CORPORATE GOVERNANCE IN BANKING: A SURVEY OF THE LITERATURE

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Abstract

The aim of this paper is to explain the particular characteristics of the corporate governance of banks and its role for good bank performance. In order to do that, it reviews the existing literature on this issue trying to answer three main questions: (i) *Why are banks different?* Existing research points at diverse features, such as, regulation, supervision, capital structure, risk, fiduciary relationships, ownership, and deposit insurance, that would make banks special and thereby influence their corporate governance. (ii) *What is different about bank governance?* According to past studies, banks' boards of directors are larger, more independent, have a superior number of committees and meet more often, but seem to play a weaker disciplinary role. Executive compensation would be higher in banking, but pay-performance sensitivity appears lower. (iii) *What works for banks?* Larger boards, more concentrated ownership structures and certain levels of managerial shareholdings are the principal factors suggested by the empirical evidence to date that seem to lead banks to higher performance.

Keywords: Corporate Governance; Banks; Performance

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1. Introduction

Banks have a central role in any economy. They mobilize funds, allocate capital and play a decisive role in the corporate governance of other firms. All this means that, when banks are efficient, they stimulate productivity growth and the prosperity of the whole economy. On the other hand, banking crises are able to destabilize the economic and political situation of nations. These strong externalities on the economy make the corporate governance of banks a fundamental issue. Well-governed banks will be more efficient in their functions than those governed poorly (Levine, 2003). And as a result of its relevance, in the case of banks, corporate governance is not merely a private, but also a public affair manifest through the existence of bank regulation and supervision.

Furthermore, not only the good governance of banks is important, but the question arises as to whether it is different from other firms. As this paper will show, banks appear to pose new questions to the corporate governance problem due to their intrinsic characteristics and their regulated condition. In the current European situation, where the deregulation process has dramatically changed the competitive scenario of the banking industry in the recent years, understanding the corporate governance of banks becomes an exciting challenge.

Given that the failure of the boards of directors and management is acknowledged to be one of the major causes of the collapse of many banks (Office of the Comptroller of the Currency, 1988), we believe that a better knowledge of the particular way banking firms are and should be governed will be very helpful in preventing important not only private, but also social costs derived from bank failures or simply poor bank performance.

From the banks' perspective, the fine development of a governance system should be a main matter of concern and could constitute an essential strategic strength for banks willing to be competitive in the new EU scenario. The European Central Bank (1999) offers a detailed analysis of the current trends in the European banking system, trends that are expected to be reinforced and accelerated by the recent introduction of the euro. All the new regulatory changes associated to the European Monetary Union will continue to gradually impact the banking industry, meaning that more internationalization of the banks across the EU is expected to take place, both through an increase in the number of mergers, acquisitions and strategic alliances, and through foreign branching and subsidiaries. Furthermore, with disintermediation becoming increasingly important and the adoption of the latest technologies by banks, extra pressure would be put on the reduction of the industry excess capacity. All this should warn banks to fine tune their strategies in the new competitive environment if they do not want to see their profitability dramatically reduced.

In this paper we review the academic literature trying to understand the special characteristics of the corporate governance of banks and its role for the good performance of the banking firm. Our findings can be briefly summarized around three main questions:

(i) *Why are banks different?* Existing research points at diverse features, such as, regulation, supervision, capital structure, risk, fiduciary relationships, ownership, and deposit insurance, that would make banks special and thereby influence their corporate governance.

(ii) *What is different about the corporate governance of banks?* According to past studies, boards of directors and takeovers, both friendly and hostile, play a weaker disciplinatory role in banks; even though boards are larger, more independent, have a superior number of committees and meet more often. Top executives compensation is higher in banking, but pay-performance sensitivity is lower. Finally, while banks present more dispersed ownership structures, high government participation is common all over the world.

(iii) *What works for banks?* Within the governance system, the elements that seem to lead banks to increased performance, as suggested by the empirical evidence on the issue, are ownership concentration, certain levels of managerial shareholdings and larger boards.

All this make us think that the whole understanding of the corporate governance problem may vary considerably with the industry and, perhaps, this could be one of the reasons behind the lack of more significant results in the corporate governance literature. In this sense, on top of banks, other sectors of the economy might benefit from this industry-specific study too by considering the potential uses of regulation to enhance their competitiveness. Nonetheless, it might also be important to keep in mind that the number of studies that focus specifically in the banking sector is not so large at the present moment and they have primarily been based on US banks. Therefore, it remains yet to be seen whether further research will confirm the current findings on the specific governance mechanisms conducing to the improved financial performance of banks.

It is necessary to make clear some delimitations to our study. The corporate governance role played by banks in other firms has been broadly touched upon in the academic literature[5], but it does not constitute the object of our research in this paper, where we are concerned with the way banks themselves are being governed. Likewise, the interesting topic of M&As within the EU banking industry[6], despite being closely related to the banks' corporate governance, will not be covered here neither. Finally, the surveyed literature focuses mainly on commercial banks or universal banks that undertake the full range of traditional banking services.

Even thought the geographical focus of the following essays will be on Europe, we include here many studies on other nations (mainly, U.S.) given the limited investigation at present available on European banks.

We will address the corporate governance problem from an agency theory[7] perspective, the most commonly used in the economic literature, thought we are aware this issue can be analyzed from other different and also interesting angles (resource dependence theory, stewardship theory, power perspective,…).

The paper is structured as follows. Section 2 broadly defines the corporate governance problem and examines the theoretical and empirical literature that links it to company performance. Section 3 explains the singularity of banks and the impact on their corporate governance. The fourth section looks at the determinants of bank performance, focusing on the particular influence of the corporate governance mechanisms. Finally, the main conclusions are summarized in section 5.

2. Corporate governance as a determinant of performance

2.1 What is corporate governance?

There is a very wide literature on corporate governance. Research has been done both in theory and empirical issues. But, why has it become such a hot topic in the last years so as to attract all this unprecedented interest? According to Becht et al. (2002), we can find the explanation to this on a set of phenomena, such as: (1) the privatization wave that spread all over the world during the past two decades, (2) the pension fund reform and the growth of private savings that meant increased investor activism, (3) the takeover wave of the 1980s in the U.S. and the 1990s in Europe, (4) the deregulation and integration of financial markets, and finally, (5) the recent scandals and failures that took place in some of the largest U.S. firms in the last years.

Now that we now what brought it into the picture, we may start wondering what is in fact all this corporate governance issue about. From a broad perspective, we could say that

> *"Corporate governance is concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders."* (Becht et al., 2002, p.2)

[5] See Gorton and Winton (2002)

[6] See Campa and Hernando (2004 and 2007).

[7] The agency theory analyzes the relationship between the principal (shareholder) and the agent (manager), in which the agent acts on behalf of the principal.

If we narrow the approach and take a straightforward agency perspective, focusing on the separation between ownership and control, then:

> *"Corporate governance deals with the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment."* (Shleifer and Vishny, 1997, p. 2)

These studies constitute today two of the most comprehensive reviews of the theoretical and empirical research on corporate governance. Finance without governance, legal protection of shareholder rights, large shareholders and takeovers, debt finance, and state ownership and cooperatives are the possible solutions mentioned by Shleifer and Vishny (1997) to the governance problem.

Similarly, Becht et al. (2002) point at five mechanisms to solve the *collective action problem*: large shareholders, hostile takeovers and proxy voting contests, the board of directors, executive contracts linking compensation and company performance, and finally, well-defined CEOs fiduciary duties combined with class-action suits. They reach the conclusion that the major problem now is balancing the tradeoff between regulation of large-shareholder supervisory power in order to protect the dispersed investors and the need to monitor managers to prevent them from self-dealing and abuse shareholders

In their survey, Shleifer and Vishny (1997) account for different governance models across countries. The US and the UK have a governance system characterized by a strong legal protection of investors and the lack of large investors, except when ownership is concentrated temporarily during the takeover process. In Continental Europe (particularly, Germany) and Japan, corporate governance relies more in large investors and banks to monitor managers; legal protection for investors is weaker and hostile takeovers very uncommon. What we see in the rest of the world is heavily concentrated ownership in families, some outside investors and banks; and an extremely limited protection of investors. Legal protection of investors and concentration of ownership are considered complementary approaches to corporate governance. All successful governance models (Anglo-Saxon, German or Japanese) are characterized by protecting efficiently at least some kind of investors.

Within the field of research that aims to find an explanation to these differences in the corporate governance models prevalent around the world, two main streams of literature stand out: the political approach and the legal perspective.

The "political view" to corporate governance argues that political pressures, together with the economic factors, influenced the evolution of the different governance models (Roe, 1991). For this "political view", the well-developed protection of small investors in the U.S. is partly the result of the suppression of large investors and bank monitoring.

Adopting a legal perspective, La Porta et al. (1998) highlight the role of the different legal systems in shaping the corporate governance model prevalent in a certain country. They show that legal systems differ across countries according to the origin of their laws [common law countries *versus* civil law countries (composed by German, Scandinavian and French families)]. Investors are better protected in common law countries than in Germany or Scandinavia, and they suffer the lowest level of protection in French civil law countries. The quality of law enforcement, together with the quality of the accounting standards, varies a lot around the world and clearly improves with higher income levels. In the best position we find now German civil law countries and Scandinavia, followed by common law countries. Again, French civil law countries are at the bottom with the weakest law enforcement. Finally, and maybe as a response to poor investor protection, they observe that concentration of ownership is very high in publicly traded companies around the world.

2.2 Corporate governance as a determinant of performance

There are numerous studies that provide us with both theory and empirical evidence to link the governance of the corporation to its performance. We will briefly highlight here the main findings from the literature that focuses on the board of directors, ownership structure, incentive compensation and the legal protection of investors.

2.2.1 Board of directors

The board of directors is known as one of the most important instruments to solve the corporate governance problem (Jensen, 1993), since it is the organ primarily used by other stakeholders to monitor management. Despite this fact, the theoretical studies on the board of directors have been quite scarce.

Hermalin and Weisbach (1998) construct a model that examines the determinants of board composition as a bargaining process between the existing directors and the CEO over the incorporation of new members on the board. Depending on the CEO's perceived ability compared to potential successors, the power of the CEO in the negotiations will determine whether he dominates the board or, instead, he will be subject to active monitoring. The model predicts a number of empirical regularities: poorly performing CEOs are more likely to be replaced than well performing ones; the sensitivity of CEO turnover increases with the independence of the board; after poor firm performance, additions of independent directors to the board are more probable; the board will become less independent over the course of a CEO career; and last, management turnover is better explained by earnings that by stock returns. The model also suggests some other

predictions not yet empirically tested. First, there will be long-term persistence in corporate governance practices. Second, when a manager is fired on the basis of private information, it should be followed by a fall in the stock price. Conversely, if the reason of the firing is public, the stock price would rise. And third, their last prediction is concerned with the sensitivity of the CEO salary to past performance, which should increase with the level of performance achieved.

In another interesting study, Bennedsen (2002) finds two motives behind the establishment of boards when this is not imposed by law. In his model, besides the governance motive (boards exist because they create firm value by monitoring the management and governing the firm), there is a second reason (distributive motive): boards help solving conflicts between controlling and non-controlling owners. The strong presence of this distributive motive leads him to argue that increased investor protection could reduce its relative importance, permitting boards to be more focused on governance, thus boosting the value of the firm.

While the formal theory on the board of directors has been quite limited, the number of empirical studies is considerable. Hermalin and Weisbach (2003) are the authors of one the most detailed surveys on the empirical literature on the issue and reach the following conclusions:

- There is no relation between board composition and corporate performance.
- A negative relationship exists between board size and corporate performance.
- Both board composition and size affect the quality of the decisions taken by the board concerning the replacement and pay of the CEO, acquisitions and poison pills.
- The evolution of the board over time is determined by the negotiation process between the existing directors and the CEO.
- The studies based on organizations with prohibitions on takeovers testing whether boards function as a substitute for an external control market (measuring the number of outside directors) found opposite results.

The fact that the empirical evidence does not show that independent boards of directors improve the financial performance of the firm could be due, according to Daily et al. (2003a), to two potential explanations: the excessive focus on directors' oversight role without consideration of alternative roles (resource, service and strategy roles), and the possible existence of intervening processes between board independence and firm performance.

2.2.2 Ownership structure

Moving on to our second governance mechanism, we find that the effect of the ownership structure on firm value has often been studied in relation to the level of product market competition. Mayer (1998) relies on the existing literature to make a theoretical overview of the interrelation between corporate governance, competition and performance. According to this author, corporate governance can bear on performance through five different channels: incentives, disciplining, restructuring, finance/investment and shareholders commitment/trust. He argues that incentives, disciplining and corporate finance are not the main features that differentiate financial systems. Instead, they are the diverse types of ownership and control across countries what seems to influence mostly the formulation and implementation of corporate strategy. This way, while insider systems (characterized by concentrated ownership and large shareholders monitoring, and common in Continental Europe and Japan) might be better at implementing policies that involve relations with stakeholders; outsider systems (dispersed ownership, management controlled firms, frequent in the US and the UK) are more flexible and can better adapt to changes. Eventually, product market competition will determine the effectiveness of the different governance systems and, consequently, their impact on performance, through the shaping of the required ownership and control structure.

In a very interesting paper, Nickell et al. (1997) also look for an interaction between competition, ownership and performance. They use a productivity growth model on a panel of 580 UK manufacturing companies from 1982 to 1994 to show us, confirming previous studies, that product market competition, financial market pressure and shareholder control are all associated with some degree of productivity growth. Furthermore, they find some significant evidence that financial market pressure and shareholder control can substitute for competition as a disciplinatory mechanism of management.

If we now centre our attention exclusively on the effect of the ownership structure[8], we will have to go back to 1933, when Berle and Means suggested a positive correlation between ownership concentration and firm profitability (Berle and Means, 1933). Since more concentrated structures would suffer less the governance problem arising from the separation between ownership and control, the opportunities for managerial self-dealing would be reduced, and consequently, that would have a positive influence on the company's profit rates.

However, later findings by Demsetz and Lehn conflict with this thesis (Demsetz and Lehn, 1985). After examining the impact of ownership structure on firm value in a single regression model, they claim that the lost of control by the owners could be offset by a lower cost of capital or other benefits of diffuse

[8] For a more thorough and comprehensive review on the theoretical and empirical aspects of the relationship between ownership and firm value, see Thomsen et al. (2006).

ownership causing the optimal degree of ownership concentration to vary across firms according to differences in firm size, the instability of the environment, the presence of regulation in the industry or the amenity potential of the firm's product for the owners.

On the whole, the empirical literature analyzing the effect of ownership on firm value is consistent with Demsetz and Lehn (1985). Demsetz and Villalonga (2001) use simultaneous equations to examine 223 US firms over the period 1976-1980, a sub-sample of the Demsetz and Lehn (1985) data. They consider two dimensions of ownership structure, managerial ownership and ownership concentration among outside shareholders, and after controlling for capital structure, advertising and research intensity, firm size, profit volatility, stock market risk and industry dummies for the financial, media and utilities sectors, they find that no significant impact of ownership structure on firm value, as measured by Tobin's Q.

But, can we generalize these findings based on US firms to the rest of the world? Thomsen and Pedersen (2000) argue that this relationship between ownership and performance may be influenced by the governance system and thus, they analyze the relation between ownership structure and economic performance in the largest European companies. Both for return on assets and market-to-book values of equity, they provide evidence of a bell-shaped effect of the share of the largest owner on firm performance, significant even after controlling for industry, capital structure and nation effects[9]. Furthermore, they find that this relationship is also influenced by the identity of the largest owner, as well as for nationality. This way, in the case that the largest owner of a British company is a financial institution, we will find the highest impact of ownership share on the above mentioned measures of performance. For sales growth, the largest effect would be found in companies in which the largest owner is a family or another company. The reason behind the relevance of owner identity could be the different goals each type of shareholder may have, besides the common interest in shareholder value maximization.

Continuing in this line of arguments, Thomsen et al. (2006) use Granger-tests for causality on data on ownership and firm value over a 10-year period (1988-1998) for 876 of the largest EU and US companies. Their results confirm the existence of a *system effect* in the relationship between blockholder ownership and firm value (using Tobin's Q). While in the US and UK they find no evidence of causality either way, corroborating previous research by Demsetz and Lehn (1985) and Demsetz and Villalonga (2001); in Continental Europe a strong negative effect of blockholder ownership on firm value is observed, though only significant for firms with high initial level of blockholder ownership. According to the authors, the high levels of blockholder ownership in continental Europe would have reduced the value of the firm, at least from the point of view of minority investors.

2.2.3 Incentive pay

Changing now to the use of incentive pay as a governance mechanism, Murphy (1999) makes a comprehensive review of the empirical and theoretical research on executive compensation. His findings suggest that pay-performance sensitivity is positive and small, but with a tendency to increase over time. Nonetheless, the causality is debatable; since, on the one hand, managers may be more likely to accept performance related pays when they expect good performance (it is not uncommon that managers influence their own pay), and on the other, there is typically more room for extra compensation packages, including performance related pay, when the company is doing well.

Even if it is true that there has been a stronger alignment between executives and shareholders during the last decades as a result of the increased reliance on equity-based forms of compensation, especially on stock options plans, Daily et al. (2003a) and Daily et al. (2003b), when reviewing the research on governance through ownership and regarding the relationship between CEO compensation (shareholdings versus salary) and firm performance, find little agreement on any strong relationship. Even when such relationship has been consistently demonstrated, the causality is not clear. Likewise, there is no firm evidence on the efficacy of the recent trend consisting on compensating members of the board of directors with stock (Daily et al., 2003b).

2.2.4 Legal protection of minority investors

Finally, and regarding the legal aspects of corporate governance, La Porta et al. (2000) examine 371 large firms from 27 wealthy economies and conclude that better investor protection is associated with higher corporate valuation. This would be explained, according to the authors, by the fact that outside investors would be willing to pay a higher price for financial assets when a better legal protection makes sure that they will receive their rents.

3. The corporate governance of banks

3.1 What is special about banks?

Banks carry out different activities that vary according to the diverse economic and institutional conditions in which they operate. Following Danthine

[9] In Thomsen and Pedersen (1997) we can see for a sample of the largest European companies that both nationality and industry have an effect on the ownership structure.

et al. (1990), we can explain the broadest concept of universal banking by dividing it into three groups performing different functions: retail banking, investment banking and asset management. Retail banking would be subdivided into commercial banking (in charge of lending to firms and consumers, collecting deposits and managing the accounts and transactions associated with the deposits) and private banking (responsible for the management of portfolios of wealthy individuals). Investment banking would comprehend the underwriting of securities, market making and mergers and acquisitions; while the category of asset management would take care of the management of institutional assets, pension funds and other large-scale savings instruments. Furthermore, the scope of banks has recently begun to include new activities, such as credit card business, insurance, etc.

Nonetheless, no matter if we consider this broad concept of universal bank or if we narrow the approach down to commercial banking, the fact is that banks are not like other firms. The very nature of its business, consisting mainly in receiving deposits, making loans and processing information, and its central role in any economy, as the basis for the payments system, make them different in many aspects. The academic literature has been prolific trying to explain the existence of financial intermediaries, i.e., what is that banks do that cannot be replicated in the capital markets through direct contracting between investors and firms. Following Gorton and Winton (2002), the major theories on this issue point at five main roles of banks:

1. Banks as delegated monitors:

Diamond (1984) was the first to suggest that financial intermediaries exist because they "monitor" borrowers.

In a contract between a borrower and a lender there is an ex post information asymmetry in that only the borrower knows the realized output of his project, and therefore, he would not pay the lender back unless he has an incentive to do so (a moral hazard problem). If the lender could produce information about the borrower's realized output, he would overcome his disadvantage and reduce the agency costs. This production of information about the borrower's output is what Diamond denominates "monitoring". Given that monitoring borrowers is costly, it will be efficient for investors to lend to a specialized agent (the intermediary) who will be monitoring borrowers on behalf of them, as long as the costs of monitoring the intermediary (known as the "monitoring the monitor" problem) are lower than the costs of lenders lending directly to borrowers and directly incurring the monitoring costs.

As Diamond shows, this centralization of the task of monitoring is an efficient solution because, as banks grow large, only if they have monitored as promised, will they be able to satisfy their commitment to pay depositors back. Otherwise, they would incur non-pecuniary penalties, such ass bankruptcy costs or loss of reputation.

Diversification among different investment projects is crucial in explaining why delegating monitoring to an intermediary is a lower cost solution to the ex post information asymmetry between borrowers and lenders than the securities market because diversification is critical to reducing the monitoring the monitor problem.

2. Banks as formation producers.

In addition, banks may also be in charge of producing information about investment opportunities and sell then the information to uninformed economic agents (see, among others, Boyd and Prescott, 1986).

In this connection, a rich strand of literature has emerged that focuses on "relationship banking" and relies on the idea that banks acquire this private information through repeated interaction over time in what is known as "customer relationship" (see Haubrich, 1989; Rajan, 1992; and for an extensive review of this literature, see Gorton and Winton, 2002).

3. Banks as consumption smoothers.

The Diamond and Dybvig model (Diamond and Dybvig, 1983) looks at the liability side of banking, where demand deposits offer consumers the right to withdraw from the bank and prematurely end investments in order to satisfy their desired consumption paths. According to Diamond and Dybbvig, banks act this way as vehicles for consumption smoothing, in the sense that consumers that save via intermediation get insurance against the consumption shocks derived by their random consumption needs.

4. Banks as liquidity providers.

A fourth characteristic of banks is related to the fact that bank liabilities can function as medium of exchange and may even dominate government-supplied money, which explains the central role banks have in payment systems as liquidity providers (Freeman, 1996).

5. Banks as commitment mechanisms.

Banks are very fragile institutions. Their above mentioned liquidity production function (the mismatch in the term structure and liquidity of their assets and liabilities) together with the high debt ratios make bank runs a serious risk to be considered and, according to some, create the need for the deposit insurance fund (Macey and O'Hara, 2003).

However, looking at it from a different perspective, fragility can also be seen as a positive attribute of banks. Some authors argue that capital structures are designed to be fragile, so that they function as a commitment mechanism, as a device to discipline bankers and prevent them to engaging in risky activities (Calomiris and Kahn, 1991; Flannery, 1994).

Nevertheless, as Diamond and Rajan (2001) point out, moral hazard may not be the only reason behind bank runs, and in a situation of

high liquidity demand very fragile structures might not be the most desirable, but the maintenance of an optimal level of bank equity capital would be a safer option.

3.2. Regulation and supervision

After reviewing the main roles played by banks, it is easy to understand that the consequences of a bank crisis can be devastating for an economy. Not only the nature of their activities and the high debt ratios make banks very fragile institutions; on top of this, because of the interconnectedness of banks, the failure of one institution can immediately affect other banks and firms they do business with. This is known as *contagion effect* and makes bank runs a very serious issue to deal with since they could potentially spread throughout the economy - in what is called a banking panic -, justifying the systemic interest to avoid bank failures and the associated high social cost (Llewellyn, 2001).

Whether banks are inherently unstable, that is, prone to panics, or not is still the object of a vast amount of theoretical and empirical literature on banking panics and the stability of the banking system[10]. But this view on the relationship between bank health and business cycles is at the root of the widespread banking regulation (Gorton and Winton, 2002), and government policies used to regulate banks reflect this systemic interest to avoid bank failure and its contagion to other banks, and aim to ensure a safety net for depositors and to promote soundness in banks' investment practices.

Given the specificity of these objectives, banking regulation raises issues that are not addressed within the general theory of regulation and its instruments must also be specific to the banking sector (Freixas and Rochet, 1997). The regulatory instruments used in banking can be classified into six types: deposit interest rate ceilings; entry, branching, network and merger restrictions; portfolio restrictions; deposit insurance; capital requirements; and regulatory monitoring. Except for entry and merger restrictions, they are all typical of the banking industry (Freixas and Rochet, 1997).

As previously commented, it is often argued that safety-net arrangements, and in particular, the deposit insurance fund, created to prevent bank runs and reduce the impact on the economy when an individual bank collapses, can modify the incentive structures of the different parties involved in the governance of the firm creating a moral hazard problem [Llewellyn (2001), Macey and O'Hara (2003)]. According to this idea, bank shareholders would have an incentive to take advantage of this deposit insurance by engaging in riskier activities than they would otherwise. At the same time, if the adoption of government deposit insurance policies leads banks to take additional risks, there will be further need for government intervention via bank regulation (Gorton and Winton, 2002; Buser et al., 1981).

Another interesting regulatory issue concerns market discipline. A profuse stream of literature has investigated this topic (Flannery and Sorescu, 1996; Berger et al., 2000; Flannery, 2001). In particular, Flannery (2001) offers a broad discussion on market discipline, which he defines as an ambiguous concept "used to incorporate two distinct phenomena: market investors' ability to monitor (identify) changes in bank conditions vs. their ability to influence a firm's actions". In this paper, Flannery advocates for more market discipline, by explaining how market information should be incorporated into the supervisory process. He argues that, since investors are better at monitoring and supervisors do better at influencing, supervisors should take market prices into consideration to act more promptly when a firm is in trouble, in order to minimize the social costs of bank failures.

In the particular case of the European banking industry to understand the regulatory environment for banks in the EU, we can divide it into two parts: the harmonized fraction and the country-specific non-harmonized part (Padoa-Schioppa, 1999). Within the harmonized set of rules, the most interesting in our case is the Second Banking Coordination Directive. If traditionally, banking legislation was primarily concerned with possible bank failures, now, an extra focus is on competitiveness on a national and international level. The Second Banking Directive (issued in January of 1988 and implemented on January 1, 1993) authorizes banks already operating in a member state to open branches and to provide services in all other member states, subject to the agreement of the supervisor in the home state. This way, it provides European banks with greater opportunities for international expansion. According to Barth et al. (1997), this Directive also increases the opportunities for regulatory arbitrage, and as a consequence, we will see greater harmonization of the regulation of banks throughout the EU.

Previously, the First Banking Coordination Directive (1977) had agreed on a definition of credit institution and the granting of a banking license. In the following years, a number of subsequent Directives have addressed the main regulatory issues for EU banking; and nowadays we can say that the EU "banking law" is quite well-developed and consistent with the Basle Committee's rules (Padoa-Schioppa, 1999).

A very important issue in the regulation and supervision of banks involves capital standards [Padoa-Schioppa (1999), Barth et al (1997), Krayenbuehl (1993)]. In July 1988 a number of countries adopted the specifications resulting from the Basle Accord realized by the Basle Committee on Banking Supervision and consisting on four basic elements: (i) a definition of Tier 1 (or core) capital,

[10] See Gorton and Winton (2002), Section IV, for a review.

(ii) a definition of Tier 2 capital, (iii) a general framework to facilitate an standardized calculation of a risk-based capital ratio, and finally, (iv) establishment of a minimum risk-based capital ratio of 8 percent (of which Tier 1 would constitute at least 4 percent).

Concerning the banking supervision system in the European Monetary Union, Padoa-Schioppa (1999) gives us a brief explanation about its singularity. This uniqueness comes from the non-coincidence of the areas of jurisdiction of monetary policy and of banking supervision The Euro area is characterized by having a central bank which carries out monetary policy issues for all the member countries, but leaves the supervisory tasks to the national states, that will exercise this supervision through the national central banks and/or other separate institutions. Since there is no expectation, according to Padoa-Schioppa (1999), that the Treaty provision that allows the European Central Bank to become the common supervisory authority in the EMU (Art. 105(6)) will soon be activated; this author calls attention to the need of co-operation between the Eurosystem and the national supervisory authorities, if we want to avoid the propagation of possible problems through the whole Euro-area.

In this same line, Wihlborg (1999) points at the necessity to modify the principles of home country control and mutual recognition within the EU, since the current difficulties of national supervisory authorities to be informed about the exposure of banks to risk would sharply increase following the internationalization of banks. This modification would comprehend an expanded role for the ECB, including power to veto the bailing-out operations of national central banks and the active coordination of activities of national supervisory authorities. According to Wihlborg, credibility would be the key concept if we want to improve bank supervision in the EU.

3.3. What is special about the corporate governance of banks?

According to Freixas and Rochet (1997), the specificity of banks lies in the fact that their creditors are also their costumers, and this entails a much more serious free rider problem related to the monitoring of widely held banks. Their reasoning goes as follows. While in non-financial firms "professional investors", such as, banks, venture capitalists or "informed" private investors, hold the majority of the debt; in the case of banks the debt is mostly held by uninformed, dispersed small agents (mostly households) that could poorly monitor the banks' activities. To make things worse, these securities can be used as a means of payment (which moderates the free rider problem involved in monitoring), and the capital structure of banks is characterized by a substantially higher proportion of debt than in non-financial firms (Freixas and Rochet, 1997).

On the other hand, it has also been broadly suggested that the existence of regulation in the banking industry has an important impact the governance of banks (Llewellyn, 2001), and more so than in other regulated industries since, as we have previously commented, banking regulation raises new questions and uses specific regulatory instruments (Freixas and Rochet, 1997).

More in particular, the fact that authorities provide some sort of subsidized monitoring might influence shareholder and depositors incentives to exercise control (Llewellyn, 2001). Following on Lindgren et al. (1996) tradition of discriminating between different levels of governance, and after analyzing the causes of recent financial crisis, Llewellyn (2001) takes a broader approach to bank regulation and builds up a model where rules are only one of the seven complementary elements of the regulatory regime (previously considered to be alternative). These key components are: (1) the regulation; (2) monitoring and supervision by the authorities; (3) the incentive structures encountered by regulatory agencies, consumers and banks; (4) the role of market discipline; (5) intervention arrangements in the case of bank failures; (6) internal governance mechanisms within banks; and (7) the disciplining and accountability standards applied to regulatory agencies[11]. With the objective of financial stability in mind (i.e. reducing the probability of bank failures and the costs of those that do occur), the way to the optimal regulatory strategy would be to combine these complementary components of the regulatory regime having into consideration the negative trade-offs that may emerge between them. Particularly, there exists the risk that excessive regulation will decrease the power of the other mechanisms, even to an extent that may reduce the overall effectiveness of the regulatory regime. Defined in this fashion, the optimal regulatory strategy would vary across countries, over time and between individual banks. Concerning what would be specifically the internal governance mechanisms, he stresses the relevance of monitoring and supervision of the risk-taking profile of banks. In this sense, he recommends the existence of a board director exclusively dedicated to the bank's risk analysis, management and control systems; as well as having in mind that some ownership structures lead to inefficient bank governance (particularly, when banks belong to larger conglomerates).

[11] In relation to this, Woods (2000) explains how the International Monetary Fund and the World Bank should make changes in their constitutional rules, the decision-making procedures and other practices if they want to achieve the same standard of "good governance" that they require to their member countries, now, that the stakeholders involved increase their number and interest in the institutions

So far our attention has been centered on the conflict of interests between bank equity holders and creditors that might give rise to a moral hazard problem possibly aggravated by the regulation and other government policies put in place to control it. But are there conflicts of interest between bank owners and their managers? The empirical evidence available (Office of the Comptroller of the Currency, 1988; Barro and Barro, 1990; and Prowse, 1995, among others) suggests that the corporate governance problem is not exclusive of non-financial firms, but banks also face a second type of moral hazard opportunities that the above mentioned bank regulatory policies fail to address. What is more, bank regulation and the traditional corporate governance mechanisms have different goals and objectives and therefore could be counteracting each other, as Llewellyn (2001) previously pointed out by referring to the negative tradeoffs between them. For example, we could think that the alignment of interests of owners and managers used to reduce corporate governance costs may result in an increase of the moral hazard problem that regulation aims to combat by making managers willing to take higher risks. In opposite direction, the presence of regulation might also directly affect the power of traditional governance mechanisms in banks by placing barriers to takeover activities (Prowse, 1995), establishing differing restrictions on the holding of shares, or determining the type of board structure as well as the existence of government representation in boards (Allen and Gale, 200; Wymeersch, 1998).

Looking at it from a different angle, if the existence of specific regulation on the banking sector opens the door to the possibility of interplay between private and public governance systems, it can also be argued that this interaction does not only mean that banks are affected by regulation, but that they can influence it too. This seems to be certainly the case in Japan through the phenomenon of the *amakudari* (Van Rixtel and Hassink, 2002), and we may wonder whether and to what extent this could also be taking place in Europe. In this connection, the stream of economic literature based on the concept of rent-seeking could be useful. The theory of rent-seeking is frequently defined as the sum of resources spent by individuals and organizations in pursuit of rents created by government[12]. In our particular situation, we could imagine banks trying to influence national regulation in order to achieve different objectives, for example, improve their competitiveness in relation to foreign banks (as we have seen a better protection of investors can boost corporate valuation (La Porta et al., 2000).

As we have discussed so far, it seems that banks' intrinsic characteristics and their regulated condition are likely to have an effect on the particular configuration of their corporate governance model. Now it would be interesting to look at the empirical evidence on the corporate governance mechanisms of banks and their functioning, and therefore we move on now to review the empirical literature on the issue. Despite the existence of all these observed elements that make the corporate governance of banks potentially different, the fact is that research on the governance of banks outside the US has received surprisingly little attention by researchers. For ease of exposition, we will broadly try to follow the order of mechanisms used in the previous section (boards of directors, ownership structure, incentive pay, legal protection); however, in some cases they appear inevitably mixed.

One of the pioneers in this area is Prowse (1995). He analyzes the effectiveness of alternative methods of corporate control for a sample of U.S. commercial Bank Holding Companies[13] (BHCs) over the period 1987-1992 considering different measures of performance, ownership structure, and board composition. In this paper, two mechanisms appear to be weaker in the banking industry when compared to firms from other sectors of the economy: hostile takeovers and intervention by the board of directors, which, according to the author, makes the governance of the BHCs a more serious issue to deal with by regulators than in the case of non-financial firms. His results for the different types of changes in control can be summarized as follows:

1. Hostile takeovers: They are less frequent among BHCs and have an unimportant role in disciplining management. Since regulatory barriers and delays are the reasons that make them infrequent, it would be beneficial for the corporate governance of banks to reduce the regulatory restrictions and the imposed delays.
2. Friendly mergers: Even if in this case they are more common within the banking sector than in other industries; they do not respond neither to the need of disciplining management, since they mainly took place among BHCs that already performed well.
3. Removal of top management by the board of directors: It follows bad performance, but it is less frequent in banking than in manufacturing firms
4. Intervention by regulators: The banks that have gone through an intervention of this kind presented lower levels of

[12] The idea was introduced by Tullock (1967), but the term would not be invented until 1974 when Krueger published a study estimating the social losses incurred by the economies of India and Turkey by rent-seeking for import licenses (Krueger, 1974).

[13] In the U.S., a Bank Holding Company (BCH) is a company that owns two or more banks and has to be registered at the Federal Reserve System.

ownership concentration prior to the intervention. From that, it is derived that concentration of ownership might improve performance due to the bigger motivation of large shareholder to monitor the managers.

Nonetheless, we should say here that there is no consensus on the potential gains from M&As. For example, Dermine (2002), concerning M&As of European banks, claims that they do help to improve profitability. Especially, they facilitate an increase in efficiency when they serve those banks active in capital markets to achieve an optimal size.

The research conducted by Adams and Mehran (2003) results very helpful if we want to analyze potential differences in the way corporate governance works in banks compared to other industries. They study the differences between the corporate governance for BHCs and manufacturing firms by comparing a set of corporate governance variables. They find that board size, the number of outside directors in the board, the number of committees and the frequency of reunion of the board are all of them larger for BHCs than for firms in the manufacturing sector. Conversely, the proportion of CEO stock pay to salary plus bonuses, the percentage and market values of direct CEO equity holdings and block ownership appear to be smaller for BHCs relative to manufacturing firms. These findings lead them to conclude that governance structures are industry-specific. The authors discuss two possible explanations behind this fact. One could be found in the existence of differences in the investment opportunities for firms in the two industries. Another reason that could explain why governance structures are industry-specific is the already mentioned more exhaustive regulation in the banking industry. The interest in bank activities comes not only from investors, but also from depositors and regulators. Regulators are particular interested because of the effect of bank performance on the overall economic situation. All this means that regulation has a crucial role in the design of bank governance structures.

In a subsequent study, Adams and Mehran (2005), besides providing further evidence of the larger size and higher independence of banks' boards, they find that, for the banking industry, larger boards are accompanied by increased performance, as measured by Tobin's Q and after controlling for firm size, capital structure, and uncertainty, as well as for a set of corporate governance variables. At the same time, in their results board composition does not appear to have any significant influence on performance. Additionally, they show how the structure of the BHC may affect board size

An interesting study by Van Rixtel and Hassink (2002) examines the flow of retirees from the Japanese monetary authorities (the Ministry of Finance and the Bank of Japan) into the boards of Japanese private banks (what is called *amakudari* or "descending from heaven"), establishing an informal network between the public supervisory institutions and the private banks. They conclude that this system has negative consequences on prudential policy in Japan, since it allows troubled banks to buy influence from the supervisory authorities to increase their risky operations. Of the three hypothesis tested, they are able to reject two: *amakudari* used only as an instrument of retirement, as a reward for top civil servants ; and *amakudari* used for monitoring purposes, as a prudential policy tool (ex-post monitoring). However, they cannot reject the possibility of the existence of *amakudari* as a way for troubled banks to buy influence from regulators. According to this, bad performing banks would be more willing to persuade these retirees to join their boards, so the retiree can influence the regulators to bend the rules and allow them to increase the risk of their activities in order to try to improve performance. To carry out their research, they take into consideration two specific characteristics of the Japanese governance system to the extent they affect the banking industry: (i) Main bank system, the main bank would perform various functions on behalf of their client banks (keeps major equity and loan positions in the client, provides information, management and monitoring and disciplining of poor management); (ii) Keiretsu, informally organized business groups with a main bank in its center. Both main banks and keiretsu member firms could exercise monitoring functions with respect to their clients banks or banks member of the keiretsu, respectively. As a result, they obtain that the inflow of retirees is positively influenced by future profitability, monitoring by main banks, lending to risky business and the fact that the bank was formerly public. On the other hand, a negative relationship was found between the inflow of retirees and changes in profitability, main bank relationships and common university background between top civil servants and board members of private banks.

Demsetz and Lehn (1985) were the first to establish a relationship between the ownership structure of the firm and its regulatory environment. They found that corporations can present different value-maximizing ownership structures influenced by the size of the firm, the instability of profit rate, whether or not the firm is a regulated utility or financial institution and whether or not the firm is in the mass media or sports industries. As they explained, the existence of systematic regulation in an industry decreases the potential gain derived from monitoring the managers that we would expect for a given instability of profit rate by reducing the options available to owners. Furthermore, regulation also implies certain degree of monitoring and disciplining for managers. These two reasons make the optimal structure in regulated industries to be more diffuse than expected for a given profit instability. Concerning size, their results show that it should be

inversely related to ownership concentration. This would also explain the dispersed ownership found in most banking firms, which also happen to be large firms.

The ownership structure and the level of investor protection are some of the few dimensions of the corporate governance of banks where we are able to find some international evidence in the form of a comparative study. Caprio et al. (2003) carry out a comprehensive and detailed study of the legal protection of minority shareholders, bank supervisory and regulatory practices, and ownership of banks around the world, as well as their interaction to influence bank valuations. They first construct a database on bank ownership covering 244 banks across 44 countries and they find that banks are generally not widely held (i.e., they do not have an owner that controls at least 10 percent of the voting rights),with only 25 percent of the banks being widely held in the average country. For banks with a controlling owner, this one is a family in more than half of the cases, followed by the State 19 percent of the time. Nonetheless, the picture changes dramatically when we focus exclusively on developed nations. In the Anglo-Saxon world and Japan, more than 80% of the banks are widely held. This percentage varies between 13 and 50 percent in Central and Southern Europe, with families and financial corporations controlling also large shares of banks. A different situation is observed for banks in the Netherlands and Scandinavia, which are predominantly controlled by trusts and foundations. As a result of this more detailed observation, it appears that banks still present, as we expected, more dispersed ownership structures than firms from other sectors, at least, in the developed countries; since we know that concentrated ownership is the norm around the world, even for industrialized economies (Shleifer and Vishny, 1997; La Porta et al., 1999). However, we should bear in mind that the sample consists of the 10 largest banks in each country, and we expect firm size to be negatively connected to ownership concentration (Demsetz and Lehn, 1985). In addition, they also show that concentration of ownership is negatively related to stronger legal protection of shareholders rights. Concerning other governance aspects, both stronger legal protection of minority shareholders and the concentration of cash flow rights boost bank valuations, while bank regulations and supervisory practices have little impact on them. Furthermore, concentrated cash flow rights reduce the impact of legal protection on valuations. As a result of this, they suggest a stronger legal empowerment of private investors as a mechanism to boost bank valuations.

Another particularity of the governance of banking firms is the frequency with what they are owned by the government. According to La Porta et al. (2002), government ownership and control of banks is large and omnipresent around the world. By order of relevance, we will first find French civil law and socialist countries, followed by German and Scandinavian law countries and in the last place, common law countries and Japan[14]. On the other hand, poor countries, with interventionist and inefficient governments and little protection of property rights, present higher government ownership of banks. Finally, these authors argue that government ownership of banks causes slower subsequent financial development and diminishes the future economic growth. This way, their provided explanation would be in line with the "political" view of government participation in financial markets that states that the aim is promoting its goals through project financing and originates lower economic efficiency (Kornai, 1979; Shleifer and Vishny, 1994), and in opposition to the "development" view (Gerschenkron, 1962; Myrdal, 1968), that says that government ownership is needed for economic growth.

One more argument in favor of the specificity of the governance of banks can be found in Thomsen and Pedersen (1997), since their investigation supports the *industry effect* on the ownership structures, hence, on corporate governance. They maintain that nationality and institutional differences are as relevant as other economic factors, such as size or industry, as determinants of the ownership structure of the corporation, and, consequently, of its governance and behavior. To support their argument, they confirm five initial hypothesis: big international differences in ownership structures exist, even after controlling for industry and size; a well-developed stock market (measured by size and liquidity) corresponds to a higher degree of ownership dispersion; the degree of dominant minority ownership[15] is positively correlated to the concentration in the banking sector; there is a positive relationship between the extent of private majority ownership and the existence of dual class shares with different voting rights; and formal and informal barriers to international capital affect negatively the degree of foreign ownership. According to these results, not only can we expect the corporate governance of banks to be different than that in other industries, but we could also imagine the existence of national differences among the governance systems of banks across the EU countries.

Another element of a corporate governance system that varies with company size (positively), industry and country is the compensation received by the executives (Murphy, 1999). Concretely, the financial services sector presents higher levels of pay for its CEOs than other sectors of the economy, and

[14] They use the division of countries by the origin of their commercial law elaborated in a previous work (La Porta, Lopez-de-Silanes, et al.(1998))

[15] Dominant minority ownership corresponds to companies where the largest owner holds between 20% and 50% of the votes.

even among European countries we can observe very different practices. According to Murphy (1999), firms in regulated industries (including financial services firms) present lower pay-performance sensitivities than other corporations belonging to other economic sectors.

Confirming Murphy (1999), John and Qian (2003) compare CEO compensation and pay-performance sensitivity for two samples of US commercial banks and manufacturing firms. Through multiple regression analysis they obtain lower sensitivities for banks, which they attribute to the presence of regulation and the higher leverage. Furthermore, they observe that sensitivity declines with bank size. These results confirm a previous theory on bank regulation and top management compensation (John et al., 2000) that maintained that management incentives should be regulated since they could be more efficient than capital regulation to monitor risk-taking. They recommend taking into consideration these sensitivities when defining the deposit insurance premiums and establishing other regulatory procedures in banking.

Finally, if we focus on the legal aspects, we have seen that the degree of investor protection provided by the country's legal institutions appears to have a positive influence on bank valuations, at the same time that it is related to lower concentration of ownership in banks (Caprio et al., 2003). La Porta et al. (2001) showed us that the different legal systems have a role as well in determining the degree of government ownership and control of banks.

In addition, the commercial law present in the different countries is also partly responsible of the observed national patterns in board and ownership structures. On the one hand, through the definition of crucial characteristics, such as the participation of employee representatives, the type of board structure to be used by banks or the existence of government representation on boards, corporate law influences the board of directors' design and functioning (Wymeersch, 1998; Allen and Gale, 2001). On the other, by placing differing restrictions on the holding of shares both by financial and non-financial corporations, the countries' legal institutions have also an important role in determining ownership patterns (Allen and Gale, 2001). However, and despite the importance of this issue to better understand and compare corporate governance practices across countries, the academic literature has so far been sparse in analyzing its implications for the corporate governance of banks.

4. Bank governance and performance

4.1 What is performance?

Firm performance is a very ambiguous concept that has different dimensions, as well as there are many ways to measure it depending on the perspective chosen. We should always keep in mind that the adequate definition and measure of performance might be dependent on the industry we look at. In our case, the special social responsibility of banks makes their performance a much broader issue than just firm profitability.

Venkatram and Ramanujam (1986) classify the different approaches to the measurement of business performance, which they consider to be a subset of the broader domain of organizational effectiveness. In this scheme, business performance would consist on financial plus operational performance. Financial performance uses financial indicators to represent the economic achievements of the firm, assuming this way the superiority of financial goals. Among these indicators, we would find growth sales, profitability (ROA, ROS, and ROE), earnings per share and market measurements (market-to-book value, stock returns and Tobin's Q). On the other hand, operational performance broadens the concept of business performance by including the key operational success factors that might lead to financial performance, such as, market share, product quality, marketing effectiveness, new product introduction and manufacturing value-added.

Adopting a corporate governance perspective, we should start by facing the shareholders' value *versus* stakeholders' value dilemma. If we believe that the purpose of corporate governance is to protect exclusively the interest of shareholders (like in the typical Anglo-American model), then we would use some of the traditional financial measures to determine performance. On the contrary, we could advocate for a governance system that would take into account the problems of other constituencies, such as employees, creditors, communities in which they operate… (better protected in the German system). In this last approach, corporate social responsibility becomes an important issue to explain bank performance, and other measures like entity survival or growth might appear to be more relevant.

In the particular case of banks as highly leveraged institutions things may be different. Otherwise defendants of the shareholder value maximization model, Macey and O'Hara (2003) advocate for a more central role of debtholders interests in the corporate governance of banks. They study the corporate governance problem of banking firms from a legal perspective while emphasizing and broadly explaining its specificity. As a result of the analysis, they recommend US banks to move towards the Franco-German corporate governance model, meaning that directors should also owe fiduciary duties to creditors; but still keeping the US system in which violation of fiduciary duties by directors implies a real litigation risk. In this hybrid model, bank managers should always take solvency risk into consideration when making a decision. For non-banking firms the authors believe in the superiority of the American corporate governance model.

In a survey of recent empirical literature on corporate governance, Börsch-Supan and Köke (2000) suggest that firms should ideally utilize the firm's equity value or total factor productivity to measure performance. In particular, they argue that Tobin's Q, the main measure for firm performance in most of the studies, might be the best measure available, though its use implies the assumption that current market value of shares coincides with the real value.

4.2 Determinants of bank performance

The literature that studies the determinants of bank performance from a general perspective is primarily characterized by its paucity. Particularly, the theory on this issue is extremely sparse. Outside the banking literature, it is worth mentioning the model suggested by Lenz in 1981, since it will be used later on in some empirical studies on bank performance. Lenz (1981) makes a comprehensive and interdisciplinary review of the literature on organizational performance looking for its determinants, and he concludes that it is not likely to find any factors that in a clear, simple and unidirectional way influence performance. What he observes is a "complex network of interdependent elements" where the direction of causality cannot be clearly stated. In his model, environment, organization structure and strategy are the mutually dependent variables especially important to explain organizational performance.

Within the banking industry, Krüger et al. (1992), as cited in Krayenbuehl (1993), develop an integration model of bank performance that consists on the success factors, their interrelation and the coordination factors-environment of the bank. The success factors are elements influencing bank performance, such as effectiveness of leaders, corporate culture, strategy, organizational structure (important for a good implementation of the strategy), systems (electronic data processing and risk control systems) and commitment to achievement of full potential (financial and human commitment to the strategy). Not only these success factors would be integrated, but they also follow a hierarchy. On top of the hierarchy we find the leaders and the strategy. Since boards of directors are the main mechanism to govern the firms, they should be able to control all these factors, focusing especially on the bank leadership and strategy. Here we find a first hint to the relevance of good corporate governance for bank performance.

The empirical studies on the determinants of bank performance do not reach any clear agreement either. While the main factors that are shown to be positively correlated to the bank's financial performance are market power (Short, 1979; Bourke, 1988; Molyneux and Thornton, 1992), deposit growth and size in the case of newly chartered banks (Arshadi and Lawrence, 1987) and corporate social performance (Simpson and Kohers, 2002); the results for other variables, such as capital scarcity (with a negative sign coefficient in Short, 1979, but positive in Bourke, 1988, and Molyneux and Thornton, 1992), government ownership (negative in Short, 1979, and Bourke, 1988, but positive in Molyneux and Thornton, 1992) or capital structure (Molyneux and Thornton, 1992) remain unclear.

Adopting a different perspective, Tainio et al. (1991) follow Lenz's approach in their study of a sample of the largest Finnish saving banks at the beginning of the 1980s. After identifying three performance groups and doing case studies, they did not find any specific combination of environmental and organizational variables that directly influenced performance, but the performance of these banks turned out to be very 'path-dependent'. For them, valid explanations of bank performance have to be dynamic and context dependent, and the focus of managers should be on context-specific processes affecting the path followed by the organization, rather than on single individual factors which will have different effects in different individual paths.

Regarding the existence of economies of scale, two theories of banking firms, the *deposit insurance theory* and the *modern intermediation theory*, predict a positive relationship between bank size and performance. The first of them claims that this is due to differences in regulation, particularly, to the existence of size-related subsidies; while for in the second theory the reason is that large banks are more cost-efficient. Boyd and Runkle (1993) examine 122 large U.S. bank holding companies (BHCs) over the period 1971-1990 and they do not find any evidence of such a relationship between size and market valuation as measured by Tobin's q. The empirical research on this issue seems to agree on the existence of economies of scale in banking only up to a certain point, from where the sign of size impact of performance is not clear.

4.3 Corporate governance as a determinant of bank performance

In the second section of the paper we reviewed the most important findings on the relationship between the corporate governance mechanisms and the performance of the firm. The third section explained the special characteristics of banks that could have an effect on their corporate governance, as well as it surveyed the empirical evidence on the issue showing the existence of notable differences in the corporate governance structures of banks in relation to those in place in other industries. If in fact the corporate governance problem and the corresponding governance structures are different in banking, as argued in Section 3, the question that arises then is whether these differences may moderate the relationship between the main corporate governance

mechanisms and bank performance. This section reviews the literature that studies this relationship in the particular case of banks to find out if the behaviors seen in non-financial firms are confirmed, or instead, we are able to observe any particularities in the relationship.

As we will see, most of the studies that investigate the performance effect of the different governance mechanisms focus on US banks and study primarily board characteristics and managerial pay. However, we do find some international comparisons that examine the banks' ownership structure and the impact of regulation.

4.3.1 Boards of directors

If we start by looking at the *size of the board*, Simpson and Gleason (1999) find no effect of the number of directors on the probability of financial distress. However, a later study by Adams and Mehran (2005) identifies a significant positive correlation between board size and bank performance, as measured by Tobin's Q. This positive effect of larger boards would be in opposition to most previous findings for other industries (Hermalin and Weisbach, 2003).

Regarding the presence of *independent directors*, these same authors find no significant relation between the degree of board independence and performance (Adams and Mehran, 2005), agreeing with previous studies by Pi and Timme (1993), Griffith et al. (2002) and Simpson and Gleason (1999), this latter studying the effect of board independence on the probability of financial distress.

Another important characteristic of the board is the so-called *CEO duality*. In the cases where the CEO is also the chairman of the board (dual CEO) we could expect increased governance difficulties. This is at least what Pi and Timme (1993) presume in their study of a sample of large publicly traded U.S. commercial bank for the years 1988-1990. The results they get appear to confirm the expectations: banks with a dual CEO underperform banks where CEO and chairman of the board are two different persons. Looking at it from a different perspective, Simpson and Gleason (1999) find that CEO duality is related to a significant lower probability of financial distress. Their interpretation lies on the idea that a powerful dual CEO-chairman of the board would take less risky decisions in order to protect his position, therefore, they suggest, CEO duality could be encouraged by regulators wanting to avoid banks' financial distress. Finally, Griffith et al. (2002) provide evidence on the insignificance of the relationship.

In summary, the literature on the relationship between the studied board characteristics and bank performance seems to agree on the insignificance of *board independence* for performance, but disagrees about the effects of *board size* and *CEO duality*, that remain less clear.

4.3.2 Ownership structure

Two US studies find conflicting results regarding the effects of an increase in the level of ownership concentration on bank performance. If in Pi and Timme (1993) bank performance is shown to be unrelated to the level of blockholdings, Prowse (1995) postulates the goodness of ownership concentration, claiming that large shareholders are more motivated to monitor the bank's management, and as a proof of that, he shows that banks that present lower levels of ownership concentration are more likely to go through an intervention by regulators.

In this same line, Caprio et al. (2003) provide international evidence of higher levels of concentration of cash flows rights having a beneficial effect on bank valuations around the world, being this relationship stronger in countries where the legal protection of investors is poorer.

Most of the studies about the role of managerial equity ownership in corporate governance debate between the existence of an inverse relationship between managerial ownership and bank performance (the *management entrenchment* hypothesis), both measured in accounting and market terms (Griffith et al., 2002), and the possibility that managerial shareholdings would motivate managers to work harder, thus increasing the firm's financial performance (the *convergence-of-interests* hypothesis (Pi and Timme, 1993).

Following Demsetz and Lehn (1985), Hirschey (1999) tests whether bank performance might be influenced by size, growth, leverage and, possibly, managerial equity ownership. For a sample of U.S. commercial bank holding companies (BHCs) during the 1992-1996 period, he finds that after controlling for firm size, there is no evidence of poorer performance among closely-held banks. Since high managerial equity ownership is only typical for small banks, he suggests that the inferior performance of closely-held banks could be due to scale inefficiencies. This explanation would be in line with Demsetz and Lehn (1985), who found ownership concentration to be dependent on firm size, but not significantly related to performance. Providing further support to this idea, Simpson and Gleason (1999) show that the shareholding owned by the CEO and other officers and directors had no significant effect on the bank's performance

The findings of Pi and Timme (1993), however, suggest the existence of different implications of managerial shareholdings for dual and non-dual CEOs. This way, they find that when the CEO is the chairman of the board, CEO ownership is insignificant or significantly negative related to performance; while for banks with a nonchairman-CEO, they obtain a significantly positive link between the two variables.

Making use of very different methodologies, De Young et al. (2001) and Griffith et al. (2002) reach

both the conclusion of a non-linear relationship between managerial shareholdings and bank performance. De Young et al. (2001) examine this relationship at small, closely-held U.S. commercial banks that are mostly not publicly traded, presenting a broad range of ownership and management arrangements, and they find that hiring a professional manager can potentially increase small closely held bank performance. Furthermore, the likelihood of this better performance increases when managers own shares in the company, but only up to a certain level when management would become 'entrenched', showing that there is an inverted U-shaped relationship between hired managers' shareholdings.

Using data from the largest U.S. BHCs for the years 1995-1999, Griffith et al. (2002) find that performance of commercial banks is related to CEO ownership, but again, this relationship is not always positive. Bank performance increases until CEO ownership reaches the 12 percent level and decreases until 67 percent is achieved. This way, for a small share of CEO ownership, we would observe the effects predicted by the alignment-of-interests hypothesis (manager's interests converge with shareholders), while when CEO ownership exceeds a certain level, its positive effects on performance are offset due to the management entrenchment hypothesis (the powerful manager focus now on protecting his job and maximizing his utility, neglecting shareholders interests). The rise in value experienced at levels of ownership above 67 percent is interpreted by the authors as the marginal impact of convergence of interests being greater than that of entrenchment once majority ownership is obtained. In their study, they use economic measures of performance, such as Economic Value Added (EVA), Market Value Added (MVA) and Tobin's Q.

4.3.3 Incentive pay

The paper by Barro and Barro (1990) is one of the first to study the relation between pay, performance and turnover of CEOs in the banking industry. They use data from large commercial U.S. banks over the period 1982-1987 and employ a logit regression model. Their findings suggest that changes in CEO pay are positively related to performance (both measured in accounting and market terms), though the sensitivity of this relationship declines over the CEO tenure. CEO compensation is not affected by regional average performance, only by relative performance. For newly hired CEOs, the pay is positively influenced by bank size. In addition, they observe a positive link between CEO turnover and age (from the early fifties on). Finally, they obtain a negative relationship between CEO turnover and stock returns, but not with accounting earnings; this might be explained by the possible manipulation of accounting returns, they argue.

Corroborating the positive sign of pay-performance sensitivities in the banking industry, Bosworth, et al. (2003) make use of three different measures of efficiency, in addition to profitability, in order to measure the performance of a sample of US BHCs. Furthermore, their results seem to suggest that executive compensation packages cause large BHCs to expand beyond their optimal size.

Despite the positive sign, the observed pay-performance sensitivities are lower in regulated industries, and among them, banking, when compared to corporations belonging to other economic sectors (Murphy, 1999). As a consequence, several studies investigate these pay-performance sensitivities in banks taking into account the presence of regulation (Crawford et al., 1995; Sigler and Porterfield, 2001; John and Qian, 2003).

Since major deregulation took place in the U.S. banking industry during 1981-1982, Crawford, et al. (1995) divide their sample into the regulated subsample (1976-1981) and the deregulated subsample (1982-1988) and find that pay-performance sensitivities (for all CEO compensation components) increase substantially in the second period as compared to the previous one. The reason behind these higher sensitivities, they argue, would be the increased need of CEO monitoring by the bank shareholders after deregulation. In addition, they provide evidence showing that CEO pay-performance sensitivities are greater for riskier banks, giving further support to their initial hypothesis saying that deregulation increases CEO discretion. Consequently, CEOs with their compensation tied to performance would after deregulation engage in riskier activities that will report higher returns.

The impact of deregulation in pay-performance sensitivities is also investigated by Sigler and Porterfield (2001). Theses authors decide to focus on a sample of publicly traded commercial U.S. banks over a period after the deregulation of the banking industry (1988-1997), so that regulatory requirements do not perturb the sensitivity of the relationship, and they find, confirming previous results by Barro and Barro (1990) and Crawford et al. (1995), a strong positive link between changes in CEO total compensation and bank performance.

Finally, John and Qian (2003) compare CEO compensation and pay-performance sensitivity for two samples of US commercial banks and manufacturing firms, confirming the existence of lower sensitivities for banks, which they attribute to the presence of regulation and the higher leverage. Furthermore, they observe that sensitivity declines with bank size.

4.3.4 Legal aspects

As we have seen, whereas legal protection of minority shareholders has been shown to boost the valuation of banks (Caprio et al., 2003), in agreement with

findings for other sectors of the economy (La Porta et al., 2000), bank specific regulations and supervisory practices seem to have little impact, if any, on them (Caprio et al, 2003),

Supporting Caprio et al. (2003) with new evidence on the little evidence of bank regulations on performance, Barth et al. (2003) address key issues in banking supervision: its structure (single *versus* multiple supervisors, central bank as a supervisor), scope (whether the banks' supervisor should supervise as well other financial services industries), and independence (the degree to which supervisors are influenced by the political and economic power), trying to find out if there are related to bank profitability. Their results show a weak impact of the structure of supervision on bank performance (particularly, the single-supervisor system might, but only might, enhance bank profitability). No strong significant relationship is found. This suggests that the selection of the right supervisory structure may be oriented to improve other aspects of the banking system: individual bank safety and soundness and the stability and development of the banking system.

5. Summary and conclusions

In the new deregulated EU banking scenario, where an extra pressure is set on banks' profitability, the design of the right corporate governance system is a must for banks that want to be successful in the new competitive environment.

But if banks are unlike other firms, as it has been long postulated by the economic literature, we may also wonder whether this singularity affects their corporate governance, and thus, makes necessary specific research that investigates the governance mechanisms in the particular case of the banking industry. This paper reviewed the academic literature that studied the corporate governance problem in the specific case of banks, analyzing its different features and the argued reasons behind them, as well as the role of the governance system for good bank performance.

Section 2 broadly defined the corporate governance problem and pointed out the different mechanisms to solve it, describing as well the principal governance models existing internationally. In addition, we looked at the theory and empirical evidence on the relationship between the main instruments of corporate governance and firm performance.

The remaining part of the paper tried to answer the following three main questions:

(i) Why are banks different? According to existing research, different factors, such as the exhaustive regulation in the sector, supervision and control by the authorities, the particular fiduciary relationship between the bank and its clients, its fragility, the systemic interest to avoid bank failure, the high debt ratios in the sector and the existence of the deposit insurance fund, contribute to the specificity of the banks and thereby influence their corporate governance.

(ii) What is different about the corporate governance of banks? The literature on the corporate governance mechanisms in place in banks seems to point to the existence of substantial differences in relation to other sectors. In particular, the empirical evidence available indicates the following:

- Banks in the developed countries present significantly more dispersed ownership structures that firms in other sectors of the economy. As expected, the lowest concentration is found in the Anglo-Saxon world. Banks all over the world present high government ownership and control.
- The size of the board, the proportion of independent directors, the frequency of board meetings and the number of committees seem to be all of them higher in banking than in the manufacturing sector.
- While the overall level of compensation is higher for bank executives, CEO shareholdings (both absolute and relative to total compensation) are observed to be smaller in banking firms.
- Takeovers are less frequent in banking due to the existence of regulatory barriers and delays.

(iii) What works for banks? As we could see in the fourth section, the group of factors that explain the performance of banks appears to be very heterogeneous and the empirical studies do not reach any clear agreement. Focusing exclusively on the elements of a governance system as determinants of performance, there is some agreement in the literature concerning the following points:

- More concentrated ownership structures are shown to have a positive impact on bank valuation, while executive shareholdings seem to present a bell-shaped effect on performance.
- The existing results on board dimensions point towards a positive effect of board size on performance, but are inconclusive about the possible impacts of board independence, the existence of a dual CEO-chairman of the board or the role of political directors.
- The sensitivity of the relationship between executive pay and bank performance is confirmed to be positive. Its size increases with the risk of the bank and deregulation, and decreases over the CEO tenure. Furthermore, executive compensation packages can provoke the growth of large banks above their optimal scale.

- On the influence of regulation, previous research suggests stronger legal protection of minority shareholders would boost bank valuations, while bank-specific regulations and supervisory practices seem to have little impact on them.

In summary, this paper tried to make clear the important role of good governance for the success of the corporation, in particular if this corporation is a bank; as well as it investigated the different governance issues and practices when it comes to banking firms.

Can we then conclude, based on existing research, that the corporate governance of banks is fundamentally different than in other industries? Overall, it seems that both the presence of regulation and the nature of their business affect the corporate governance problem in banks and this is reflected in the different governance structures observed.

But the question is still open as to what extent the functioning of these corporate governance mechanisms and their relation to performance is different in banking compared to non-financial firms, as well as what would be the specific causes behind the different behaviors. While more research is needed on the underlying reasons, the initial findings on this matter appear to show the existence of particularities in the relationship to performance; further emphasizing that if the governance problem is different in the banking industry, we will not be able to successfully apply our knowledge on the governance of industrial firms to solve it. As an example, let's take the restrictions to keep ownership concentration or board size under certain levels, both regulators and investors can benefit from being aware that, while these measures might perhaps be helpful in other settings, their application with the objective of improving the bank's governance and, thereby, performance does not have any foundation on existent research. Furthermore, while supervisory activity might be beneficial for the general economic stability, its use has not been shown to increase the market value of banks, as the improvement of the legal protection of investors would, according to the existing literature.

However, the literature leaves unsolved some of the most publicly debated issues, such as the true value of enhancing the independence of the board, the impact of having a dual CEO/chairman of the board, the actual role played by political directors, the influence of the governance system, or the question of whom should ideally be the object of the bank directors' fiduciary duties.

This last discussion stems from the banks' highly leveraged condition and entails two important implications for the design of an efficient corporate governance system from the regulators' point of view. First, it can be argued that debtholders interests should receive greater protection, meaning that directors should owe fiduciary duties to them as well as to shareholders, and bank managers should always take solvency risk into consideration when making decisions. Second, some authors have proposed the regulation of management incentives as a more efficient tool than capital requirements to monitor risk-taking by the bank

Finally, most of the work reviewed here deals with US and, sometimes, Japanese banks. Given the existence of different governance systems and the particular impact that institutions have in the banking sector, only further research on the corporate governance of banks across countries will allow us to tell whether these observed specific features are confirmed internationally; or, if this was not the case, the different governance solutions respond to the existence of diverse national institutions or even individual firm-specific needs.

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