THE ADJUSTMENTS OF CORPORATE GOVERNANCE MECHANISMS IN CANADIAN BANKS FOLLOWING REGULATORY CHANGES

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Abstract

The recent scandals on corporate governance have forced the regulatory bodies to issue new corporate governance mechanisms. These new governance mechanisms include banks. The purpose of this study was to observe changes to the boards of directors, to the committees reporting to the board, to the board of directors' independence and adoption to certain charters and checklists in Canadian banks for the periods covering the years 2002-2004. Our sample covers the eight largest domestic banks in Canada. Results indicate a reduction in board members and in the number of committees reporting to the board. However, it increased supervision by increasing the number of board committee meetings. Most of the banks in our sample have separated the role of Chairman and CEO, thereby increasing the independence of the board. There was also an improvement in the adoption of a new charter for the board of directors.

Keywords: Corporate governance, regulatory bodies, board of directors, committees of the board.

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1. Introduction

The purpose of this paper is to observe how corporate governance changes in Canadian banks in response to regulatory modifications during the years 2002, 2003 and 2004, after the wave of corporate scandals of 2001. The main focus of our research is to observe the changes to the board of directors, the changes to the committees reporting to the board, the changes to the board of directors independence, and the adoption of certain charters and corporate governance guidelines of the Toronto Stock Exchange (TSE), Ontario Securities Commission (OSC) and the Bank Act 1991. Since the 5 largest banks in Canada are also listed on the New York Stock Exchange (NYSE), they therefore, must comply with the NYSE Corporate Governance Guidelines and the corporate governance procedures dictated by the Sarbanes – Oxley Act of 2002.

From the end of World War II until the end of the mid 1980s, little attention was paid to the role of the board in the governing of the corporation, or indeed to any aspect of corporate governance. In fact, the term "corporate governance" was not even used until well into the 1980s (Bliss, 1987, CIMA 2000, Leblanc and Gillies 2005). Corporate governance has recently received much attention due to high profile scandals such as Adelphia, Enron, World Com, Parmalat and Nortel (Brown and Caylor, 2006; Leblanc and Gillies 2005).

Some of the earliest considerations of corporate governance came from the United States (US). The Threadway Commission issued a report on fraudulent financial reporting in 1987 (Threadway Report 1987) which influenced the Securities and Exchange Commission (SEC) to incorporate in its listing agreement from 1988, that all SEC regulated companies should have an audit committee with a majority of non-executive directors (CIMA 2000).

Corporate governance has received wide attention recently in both practice and in academic research (Brown 1999; Levitt 1998; Beasley, Carcello and Hermanson 1999; De Zoort and Salterio (2001); Xie et al (2003); Eng and Mak (2003); Ho and Wong (2001); Beasley et al (2000); Levitt, 1999, 2).

In response to the wave of scandals, the regulatory bodies that govern capital markets issued new directives on good corporate governance. In the United Kingdom (UK), the Cadbury Report (1993) recommended that public companies have at least three independent directors and that the boards of these companies appoint an audit committee comprised of independent directors. In Canada, the MacDonald Commission (1988) required all public companies to have an audit committee composed entirely of independent directors.

The Bank Act (1991), in Canada, provides regulations on corporate governance of Canadian banks. The Toronto Stock Exchange (TSE) has also prepared guidelines on corporate governance consisting of 14 points which deal specifically with the powers of the board, the review procedures required for good governance and the roles of committees (Dey, 1994). The Ontario Securities Commission (OSC), in the province of Ontario, Canada, has also provided guidance on corporate governance best practice, but it is not mandatory (OSC – Multilateral Instrument 58-101). Since many Canadian companies, including Canadian banks, are listed on the New York Stock Exchange (NYSE) they must comply with the corporate governance guidelines issued there. In July 2002, in response to the Enron and World Com scandals, the Sarbanes – Oxley Act was enacted in an effort to maintain investor confidence and combat fraud on the market. The act introduced measures to strengthen the composition and independence of audit committees (Sarbanes – Oxley Act of 2002 [2002], 107th session of the United States Congress). A summary of the regulations on corporate governance mechanisms in Canada and the US is given in Appendix 1. The main purpose of these regulations and laws is not only to strengthen corporate governance, but also, to effectively delineate the rights and responsibilities of each group of stakeholders of the company (Levitt 2000b; Ho and Wong, 2001; Blue Ribbon Committee, 1999; Cohen and Hanno, 2000).

The rest of the paper is organized in the following way. Section II examines and describes the characteristics of the banking sector in Canada. Section III presents the research methodology and how the data are gathered from the proxy statements and the annual reports on the websites of the banks, while Section IV gives a review of the literature. Section V analyzes the data and discusses the results of our findings. The conclusion is given in Section VI.

Characteristics of the Banking Sector in Canada

As of February 2003 the Canadian banking industry is comprised of 18 domestic banks and 25 foreign bank subsidiaries. In total, these institution have over 1.79 trillion dollars in assets, which represent more than 70% of all assets in the Canadian financial service sector. "Canada"s banks operate through an extensive network that includes over 8,000 branches and close to 18,000 automated banking machines (ABMs) across the country."[2] The 5 largest banks dominate the market with 88% of all banking assets under their control (see Table 1). The other 13 domestic banks hold less than 6% of total assets. Therefore, it is not surprising that studies on the Canadian banking industry often concentrate on the 5 leading banks.

In 2003, the banking sector made 11.9 billion dollars in net income. The main source of revenue for the banking industry is net interest income, the difference between interest paid on liabilities (such as deposits) and interest received on assets (such as mortgages). However, the contribution of non-interest income to revenue has increased over the years. Non-interest income includes fees for services such as "mutual fund and wealth management, securities underwriting, derivatives trading, asset securitization, brokerage transactions, ABM transactions, credit card transactions, foreign exchange and deposit services."[3] Historically, 48% of all bank earnings are paid in taxes, 15% are reinvested into the business while the other 37% are distributed to shareholders[4]. In recent years the 5 largest Canadian banks have demonstrated consistent performance as measured by their net income and have enjoyed a rising trend in the total asset size of their portfolio. It is also important to note that these banks have significant international operations, which account for almost one third of their gross revenue.[5] Furthermore, the big five have also implemented automation and strict management control systems to drive cost down.

Banks are among Canada"s leading employers. In 2000, the industry employed over 268,210 Canadians and had a Canadian payroll of approximately $16.1 billion. This means that the good and bad fortunes of the banking sector greatly influence the employment picture of the Canadian economy. In addition, in 2002 the six major domestic banks paid $5.8 billion in taxes to all levels of government.[6]

Since this industry is one of the key factors in a healthy Canadian economy, it is heavily regulated and supervised by a government agency. The Office of the Superintendent of Financial Institutions (OSFI) is the federal agency principally responsible for supervising all federally regulated financial institutions and pension plans. OSFI"s role is to safeguard policyholders, depositors and pension plan members from undue loss, and to advance and administer a regulatory framework that contributes to public confidence in a competitive financial system.[7]

The banking sector of the Canadian economy is a very competitive mature industry with high barriers of entry. The main barriers of entry are the need for: sophisticated knowledge of risk management, advanced technology and a large capital investment. The existing banks derive stability from their large diversification into different financial products and their exposure to international markets, such as the United States. The fortune of Canadian banks has been helped by the strong credit culture in Canada and the population"s ability to adopt new technologies into their way of life. The Canadian banks are one of the

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[2] **Ministry of Finance, http://www.fin.gc.ca/toce/2002/bank_e.html**

[3] **Ministry of Finance, http://www.fin.gc.ca/toce/2002/bank_e.html**

[4] **Canadian Banking Association, http://www.cba.ca/en/viewDocument.asp?fl=6&sl=111&tl=&docid=400&pg=1**

[5] **Ministry of Finance, http://www.fin.gc.ca/toce/2002/bank_e.html**

[6] **Canadian Banking Association, http://www.cba.ca/en/viewDocument.asp?fl=6&sl=111&tl=&docid=400&pg=1**

[7] **Ministry of Finance, http://www.fin.gc.ca/toce/2002/bank_e.html**

most technologically advanced in the world. For example: "Canada has the highest number of ABM per capita in the world and benefits from the highest penetration levels of electronic channels such as debit cards, internet banking and telephone banking."[8] In addition, Canada‟s banks play an important role in the national clearing and settlement system, which is among the most efficient payment systems in the world. In 2001, the system cleared over 4.4 billion transactions worth over $33 trillion for all Canadian institutions. [9]

As of February 2003, 25 foreign bank branches were operating in Canada. The recent increase in the number of foreign bank branches stems directly from new legislation passed in 1999 allowing foreign banks to establish operations in Canada without having to set up Canadian-incorporated subsidiaries.[10] Most of the foreign branches are from some of the largest banks in the world but, as of yet, they have not been able to penetrate the Canadian market. These banks represent only 5% of all banking assets in Canada, but there has been a recent trend upwards in the growth of their assets in Canada.

Methodology and Data

Sample Selection

The sample for this paper is drawn from the banks listed on the Toronto Stock Exchange. While there are 43 chartered banks currently operating in Canada, only 8 met the required criteria of the study. These criteria were:

1. <u>The subject bank must be a widely held bank</u>. Hence, no single shareholder can own more then 10% of the total shares of the bank. This excludes all bank subsidiaries. This selection criterion was added because bank subsidiaries do not have the same disclosure requirements or the same corporate governance mechanisms as widely held banks and the aim of the study was to keep the type of banks constant. Simply put, this selection criterion allowed the study to compare "apples with apples".
2. <u>The bank must be traded on a stock exchange.</u> This selection criterion was added to guarantee that the bank would publish an annual report and an annual proxy statement available to the public, and thus allow the study to keep the sources of information between banks constant.
3. <u>The bank must be chartered in Canada</u>. This excludes all foreign subsidiaries and thus focuses the study on Canadian chartered banks.

Although the 3 selection criteria above reduce the sample size to 8 banks, the researchers believe that they are necessary to keep as many variables as possible constant and to better narrow the focus of the study. The 8 banks selected are: Royal Bank of Canada (RBC), Toronto-Dominion Bank (TD), Bank of Nova Scotia (BNS), Canadian Imperial Bank of Commerce (CIBC), Bank of Montreal (BMO), National Bank of Canada (NBC), Laurentian Bank of Canada (LBC) and Canadian Western Bank (CWB). Table 2 shows the sample selected and it should be noted that it accounts for 94.24 percent of the total assets of all Canadian banks.

There are only 8 widely held chartered domestic banks in Canada and all of these banks disclosed their corporate governance information on the web. This is not surprising since they are public corporations listed on the TSE. In addition, the 5 largest banks in Canada are listed on the NYSE and the 2 largest banks in Canada are also listed on other foreign stock exchanges.

The other 35 banks are subsidiaries of either other banks or of large corporations. Although most parent companies disclose corporate governance information, their subsidiaries in Canada offer little valuable information on their governance structure. Only 4 bank subsidiaries divulge the names of their board of directors. Furthermore, only 2 subsidiaries publish annual reports, and of these two, HSBC Canada is obliged to reveal this information because it is listed on the TSE.

Source of Data

The Internet was the major data collection device used to research corporate governance of Canadian banks. There were 3 sources of data that disclosed corporate governance information: the corporate governance section of the website, the 2002, 2003, 2004 annual reports available on the website and the 2002, 2003, 2004 proxy circulars, also available on the website. The annual reports and the proxy circulars were found to be the most useful data source.

Methodology Used to Construct the Tables for 2002, 2003 and 2004

Size of Board

The number of candidates for re-election was counted from the annual reports and proxy statements.

Diversity of Board Members

The pictures of women and visible minorities presented in the annual reports and proxy statements were examined. The methodology is supported in the literature (Brammer et al 2007; Bernardi et al 2005; Bernardi et al 2002).

[8] Ministry of Finance, http://www.fin.gc.ca/toce/2002/bank_e.html
[9] Ministry of Finance, http://www.fin.gc.ca/toce/2002/bank_e.html
[10] Ministry of Finance, http://www.fin.gc.ca/toce/2002/bank_e.html

Table 1. Banks in Canada Ranked by Asset Size (in $100,000 of CDN)

Ranking by Assets		Name of Financial Institution	Total Assets (as of 2004-02-29)	Percentage of total assets	Cumulative % of total assets
World (2002)	Canada (2004)				
51	1	Royal Bank of Canada	427,628	23.88%	23.88%
64	2	Toronto-Dominion Bank (The)	313,306	17.50%	41.38%
60	3	Bank of Nova Scotia (The)	288,955	16.14%	57.52%
65	4	Canadian Imperial Bank of Commerce	286,745	16.01%	73.53%
66	5	Bank of Montreal	268,919	15.02%	88.55%
149	6	National Bank of Canada	80,514	4.50%	93.05%
7	7	HSBC Bank Canada	37,798	2.11%	95.16%
	8	Laurentian Bank of Canada	16,925	0.95%	96.10%
1	9	Citibank Canada	13,494	0.75%	96.86%
21	10	ING Bank of Canada	13,020	0.73%	97.58%
19	11	Société Générale (Canada)	9,779	0.55%	98.13%
	12	Amicus Bank	5,484	0.31%	98.44%
	13	Canadian Western Bank	4,315	0.24%	98.68%
		OTHERS	23,695	1.32%	100%
		Total of All Banks in Canada	1,790,576.66		

- A bank is defined as a financial institution that accepts deposits in Canada
- Domestic banks are bolded. Foreign banks in voluntary liquidation were excluded.
- Assets Size for 2004 - Source: http://www.osfi-bsif.gc.ca/eng/institutions/banks/financial/index.asp
- Top 150 World Banks Ranked by Asset Size - Source: *The Banker*, July 2003

Table 2. Sample Selected

Bank	Total Asset's (in $100,000)	Percentage of total assets	Number of Employees
RBC	427,628	23.88%	59,575
TD	313,306	17.50%	41,934
BNS	288,955	16.14%	44,294
CIBC	286,745	16.01%	42,000
BMO	268,919	15.02%	33,993
NBC	80,514	4.50%	13,910
LBC	16,925	0.95%	3,167
CWB	4,315	0.24%	873

Number of Committees

The annual reports and proxy statements were examined and the number of committees were counted.

Number of Corporate Governance Meetings

A count was done after an examination of the annual reports and the proxy statements.

Size of Committees

The number of members in each committee reporting to the board was obtained by counting the names in the proxy statements and annual reports under each committee report.

Independence of the Board of Directors

The two sources of data for determining the independence of the board members are the annual reports and the proxy statements. The types of independent board members identified are unrelated directors, unaffiliated directors, and directors not from management.

Separation of the Role of Chairman and Chief Executive Officer

The information on the split of the roles is obtained for the annual reports and the proxy statements. The subject bank receives a positive rating of 1 if the role of chairman and CEO has been separated. Otherwise, the bank receives a negative rating of 0.

Adoption of TSE Corporate Governance Guidelines

The sources of data were the annual reports and proxy statements. The scoring is similar to what is used in item 7 above.

Adoption of Charters by the Committees and the Board of Directors

The sources of data are the annual reports and proxy statements. The scoring is similar to that used in item 7 above.

Review of Literature

The subject of corporate governance is of enormous importance. There is a great deal of disagreement about how good or bad existing governance mechanisms are. Favourable assessments of the US corporate governance system are given by Easterbrook and Fischel (1991) and Romano (1993a). The United States, Germany, Japan and the United Kingdom have some of the best corporate governance systems in the world (Shliefer and Vishny, 1997). The latter authors, as well as others (Jensen and Meckling, 1976; Fama and Jensen, 1983a, b), believe that corporate governance is a straightforward agency problem arising because of the separation of ownership and control in the corporate (and non-corporate) world.

The emphasis on corporate governance and strengthening of corporate governance has received considerable publicity because of the highly publicized financial reporting frauds or scandals mentioned earlier (eg. Blue Ribbon Committee Report 1999; Sarbanes-Oxley Act 2002; Bebchuck and Cohen 2004). There have been a spate of earnings restatements (Loomis 1999; Wu 2002; Palmrose and Scholz 2002; Larker et al 2004). Academic research has found an association between weak governance and poor financial reporting quality, earnings manipulation and weak internal controls (eg. Dechow et al 1996; Beasley, 1996; Beasley et al 1999; Beasley et al 2000; Carcello and Neal, 2000; Forker 1992). Throughout the world, there is an attempt to improve corporate governance over the financial reporting process. Legislation and guidelines have been introduced in Canada, the UK and the US to strengthen the financial reporting process.

Although there are extensive studies on the subject of corporate governance, there is practically no research on corporate governance in the Canadian banking sector. Most studies on corporate governance in the banking sector concentrate on American banks. Not surprisingly, the researchers at the Federal Reserve have been the main publishers of such reports.

Adams and Mehran (2003) have found that, in general, banks‟ board size are larger and are comprised of a higher percentage of outside directors than manufacturing firms. They also report that banks have more committees and that these committees meet more frequently than those of manufacturing firms. In addition, the CEOs of banks receive a proportionally higher percentage of their annual compensation in the form of salary and bonuses than their manufacturing counterparts. Furthermore, bank CEOs hold less equity in the company than do manufacturing CEOs.

John and Qian (2003) attempt to explain the compensation discrepancies between banks and other firms. They follow the general theory that, as leverage increases, shareholders will tend to encourage risky behavior. Since banks are highly leverage firms, if the executive motivations are closely aligned with those of shareholders they would engage in risky investments to the detriment of fixed claimants (ie: depositors and bondholders). Therefore, to negate this effect, bank executives are paid a higher proportion of their compensation in cash to increase their risk averseness and minimize the agency costs of debt.

This would be consistent with the *Macey and O'Hara (2003)* argument that banks should be governed by the Franco-German approach that has the interest of the long-term stakeholders, such as depositors, in mind instead on the Anglo-American approach that seeks to maximize shareholder value. They also argue that the major stakeholders (ie: depositors) disregard excessive risk taking by the bank because their deposits are federally insured. Therefore, bank regulators, in charge of deposit insurance, act as one of the mechanisms of corporate governance control since they attempt to minimize bank failures.

This last argument probably stems from the *Booth, Cornett and Tehranian (2002)* study that suggest that, as one method of monitoring corporate governance increases, the other methods of monitoring become less necessary. In this study, they observe that industries with extensive regulations tend to have less market-based corporate governance mechanisms, and yet, be equally well governed as those in less regulated industries. They conclude that monitoring by regulators helps to reduce the agency conflict of managers. This view is endorsed by *Pi and Timme (1993)* who observe that the most important corporate control mechanism in banks is regulatory intervention.

The results of these studies are quite interesting. Yet, one cannot automatically infer the corporate governance mechanism of Canadian banks from those of American banks. Furthermore, the studies highlighted above do not attempt to observe the evolution of corporate governance after regulatory changes.

Analysis and Discussion of Results

Table 4. Number of Directors on the Board

Bank Name	2004	2003	2002
RBC	17	18	19
TD	15	16	16
BNS	15	18	20
CIBC	18	20	21
BMO	16	15	15
NBC	15	18	20
LBC	13	15	15
CWB	12	12	13
Average Size	15.1	16.5	17.4
Std. Dev.	2.0	2.5	3.0
Minimum Size	12 (CWB)	12 (CWB)	13 (CWB)
Maximum Size	18 (CIBC)	20 (CIBC)	21 (CIBC)

Size of Board

Table 4 shows that the size of the board of directors of Canadian banks is well above the required number of 7 members demanded by the Bank Act (1991). The larger banks tend to have more directors than the smaller banks. A simple explanation for this discrepancy is that, since larger banks have more assets and are more diversified, they need more supervision and input from the board of directors. However, from Table 4, one observes that both the average size of the board and the standard deviation show a downward trend in all the banks. This reduction might be an indication that the board of directors is attempting to be more efficient or that the board wishes to give individual directors more decision-making powers. These results corroborate the findings of Leblanc and Gillies (2005) who found that the average size of boards in Canada is declining because boards are becoming more functional and less decorative (prestige). In the past, they claimed that Canadian banks had large boards exceeding 50 members in the 1950s, but they have reduced board membership size to between 10 and 15 members to make the boards more efficient and effective.

Diversity of the Board of Directors

Table 5. Number of Women on the Board

Bank Name	2004	2003	2002
RBC	3	3	3
TD	3	2	3
BNS	3	3	3
CIBC	3	3	4
BMO	3	3	3
NBC	5	5	5
LBC	3	3	3
CWB	1	1	1
Average	3.0	2.9	3.1
Proportion	21%	18%	18%

Table 6. Number of Visible Minorities on the Board

Bank Name	2004	2003	2002
RBC	0	1	1
TD	0	0	0
BNS	1	1	1
CIBC	0	1	1
BMO	1	1	1
NBC	0	0	0
LBC	0	n/a	n/a
CWB	n/a	n/a	n/a
Average	0.3	0.7	0.7
Proportion	2%	4%	4%

The number of women on the board and the number of visible minorities on the board are presented in Tables 5 and 6 respectively. Our evidence suggests that the degree of diversity present in the boards of Canadian banks is very low. The number of women shows an average of 3 women on the board and between 18 to 21 percent. This is slightly higher than the rest of the country which is between 8 and 12 percent and have been relatively constant over the last ten years (Leblanc and Gillies, 2005). This compares well with the study by Bernardi et al (2002) which found that women make up 11.9 percent of Fortune 500 corporate boards of directors which is consistent with Daum‟s (2000) finding that women make up 12 percent of S&P boards. Opinions are mixed for the low number of women and visible minorities on the board. It appears that recruitment of new board members is mainly done through the "old boys club" and less women or minorities have access to such a network. One tends to believe the latter explanation.

There does not appear to be any link between asset size and percentage of women on the board of directors. The National Bank of Canada has the largest percentage of women board members, while Canadian Western Bank has the lowest percentage. When it comes to visible minorities, all banks lack diversity, although the smaller banks (NBC, CWB and LBC) seem to fare worst in this category, since they do not have any minority members on their boards. The number of visible minorities on the board has decreased both on an average basis and a proportional basis (Table 6). For the years 2002 and 2003, the averages were slightly higher in Canada (0.7) than what was found by Brammer et al (2007), in their recent UK study on Gender and Ethnic Diversity Among UK Corporate Boards, where they found that the average size of the board was 0.2 for non-whites. The Bernardi (2005) study in the US was slightly higher at between 13.1 percent and 9.4 percent.

Number of Committees

Table 7. Number of Committees

Bank Name	2004	2003	2002
RBC	4	4	5
TD	4	4	3
BNS	5	6	6
CIBC	4	4	4
BMO	5	5	5
NBC	3	3	6
LBC	3	4	5
CWB	4	4	4
Average	4.0	4.3	4.8
Std. Dev.	0.76	0.89	1.04

Table 7 shows that the number of committees is decreasing over the years. From the evidence we obtained, this reduction is due to the fact that the banks are merging committees together to create committees with combined duties. The most common mergers are the Human Resource Committee and Nominating Committee or the Corporate Governance Committee and the Conduct Review Committee. The reason given for these mergers is that the board wishes to increase the power and efficiency of the committees.

Number of Committee Meetings

Table 8. Number of Meetings of the Conduct Review / Risk Committee

Bank Name	2004	2003	2002
RBC	6	7	8
TD	7	9	8
BNS	1	2	2
CIBC	9	12	15
BMO	4	12	11
NBC	5	5	6
LBC	9	10	7
CWB	2	2	3
Average	5.4	7.4	7.5
Std. Dev.	2.97	4.07	4.17

Table 9. Number of Meetings of the Corporate Governance Committee

Bank Name	2004	2003	2002
RBC	4	2	6
TD	6	6	4
BNS	4	3	3
CIBC	8	6	9
BMO	8	10	7
NBC	5	5	6
LBC	12	6	6
CWB	4	4	5
Average	6.4	5.3	5.8
Std. Dev.	2.83	2.43	1.83

Table 10. Number of Meetings of the Board of Directors

Bank Name	2004	2003	2002
RBC	10	12	12
TD	13	12	10
BNS	10	10	9
CIBC	19	15	13
BMO	12	18	13
NBC	13	15	14
LBC	17	14	18
CWB	6	6	7
Average	12.5	12.8	12.0
Std. Dev.	4.11	3.65	3.38

Table 11. Number of Meetings of the Audit Committee

Bank Name	2004	2003	2002
RBC	11	8	10
TD	4	9	8
BNS	6	8	5
CIBC	9	11	7
BMO	6	6	7
NBC	12	12	8
LBC	7	5	11
CWB	4	4	4
Average	7.4	7.9	7.5
Std. Dev.	3.02	2.80	2.33

Table 12. Number of Meetings of the Human Resource Committee

Bank Name	2004	2003	2002
RBC	3	3	6
TD	8	9	6
BNS	5	4	4
CIBC	7	5	4
BMO	8	12	8
NBC	6	7	9
LBC	12	8	6
CWB	4	4	5
Average	6.6	6.5	6.0
Std. Dev.	2.83	3.17	1.77

Companies usually report the number of board meetings and committee meetings in the proxy statement, and we interpret this as a measure of board and committee activity. Tables 8, 9, 10, 11 and 12 present the number of meetings, the average number of meetings and the standard deviation of the Conduct Review/Risk Committee, the Corporate Governance Committee, the Board of Directors, the Audit Committee and the Human Resource Committee.

Examining the 5 tables, one notices that the number of meetings of the board and of the committees varies widely among the banks. There does not appear to be a link between asset size and the number of corporate governance meetings. However, from the evidence we obtained, there seems to be a direct link between the number of meetings and committee membership compensation. The highest paid committee, the Audit Committee has the highest number of meetings among the four committees, while the Conduct Review and Risk Committee, with the lowest paid members, has the fewest meetings.

Since the audit committee consists mainly of outside directors (Dey, 1994), it can help to reduce the amount of information that is withheld. Agency theory predicts the establishment of audit committees as a means of attenuating agency costs (Ho and Wong, 2001).

Table 10 shows that the average number of meetings of the Board of Directors is increasing from 12.0 in 2002 to 12.5 in 2004, while the range is from 6 to 19. The increase in board meetings and committee meetings is a good indication that the board and the committees are increasing their supervision of management. A major part of corporate governance is to provide oversight of the operations of management – the monitoring function. This can be viewed as an agency problem because of the separation of ownership and control. The interests of the shareholders and the managers of the corporation are not the same. The former want the maximization of shareholder wealth while the latter are the agents of the shareholders and are more interested in maximizing their own wealth through high salaries, bonuses, options and various perks. It is the role of the board of directors to control these "agency costs" in the interest of the shareholders [Jensen and Meckling (1976); Fama and Jensen 1983a, b); Leblanc and Gillies (2005)].

Size of Committees

Table 13. Number of Members on the Conduct Review / Risk Committee

Bank Name	2004	2003	2002
RBC	6	6	7
TD	6	5	6
BNS	6	5	4
CIBC	5	5	6
BMO	6	6	6
NBC	7	7	7
LBC	5	5	6
CWB	4	4	4
Average	5.6	5.4	5.8
Std. Dev.	0.92	0.92	1.16

Table 14. Number of Members on the Human Resource Committee

Bank Name	2004	2003	2002
RBC	6	6	8
TD	6	5	5
BNS	6	6	7
CIBC	5	5	5
BMO	4	4	4
NBC	6	7	6
LBC	4	5	6
CWB	6	6	6
Average	5.4	5.5	5.9
Std. Dev.	0.92	0.92	1.25

Table 15. Number of Members on the Audit Committee

Bank Name	2004	2003	2002
RBC	6	6	8
TD	6	5	6
BNS	7	6	8
CIBC	6	6	8
BMO	6	6	6
NBC	6	6	5
LBC	5	5	6
CWB	4	5	5
Average	5.8	5.6	6.5
Std. Dev.	0.89	0.52	1.31

Table 16. Number of Members on the Corporate Governance Committee

Bank Name	2004	2003	2002
RBC	4	6	6
TD	6	6	5
BNS	5	5	5
CIBC	5	5	5
BMO	5	5	4
NBC	7	7	7
LBC	4	5	6
CWB	6	6	6
Average	5.3	5.6	5.5
Std. Dev.	1.04	0.74	0.93

From Tables 13, 14, 15 and 16, we observe that the number of members of each committee is decreasing. This is consistent with the goal of the board of directors of increasing efficiency and empowering individual directors. There are many reasons for this, but probably the most important one is that committees are becoming more functional and less decorative (Leblanc and Gillies, 2005). Another reason is the increase in the definition, through the law, regulation and guidelines, of the responsibilities and duties of the members in the various committees. However, there is a negative aspect to this in that a smaller committee could also be prone to manipulation by influential directors or be less able to provide substantive oversight of management.

Independence of Board of Directors

Table 17. Percentage of Unrelated Directors

Bank Name	2004	2003	2002
RBC	82%	89%	84%
TD	93%	81%	81%
BNS	80%	83%	80%
CIBC	89%	90%	86%
BMO	94%	93%	93%
NBC	73%	72%	75%
LBC	92%	93%	93%
CWB	92%	92%	92%
Average	87%	87%	86%
Std. Dev.	7.53%	7.36%	6.86%

Table 18. Percentage of Unaffiliated Directors

Bank Name	2004	2003	2002
RBC	88%	89%	84%
TD	93%	81%	81%
BNS	80%	83%	80%
CIBC	89%	90%	86%
BMO	94%	93%	93%
NBC	80%	67%	65%
LBC	92%	93%	93%
CWB	92%	92%	92%
Average	89%	86%	84%
Std. Dev.	5.61%	9.00%	9.48%

Table 19. Percentage Directors not from Management

Bank Name	2004	2003	2002
RBC	88%	89%	89%
TD	93%	94%	88%
BNS	87%	89%	90%
CIBC	94%	95%	95%
BMO	94%	93%	93%
NBC	93%	94%	95%
LBC	92%	93%	93%
CWB	92%	92%	92%
Average	92%	92%	92%
Std. Dev.	2.80%	2.38%	2.77%

In recent years, it has become the custom in various countries for regulators to classify directors as "unrelated" "versus related", "outside directors", "non-management directors", "affiliated" versus "unaffiliated directors" (Canada), "independent" versus "non-independent" (US, Australia and New Zealand) or "executive" versus "non-executive" (UK) and to recommend that the majority of directors be outsiders (Dey, 1994; Leblanc and Gillies, 2005). The definitions of the terms used in Canada are given by the TSE and the Bank Act (1991). The assumption is that if a director is independent he or she is somehow able to keep a check on management. On the other hand, if a director is not independent he or she can hardly be trusted to act in the best interest of the company and its shareholders.

Tables 17, 18 and 19 show that all of the subject banks have a very high percentage of independent directors. In general, Canadian banks have made a determined effort to create an independent board of directors. The Bank Act (1991) has been responsible for this, by stipulating that more than half of the members of the board must be unaffiliated directors. Another motivation for such a high percentage of independent members is the fact that shareholders demand it, although the TSE guidelines did not require that all members (but a majority) of the board of directors be independent. The percentage of unrelated directors, unaffiliated directors and directors not from management has not hit the magic figure of 100 percent. The proportion of independent directors has increased over the three year period. This is due to the fact that the board is asking related directors to step down in order to decrease the size of the board, while maintaining its board independence.

Separation of Role of Chairman and Chief Executive Officer

Table 20. Separate role of Chairman and CEO

Bank Name	2004	2003	2002
RBC	1	1	1
TD	1	1	0
BNS	1	0	0
CIBC	1	0	0
BMO	0	0	0
NBC	1	1	0
LBC	1	1	1
CWB	1	1	1
Total	7/8	5/8	3/8

One of the most strongly debated issues in corporate governance is whether the positions of chair and CEO of a company should be held by one or two people (Leblanc and Gillies, 2005). Properly executing the duties of the chair of the board has become very time consuming and critical to the effective management of the board of directors. In many companies, particularly in the US, it is not unusual for the role of chairman of the board and CEO to be combined. It such a case, it is not surprising that persons holding the combined position become extremely powerful within their companies. The person who occupies both roles (CEO duality) could tend to withhold unfavourable information to outsiders. Fama and Jensen (1983) argue that any adverse consequences could be eliminated by market forces. However, Forker (1992) makes the point that a dominant personality in both roles poses a threat to monitoring quality, and is, of course, harmful to the quality of disclosure.

Table 20 shows that most banks have conformed to the demands of the market of improving the independence of the board by separating the roles of the chairman and the CEO. The chairman is appointed to run the board, while the CEO is appointed to run the company. The board can "hire and fire" the CEO and monitor the activities of the company. It must have a leader different from the person whose performance it is assessing. There must always be some "creative tensions" between the chairman and the CEO (Leblanc and Gillies, 2005).

Adoption of the TSE Corporate Governance Guidelines

Table 21 presents the information about compliance or non compliance with the 14 points suggested by the TSE. The banks that decided to adopt them have done so before 2001, and the one bank that did not, has not changed its policy.

Table 21. TSE Corporate Governance Guidelines

Bank Name	2004	2003	2002
RBC	1	1	1
TD	1	1	1
BNS	1	1	1
CIBC	1	1	1
BMO	1	1	1
NBC	1	1	1
LBC	1	1	1
CWB	0	0	0
Total	7/8	7/8	7/8

Adoption of Charters by the Board of Directors and the Committees

Table 22. Charter for the board of directors

Bank Name	2004	2003	2002
RBC	1	0	0
TD	1	1	0
BNS	1	1	1
CIBC	1	1	1
BMO	1	1	1
NBC	0	0	0
LBC	0	0	0
CWB	1	1	1
Total	6/8	5/8	4/8

Table 23. Charter of the Committees

Bank Name	2004	2003	2002
RBC	1	1	1
TD	1	1	1
BNS	1	1	1
CIBC	1	1	1
BMO	1	1	1
NBC	1	1	1
LBC	1	1	1
CWB	1	1	1
Total	8/8	8/8	8/8

Table 22 presents the information about banks which have charters for the board of directors. The charter formally defines the duties and responsibilities of the board. One observes that initially 4 banks had charters in 2002, and this has increased to 6 banks in 2004. Two small banks continue without charters for all years in our study and before that.

Table 23 shows that the charters of the committees have been in place for at least three years. This is not surprising, because investors have long ago demanded to know the role of each committee within the corporate governance framework, since an ever increasing amount of important work of the board of directors is done by committees of the board. The board has delegated a lot of its work to the various committees which report back to the chairman and the board.

Conclusion

It is apparent that certain aspects of the corporate governance mechanisms of Canadian Banks have changed over the 2002-2004 period, thus demonstrating that governance is not static but dynamic. The banks reduced their board size while maintaining the number of women directors on the board. They also decreased the number of committee members as well as the number of committees reporting to the board. The latter was achieved by merging certain committees together, most notably the Human Resource committee with the Nominating committee or the Corporate Governance committee with the Conduct Review committee. These reductions were implemented to enhance the efficiency of the board and thus increase the board"s supervision of management. The increased supervision could also be observed by the fact that the number of board meetings and committee meetings had increased since 2002.

The independence of the board has remained stable or has increased depending on if one looks at the term unrelated director or unaffiliated director. By 2004 seven out of the eight banks had separated the role of Chairman and CEO. This is in stark contrast to 2002, when only three of the eight banks had implemented this regulatory suggestion. This separation will no doubt increase the independence of the board. There is also improvement, over the time period, in the adoption of a new charter for the board of directors. The adoption of a charter for the committees and the addition of the TSE guidelines in the banks annual reports remained constant for the period.

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54. New York Stock Exchange: www.nyse.com
55. Office of the Superintendent of Financial Institutions: www.osfi-bsif.gc.ca
56. Ontario Securities Commission: www.osc.gov.on.ca
57. Royal Bank of Canada: www.rbc.com
58. Toronto-Dominion Bank: www.td.com
59. Toronto Stock Exchange: www.tse.ca

Law:
Bank Act, [1991], c. 46
Sarbanes-Oxley Act of 2002, [2002], 107th session of the United States Congress

Appendix I

Regulations on Corporate Governance Mechanism

Summary of the Bank Act
Board of directors
The bank"s board of directors must have a minimum of 7 members, of which, at least half for foreign banks or two-thirds for domestic banks must be Canadian residents. (art. 159). In addition, no more than two-thirds of the board members may be affiliated with the bank. (art. 163). Article 160 lists a series of category of people who are disqualified as board members. Qualified directors may be elected for a term of 3 years. (art. 166) At least 5% of the shareholders must nominate a board member to be placed on the ballot (art. 143). The specific duties of the board of directors is listed in article 157.

Meeting of the board
The board must meet at least four times during the financial year. (art. 180). The meeting cannot be held unless a majority of the members present are Canadian residents and unless, at least one unaffiliated member is present. (art. 183).

Affiliation
The Superintendent has discretionary powers to determine which board members are affiliated with the bank. Normally, an affiliated director is someone who has sufficient commercial, financial or business ties with the bank, which can affect his judgment (art.162)

Directors and Officers Authority
The chief executive officer is appointed from members on the board of directors (art. 196). In addition, two or more offices of the bank may be held by the same person (art. 197). The board of directors may also delegate some of their powers to the bank officers, but there are certain limits on the extent of the delegation of power (art. 198). The directors fix their remuneration and the remuneration of employees by by-law (art. 199).

Conduct Review Committee
The directors may appoint to committee members from the board (art. 193). The conduct review committee consists of at least three board members of which the majority are not affiliated with the bank. None of the committee members may be employees or officers from the bank. This committee has an obligation to review all transactions with related parties and to ensure the board is complying with the corporate governance regulation of the Bank Act. (art. 195).

Audit Committee
The shareholders of the bank have the duty of appointing a firm of accountants to act as auditors for the bank (art. 314). The auditing firm must be independent, that is, members of the accounting firm may not be on the board of directors and may not own a material interest in the bank. (art. 315).The shareholders of the bank may, by ordinary resolution, revoke the appointment of an auditor (art. 317). At least three members of the board must be on the audit committee of which the majority must not be affiliated with the bank. None of the members may be employees or officers of the bank (art. 194).

Conflict of interest
Any director, with a material interest in a specific transaction

between the bank and another entity, must disclose it to the board of directors (art. 202). When conflict of interest is present the said director must abstain himself of any board meetings dealing with that matter. A director who knowingly contravenes this regulation ceases to hold office and may not serve on another board of directors of a financial institution for five years. (art. 203). A director or an officer is considered an insider (art. 265) and thus must disclose to the appropriate authority all security transactions dealing with the bank.

Permitted Related Party Transaction
A bank may enter into a transaction with a director of the bank (art. 496) as long as the board approves the transaction and the loan does not exceed 50% of the regulatory capital of the bank (art. 497). The terms and condition of the loan to a director cannot be more favorable than market terms and condition (art. 501). In addition, if the bank has reasons to believe that a party with which they are transacting is a related party it must ask for a written letter of disclosure from the said party. (art. 504)

Summary of the Toronto Stock Exchange (TSE) Corporate Governance Guidelines
The TSE Corporate Governance Guidelines, consisting of 14 points, are voluntary. These guidelines deal specifically with the powers of the board, the review procedures required for good governance and the roles of the committees.

Powers of the board of directors:
The board of directors should explicitly assume responsibility for stewardship of the company. Thus, the board should approve all corporate objectives and develop a description of its responsibilities. Furthermore, the board should be comprised of a majority of unrelated directors. Therefore, the circumstances of each individual director should be examined annually to determine their relationship to the firm. In addition, the board should be structured in such a way that it can function independently from management. To improve the independence of the board an orientation program should be provided to new board members and a system should exist to permit individual directors to engage outside advisers at the expense of the corporation.

Role of the committees:
Firms should have a committee for nominating new directors and a committee responsible for corporate governance issues. Committee members should be outside directors of whom a majority should be unrelated. More specifically, the audit committee should have well-defined responsibilities and be composed of outside directors. This committee should have direct communication channels with internal and external auditors and also have oversight responsibility for the system of internal control.

Review procedures:
A process should be implemented to assess the effectiveness of the board, its committees and its individual directors. The board should also review its size and the potential for its reduction. In addition, the board should review the adequacy and form of directors"' compensation.

Summary of the New York Stock Exchange (NYSE) Corporate Governance Guidelines
The NYSE has imposed certain corporate governance procedures on firms that are listed on its exchange. First, a majority of directors must be independent and it is the Board which determines the independence of these directors. Furthermore, to reduce the influence of management on the Board, the NYSE insists that non-management directors meet at regularly scheduled executive sessions without management. Second, the nominating committee, the corporate governance committee and the compensation committee must be composed entirely of independent directors. These three committees must have a written charter that addresses the committee"s purpose and responsibilities. The charter must also adopt guidelines for an annual performance evaluation of the committee. Third, the audit committee must be comprised of at lest three members, all of whom must be independent. The audit committee must also have a charter addressing its purpose, responsibilities and annual performance evaluation. In addition, the NYSE specifies that the listed firms must have an internal audit function. These corporate governance procedures were put in place by the NYSE to increase investor confidence in its exchange.

Summary of the Sarbanes-Oxley Act
The U.S. Congress enacted the Sarbanes-Oxley Act in 2002 to restore public confidence in the capital markets. Its main focus is to impose legal liabilities on the CEO and CFO of the company. However, it also imposes new corporate governance procedures such as forcing firms to draft and implement a written code of ethics that applies to all senior financial officers and CEO"s. The act also adds new responsibilities to the audit committee. It is now charged with the task of developing policies for pre-approval of audit and permitted non-audit services. It also has the task of developing procedures to protect whistle blowers when the complaint concerns accounting or auditing matters. In addition, the act also restricts lending to its directors and executive officers. The U.S. government hopes that these regulations will strengthen corporate governance in the American market.

Summary of the Ontario Security Commission (OSC) – Multilateral Policy 58-201
The Multilateral Policy 58-201 provides guidance on corporate governance best practice but it is not mandatory. The OSC reviewed the guidelines of other regulatory bodies to develop this policy. The corporate governance procedures suggested are as follows. First, a majority of the board should be composed of independent directors. These independent directors should hold separate regularly scheduled meetings at which management are not in attendance. Furthermore, the chair of the board should be an independent director. Second, the Board should adopt a written mandate that explicitly assumes responsibility for the stewardship of the firm. This includes overviewing the strategic planning process, implementing succession planning and ensuring the integrity of the internal control process. Third, the board should adopt clear position descriptions for directors, the chair of the board, the chair of each committee and the CEO. Fourth, new directors should receive an orientation course and board members should be provided with the opportunity to advance their knowledge. Fifth, a code of conduct should be implemented and the board should be responsible for monitoring the firm"s compliance to it. This code should deal with conflict of interest, proper use of company assets, fair dealings with shareholders and compliance with the law. Sixth, the nominating committee should have a written standard delineating its responsibilities and it should be composed entirely of independent directors. This committee should be responsible for nominating new directors, identifying the qualifications needed for the board and assessing the appropriate size of the board. Seventh, the compensation committee should also have a written charter defining its responsibilities and be composed of entirely independent members. Eight, directors should be allowed to hire outside advisers at the expense of the firm. Lastly, the board should review its own effectiveness as well as the effectiveness of each of the committees. These OSC recommendations are meant to increase the corporate governance mechanism of publicly trade companies in Canada.