CHANGES IN BANK RESOLUTION MECHANISM: OPPORTUNITY FOR CHANGE IN BANK GOVERNANCE TOWARDS STAKEHOLDER APPROACH

Živa Skok Jezernik*

Abstract

The current financial crisis has vividly demonstrated that due to the incentives of bank shareholders to take excessive risks on behalf of other stakeholders and society, banking governance based exclusively on shareholder interests results in systemically fragile banks and financial instability.
The key challenge is to establish a bank governance framework in which financial institutions begin to perform their central function of serving and supporting long-term economic development. The recent change in the bank resolution mechanism legislation for banks in the EU from a bail-out to a bail-in approach that creates a new group of bank stakeholders with strong incentives to oppose excessive risk-taking – uninsured debtholders – can be seen as an opportunity to enact substantial change in bank governance.

Keywords: Banking, Corporate Governance, Financial Crisis, Excessive Risk-Taking, Bail-In

* *Faculty of Economics, University of Ljubljana, Kardeljeva ploščad 17, 1000 Ljubljana, Slovenia and 'Young researcher for the economy' in Abanka Vipa d.d., Slovenska 58, 1000 Ljubljana, Slovenia*
Fax +386 1 4718 970
Tel.: +386 1 4718 979
E-mail: ziva.jezernik@abanka.si

1. Introduction

Authors differ in opinion regarding the importance of corporate governance inefficiencies and the impact of such on the development of the financial crisis. Views range from those that find the topic of bank governance irrelevant (Acharya et al., 2009, p. 111; Moslein, 2009; Anwar, 2009, p. 27), to those who understand it as a partial or major cause of the crisis (Blundell-Wignall et al., 2008, p. 11; Kirkpatrick, 2009, p. 2; The High-Level Group on Financial Supervision in the EU, 2009; Walker, 2009; Fetisov, 2009; Clarke, 2010; Yeoh, 2010). Even authors who assign corporate governance a contributory role in the financial crisis disagree on the importance of particular causes of governance failure.

Some authors believe that a decline in corporate governance standards led to the global financial crisis (Fetisov, 2009), as corporate governance practices failed to serve their purpose of safeguarding against excessive risk-taking (Kirkpatrick, 2009, p. 2). The boards and senior management of many banks seriously underestimated the risks they were taking, while many board members and shareholders did not provide the necessary oversight or control of management. Shareholders pressured management to deliver high short-term profits and these pressures were not contained by regulatory or supervisory policy or practice (The High-Level Group on Financial Supervision in the EU, 2009, p. 10).

Nevertheless, the majority view still views flawed corporate governance as playing a limited role in the financial crisis (Hopt, 2013, p. 49). In this view, the failures in banking governance were not sufficient to cause a crisis of such magnitude (Acharya et al., 2009), as examples of flawed corporate governance do not support the claim that these flaws were the most important cause of the crisis (Mülbert, 2010).

Even empirical studies show that the governance of financial firms is, on average, not obviously worse than in nonfinancial firms (Adams, 2009) and that a case for fundamental reform of the current corporate governance framework has yet to be made as corporate governance functioned tolerably well (Cheffins, 2009).

In this article I show why the traditional understanding of corporate governance cannot be used in the case of banks. I argue that due to the special features of banks, a modification of agency theory, according to which management is also accountable to other stakeholders, is necessary. The central question posed is what kind of change is required in order to achieve banking governance that will support financial institutions in once again performing their central function of serving and supporting long-term economic development.

First, I explain how the traditional definition of corporate governance differs from the definition under the stakeholder approach and analyse how banks differ from other companies and how these differences influence bank governance. Secondly, I provide an explanation for the conflict between different stakeholders in banking arising from their different attitudes to risk taking. Finally, I present the recent changes in the banking resolution mechanism legislation for banks in the EU. On the basis of these changes, a change in banking governance with the inclusion of uninsured debtholders is proposed.

2. Corporate Governance: the Shareholder Approach vs. the Stakeholder Approach

Corporate governance is "the system by which companies are directed and controlled" (Cadbury, 1992) and "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer and Vishny, 1997).

Although a generally accepted definition has not yet evolved (Mülbert, 2010, p. 4), in the traditional understanding of the concept, corporate governance contains all the mechanisms, decision-making processes, and contracts that ensure that the objectives of a company and its shareholders are satisfied.

A key problem lies in the separation of ownership (finance) and control (management), as managers may not always act in the interest of the firm's owners (Shleifer and Vishny, 1997, p. 5). Therefore, proper initiatives for the management to work on behalf of shareholders to maximize the value of the company and to serve the interests of shareholders, rather than pursuing their own interests, are required. This theory is known as the agency theory (Jensen and Meckling, 1976) and serves as a standard definition of corporate governance, where the latter refers to the defence of shareholders' interests (Tirole, 2001).

As also other stakeholders can affect and be affected by a firm's objectives, a broader definition of corporate governance evolved in the form of the stakeholder theory (Freeman, 1984). Under the stakeholder approach, the management should take the interests of different stakeholders into account in the decision-making process (Donaldson and Preston, 1995). In contrast to the traditional definition of corporate governance, which has a shareholder orientation, a broader definition includes stakeholders, such as debtholders, the general public, and the government (Hopt, 2013, p. 4).

Significant evidence has been found that banks with more shareholder-friendly boards have performed worse during the crisis (Beltratti and Stulz, 2012), as managers who are accountable to shareholders find it difficult to justify a reduction in profits in the short term in order to maximize the long-term value of the company. Such managers may also be forced to resign (Pacces, 2010, p. 19). Traditional corporate governance principles established to deliver higher share prices and dividends incorporate strong incentives for managers to take risky decisions, while punishing those who pursue the goal of the long-term sustainability of the bank and the stability of the financial system (Tarraf, 2010, p. 29).

Under the conventional understanding of corporate governance, where agents are supposed to act in the best interests of shareholders, the corporate governance failures in banks have not had a significant effect on the evolution of the financial crisis. In this context, the role of regulation is very important, as it offers an instrument that can be used to pressure the shareholders to take less risky actions. However if we acknowledge that banks are different than other firms and that bank regulation creates moral hazards and is imperfect, a broader definition of corporate governance is required, as banking governance needs to be influenced also by other considerations apart from shareholders' profits. Shareholder-oriented corporate governance cannot be relied upon to deliver an outcome that is in the interests of other stakeholders and society. The possibility of modifying corporate governance agency theory to make managers accountable to all stakeholders, not only to the company's shareholders, needs to be addressed (Tarraf, 2010, p. 29).

3. Special features of banks and bank governance

The most important feature that makes banks different from other companies is their maturity transformation function (Hopt, 2013, p. 4). The liquidity producing function, essential for financing the economy, is based on a mismatch between the two sides of a bank's balance sheet – the term structure of the bank's assets and its liabilities. Banks create liquidity by issuing liquid liabilities (typically demand deposits) against illiquid assets (often loans with longer maturities) (Macey and O'Hara, 2003, p. 97). This allows for exposure to liquidity risk that can result in bank runs (Becht et al., 2012, p. 444).

Because of their liquidity production function, banks can only keep a small part of deposits readily available at any time as liquid reserves. If many depositors withdraw their money simultaneously, the bank will not be able to repay all the liabilities at once. Thus, a mismatch between deposits and liabilities may lead to a bank run, as every one would like to withdraw their money before the reserves are drained. Deposit insurance schemes were established to prevent bank runs, but at the same time they create a moral hazard and motivate shareholders and managers to engage in excessive risk-taking (Macey and O'Hara, 2003, p. 97; Mülbert, 2010, p. 10; Ferrarini and Ungureanu, 2011, p. 440).

Banks are also significantly more leveraged than nonfinancial firms as 90% of their liabilities are debt (Macey and O'Hara, 2003, p. 97; Mülbert, 2010, p. 10). This results in a conflict between shareholders and debtholders that is more acute than in other companies (Macey and O'Hara, 2003, p. 98).

Information asymmetries make it is difficult for outsiders, particularly depositors, to assess a bank's risk profile and stability, which further increases the moral hazard for bank managers (Ferrarini and Ungureanu, 2011, p. 441).

Banks are interconnected as a large part of their operations is with other financial institutions. Therefore, they are exposed to a high level of counterparty risk, which makes the banking system prone to contagion (Mülbert, 2010, p. 11).

For all these reasons, a traditional definition of corporate governance that provides incentives for management to serve in the interests of shareholders may lead managers to take excessive risks. The risks are externalized to other stakeholders, while potential gains are fully internalized by shareholders (Ferrarini and Ungureanu, 2011, p. 441).

The specific nature of banking activities has led to particularities in corporate governance and the current financial crisis has brought the realization that a specific view of bank governance is required (Ciancanelli and Reyes-Gonzales, 2000; Adams and Mehran, 2003; Gup, 2007; Mülbert, 2010).

There are two key differences that make bank governance different from the governance of nonfinancial firms. The first difference is that, in comparison to nonfinancial firms, banks have more stakeholders, and the second is in the opaqueness and complexity of banking operations (Mehran et al., 2011, p. 3).For the purpose of this article, I will focus on the first difference, although the role of the complexity and lack of transparency of the banking system is also important regarding banking governance, as "no corporate governance model can work well when the principal actors face severe limitations in their knowledge and understanding of risks due to objective factors" (Avgouleas and Cullen, 2014, p. 2).

Banks have more stakeholders than non-financial firms, since debt represents a significant part of their financial liabilities. Therefore, beyond shareholders, debtholders are also important stakeholders in banks. Due to the limited liability of a bank's shareholders, debtholders (together with taxpayers) carry the burden of the bank's risk-taking activities.

Government guarantees in the form of deposit insurance schemes are in place in most of countries in order to protect the financial system against a panic reaction in the form of 'bank runs'. But due to the fact that a moral hazard is introduced with deposit insurance (since depositors do not worry about the bank's stability), banking regulation is necessary. Banking regulators protect insured depositors from excessive risk taking by banks and monitor bank risk (Spong and Sullivan, 2010, p. 6), with an aim to managing the moral hazard issue arising from deposit insurance (Macey and O'Hara, 2003).

Today, bank regulators and regulation influence bank governance everywhere in the world (Ciancanelli and Reyes-Gonzales, 2000, pp. 5-6), representing another dimension that makes corporate governance in banking more complex than the governance of nonfinancial firms (Wilson et al., 2010).

Mainstream theory predicts that banks need to be regulated in order to internalize the effects of excessive risk-taking on society (Pacces, 2013, pp. 5-6). An alternative point of view shows that shareholders' interests diverge from those of other stakeholders (Mehran et al., 2011, p. 4; Hopt, 2013, p. 63) and that banking regulation is imperfect and creates a moral hazard. As not only shareholders but also other stakeholders are at risk from banks' activities, mechanisms that provide protection to other stakeholders are required (Becht et al., 2012, p. 445; Tirole, 2001), especially depositors (Green, 1989). A solution can be found in a more inclusive form of bank governance, as the further empowerment of shareholders does not lead to a change in their risk attitudes (Tarraf, 2010, p. 25; Rose, 2010).

4. The conflict between bank stakeholders arising from different risk attitudes

Shareholders' interests diverge from those of other stakeholders, especially with regard to risk. Due to their limited liability in the event of losses and full enjoyment of benefits in the case of high yields, shareholders are risk-seeking as they prefer high volatility and usually have a short-term perspective. On the other hand, debtholders and regulators are risk-averse. They prefer low volatility and have a long-term perspective (Mehran et al., 2011, p. 4; Hopt, 2013, p. 63).

Apart from the probability of default, debtholders and regulators are also concerned with the expected losses in the event of the insolvency of the bank, while the bank owners and managers are less sensitive to the size of losses (as the value of the equity is already lost in the case of insolvency and managers are likely to have lost their job) (Ford and Sundmacher, 2005, pp. 12-13).

Thus, it is surprising that some suggest improving the corporate governance of banks by strengthening the influence of shareholders, which is expected to further increase the accountability of bank managers. Under this explanation, a key contributing factor in corporate governance failure is a lack of the board's accountability to the bank's shareholders (Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. § 2, 2009).

Even reforms following the onset of the crisis aimed at limiting excessive risk taking include initiatives for strengthening shareholders' power (Bruner, 2011, p. 316). Further empowerment and engagement of shareholders cannot have a positive influence on bank governance, as their incentives are not in line with the long-term interests of the bank (Parliamentary Commission on Banking Standards, 2013a, p. 14). Due to the fact that managers left to themselves have already excessively focused on shareholders' interests, proposals that give even more power to shareholders are unlikely to yield the desired results (Bruner, 2011, p. 322). Such proposals do not consider the differences between the corporate governance of financial and non-financial firms arising from the specific nature of banking activities.

5. Changes in the banking resolution mechanism

The need for a consistent banking resolution mechanism has become apparent during the current financial crisis (Laeven and Valencia, 2010), especially in the European Union, where an uncoordinated approach in different Member States has resulted in a lack of clarity and potentially led to a "flight to quality" (Longstaff, 2010). In the absence of early intervention and resolution tools for failing institutions, bailing out systemically important institutions was the only option available to national governments. This not only exacerbated the moral hazard, but also created competitive distortions, penalizing banks in countries with weaker economies, as they could not bail out their banks (Ferrarini and Chiarella, 2013, pp. 10-11). A vicious cycle between bank risks and sovereign risks was created at the onset of the financial crisis, reflecting a strong correlation between banks' finances and the debt of the EU Member State where a given bank is based (Ferrarini and Chiarella, 2013, p. 16).

The Banking Union is therefore perceived as a response to tackle the roots of the banking crisis. An European framework for managing the crises is necessary due to the need to restore confidence in the public debt and the need to clearly distinguish public and private liabilities (Riso, 2013).

A change from the currently dominant system of state intervention to a system where private stakeholders bear responsibility for risky decisions is required (Constancio, 2013). A legal mechanism that forces debt holders to bear bank losses could serve as a tool for reinforcing financial stability, as debtholders are only willing to spend resources to monitor a bank's risk exposure when they themselves are at risk (Dermine, 2011, p. 6).

Changes in the banking resolution mechanism follow the goal of minimizing costs for taxpayers. Furthermore, the Basel III regulatory framework and the new European capital directive CRD IV are aimed at achieving greater loss absorption for subordinated debt. The establishment of a single rescue mechanism at the level of the European Union is an important priority and should include clear *ex ante* bail-in rules (Asmussen, 2013).

The so-called 'bail-in approach' is a resolution mechanism that includes restructuring financial obligations by writing off unsecured debt and/or converting it into equity. This mechanism enables immediate bank recapitalization and restructuring of a distressed institution (Zhou et al., 2012, p. 6). It reduces the likelihood of a government bail-out as it ensures that shareholders and creditors bear the losses.

A bail-in can occur on a 'going concern' basis, where the bank continues with its operations, or on a 'gone concern' basis, leading to bank liquidation or an orderly wind-down (Le Leslé, 2012, p. 19). In the event of a bank failure, the bank should be allowed to fail. There should be no bail-out once the payments system and insured deposits are protected (Parliamentary Commission on Banking Standards, 2013a, p. 14).

A bail-in applies to all liabilities, with the exception of deposits protected by a deposit insurance scheme, short-term inter-bank lending, and client assets. In the event of the insolvency of a financial institution, the initial losses are absorbed by equity holders, followed by subordinated debt holders, senior debt holders, and finally depositors who are not protected by a deposit insurance scheme (Conlon and Cotter, 2013, pp. 2-3). Most of the burden sharing is expected from subordinated and senior unsecured creditors (Le Leslé, 2012, p. 20).

Thus, in the event a bank has problems a new group of stakeholders is created, as part of the debt is converted into equity. Other stakeholders, contrary to traditional bank shareholders, oppose excessive risk taking, but only gain voting power when the financial institution approaches insolvency (Coffee, 2010, p. 809).

6. Proposed solution

A clear connection between bank governance and risk taking has been established in the literature (Caprio et al., 2007; Laeven and Levine, 2009; Pathan, 2009; Beltratti and Stulz, 2012). During the financial crisis a mismatch between shareholder interests and the long-term interests of the financial institution became apparent, as major weaknesses in shareholders' empowerment in bank governance were exposed. Banks that are managed by shareholders "are potentially the greatest endogenous source of systemic risk" (Ciancanelli and Reyes-Gonzales, 2000, p. 23). Management pursuing the goal of stock price maximization focused on increasing observable earnings, leaving increases in risk exposure largely unobserved (Bratton and Wachter, 2010).

The bail-out resolution mechanism is commonly perceived as a way of shifting losses from banks' shareholders to taxpayers. Under this regime, regulation is a key factor contributing to a safer banking sector.

As changes in the European Union banking resolution mechanism for problematic banks entail that debtholders are forced to cover the losses of failing institutions, a change in bank governance is required. Bank debtholders are not involved in high yields in the case of profit, but are burdened with the risk of losing their stake in the event of a bank failure (Admati et al., 2011, pp. 30-31). Therefore, uninsured debtholders should gain a formal role in bank governance on an *ex ante* basis, not only as the institution approaches insolvency.

The presence of unsecured debt that can be expected to bear the losses in the event of bank failure can provide an important market mechanism that would work as a counter-balance to shareholders' incentive to pursue excessive risk-taking, potentially reducing the excessive leverage associated with banks that have underperformed in the current financial crisis (Beltratti and Stulz, 2012). A greater incentive for bondholders to properly assess the credit risk should work as a market discipline tool encouraging management to balance downside and upside risks better (Parliamentary Commission on Banking Standards, 2013a, p. 40; Parliamentary Commission on Banking standards, 2013b, pp. 329-330).

7. Conclusion

In this paper I have demonstrated how changes in bank governance leading to a formal role for uninsured lenders could represent an important addition to or even substitute for banking regulation, as debtholders' interests are directly linked to the objective of maintaining safe operations and would also result in the systemic stability of the financial system.

Bank debtholders are usually not in a position to control excessive risk taking in banks and have even less incentive to monitor such in the presence of implicit and explicit government guarantees. Therefore, the inclusion of bank debtholders in bank governance can only be credible when debtholders participate in losses in the event the bank experiences difficulties and they do not benefit from any form of implicit or explicit government guarantees. Recent changes in the banking resolution mechanism legislation for banks in the EU from a bail-out to a bail-in approach that creates a new group of bank stakeholders with strong incentives to oppose excessive risk taking – i.e. uninsured debtholders – can be seen as an opportunity to bring about substantial change in bank governance.

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