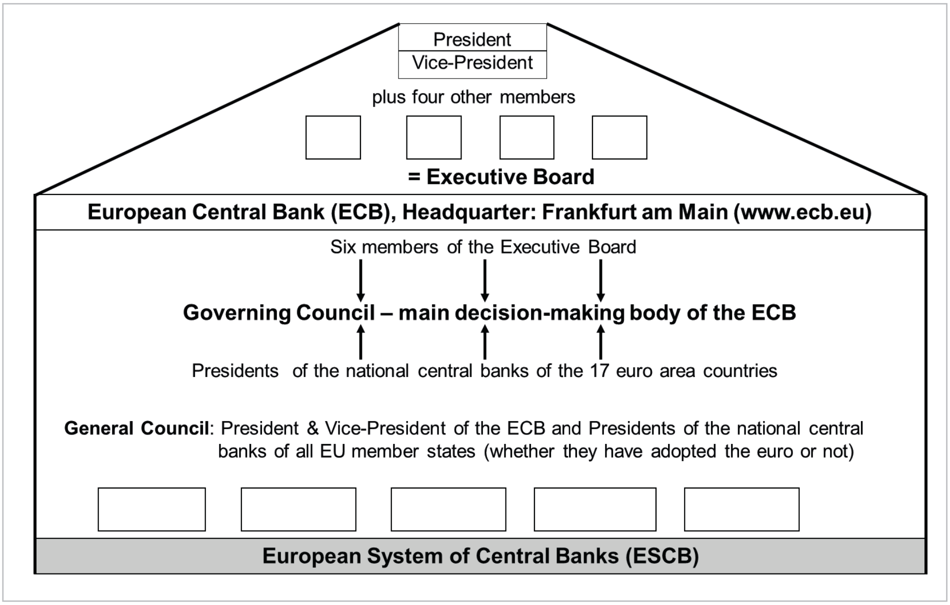
To cap the compensation payments for executives in banks was one of the first ideas and was partly implemented in banks with public equity (state owned banks) in Germany. Theoretically there are two ways for limiting payments: an absolute and a relative limit. An absolute limit can be viewed like a cap at a certain level. The relative limits are more flexible and depend on other bank specific factors. One version of such relative compensation limit would link the highest compensation package to the lowest (e.g. the highest total compensation can only be 10 times higher than the lowest in the same bank). The approach with a special tax on the variable compensation can reduce the quantity of high payments, but it does not tackle the initial problem of balancing risk taking.
Both proposals do not appear to work as wished. And we should not forget the global competition in the banking market for high potential executives. It is necessary to take risks, if a bank prefers to win and to grow in the global banking market.

6. Banking supervision and regulation

In 2008 the EU commission delegated Jacques de Larosiére to lead a group of financial experts to find out impacts on crisis and to give recommendations for banking regulations and supervision of the European financial markets. The report revealed fundamental failures in risk assessment, on the institutional side and on the supervision authority side.

In the literature we find some general definitions of corporate governance for an organization:
"Generally, good corporate governance for an organization can be defined as the establishment of institutional arrangements that ensure that the organization pursues its statutory goal."
For public, national and multinational organizations I think without any doubts we can underline:
"Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals."
The most central banks do quote the central bank law to describe their objectives, but only very few central banks have a mission statement and also publish it.

Figure 3: Structure of the European Central Bank



Source: Deutscher Sparkassen- und Giroverband, 1996

Actual framework of voting rights:

- in general: one person, one vote
- in financial questions: weighted votes
- governors of the NCBs: weighted with the capital key

Voting right in the Governing Council of the ECB:

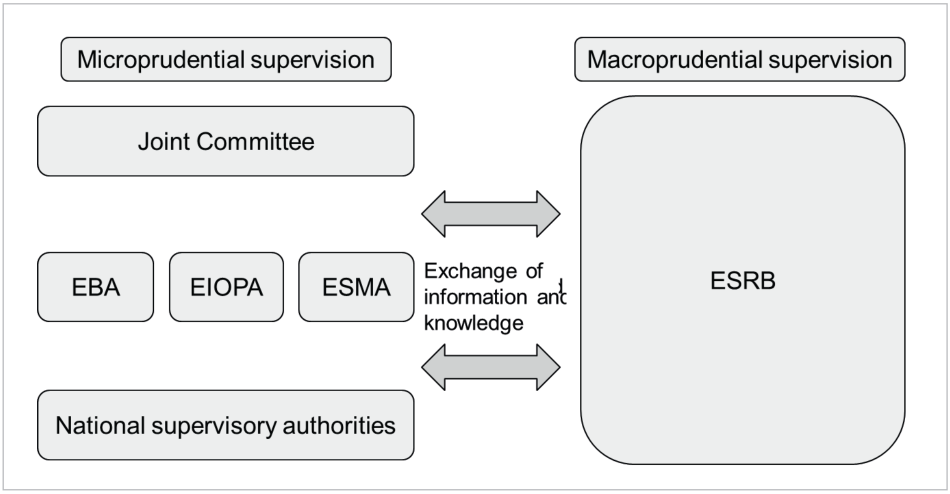
- Executive Board member of the ECB: weighted with zero
- when the external euro system grows, a detailed rotation scheme shall be applied (applicable if there are more than 21 members)

Because of the actual questions and the role of ECB here, we have to clear up some different positions inside of the EU. In addition to the decision-making bodies, the corporate governance of the ECB needs a number of external and internal control layers, like external auditors and European Court of Auditors, internal audit and control structure, ethics framework etc.

7. Reform of European institutions for financial stability

The European System of Financial Supervision (ESFS) was established in 2011 to implement the de Larosiére Group's proposed greater integration of European financial supervision.[9] What is happened with the new European supervisory structure? This ESFS was established to improve the microprudential and macroprudential supervision, because of need to be closely linked together.

Figure 4: Structure of the European System of Financial Supervision



Source: Deutsche Bundesbank, 2012

The European Systemic Risk Board (ESRB) as a part of the EFSF, was established in the context of a reorganization of European supervisory structures. This gave the national central banks a strong position in the ESRB. Very important will be to exchange data between ESRB and other authorities and to strength the cross border cooperation or to give up national power to the new institutions?

One key question is which banks from over 6000 in Europe should be regulated by the euro-supervisors ECB and EBA – only systemic banks (large enough to have an impact on the eurozone)? What will be the task of national banking supervision authorities, the most of them inside of the National Central Banks. In Germany we have to answer the question, what will be the task of the BaFin anymore, with its long analytic and practical experiences and high developed infrastructure.

9 See Deutsche Bundesbank, 2012.

Excursus: EU Rescue Packages, EFSM, European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM)

Since 2010/11 we have to deal with the European Sovereign Debt Crisis because of some members of the EU. Several loans were granted under strict conditionality (adjustment programs), like for Greece, Ireland and Portugal.

The EFSM includes 60 bn Euro, the EFSF possesses 440 bn Euro for EU-member states in trouble. All activities came along closely in cooperation with the IMF.

The EU council agreed with a permanent European Stability Mechanism (ESM, 700 bn Euro, 80 bn cash deposit).

The Euro Group agrees to widen the mandate of the EFSF by incorporating preventive elements, including interventions on secondary markets, financial recapitalization of banks through loans to governments. The ECB revives its covered bond purchasing program and the Euro Group agrees to leverage the resource of the EFSF and we had a long discussion as well as several proposals for the introduction of Eurobonds.

In the next month and years we have to go further to reform the EMU by harmonization and consolidation of the fiscal policy of EU-member states. There will be challenges like to bring the European Central Bank back to her core task. The ECB has to realize a monetary policy not only to extend but to stabilize the growth of monetary volume and the stability of the common single currency, to retain the euro system as whole.

Now, the ESM is planned as a permanent crisis resolution mechanism for the countries of the euro area (member and non member states of the EMU). The ESM will issues debt instruments in order to finance loans and other forms of financial assistance to euro area member (and nonmember states).

The decision to create the ESM was taken by the European Council in December 2010 and the euro member states signed an intergovernmental treaty in order to establish the ESM in February 2012. The ESM will be located in Luxembourg and will complement the EFSF after inauguration at the end of 2012.

About such activities and other plans in order to manage the sovereign debt crises we have to force our controversial discussions and we have to find common solutions between scientific and legal specialists.

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