

35 YEARS OF LITERATURE ON CORPORATE GOVERNANCE IN BANKS: RISK MANAGEMENT, OWNERSHIP AND COMPENSATION

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How to cite: Lagasio, V. (2019). 35 years of literature on corporate governance in banks: Risk management, ownership and compensation. *Corporate Governance: Search for the Advanced Practices*, 116-122. <https://doi.org/10.22495/cpr19p4>

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Received: 06.12.2018
Accepted: 19.12.2018
JEL Classification: G21, G32, G34, G38
DOI: 10.22495/cpr19p4
Keywords: Corporate Governance, Banks, Systematic Review, Risk Management, Ownership Structure, Compensation

Abstract

This paper provides a systematic literature review on the literature on corporate governance in banks. The review is conducted over academic papers published in the period 1980-2015, identifying 35 years of evolution in the core aspects of banking corporate governance: risk management, ownership structure and executive compensation of banks. Best practices for increasing performance and reducing risk in banks are commented, when identified. Gaps in the literature and lack of univocal consensus on the different implementation of corporate governance in the selected topic are also identified.

1. INTRODUCTION

In this paper we review the academic publications on corporate governance (CG) of banks, published from 1980 to 2015. A systematic literature review to identify the prevalent theories in the academic literature and the evolution of the core aspects of CG in banks. We select papers focused on three core CG topics: risk management; ownership structure and executive compensation¹. Indeed, since banks are in the business of taking risks, risk management function has received

¹ For instance, these topics are address in most of the 15 Corporate governance principles for banks issued in 2015 by Basel Committee on Banking Supervision (BCBS), specifically in principles 1-8 and 11.

increasing attention from both academic and policy makers perspective, especially in the aftermath of the financial turmoil (Brogi & Lagasio, 2018). Ownership structure is also widely researched topic in banking Corporate Governance literature (Shleifer & Vishny, 1986). From a firm's perspective, it was initially inspected by Berle and Means (1932) and lately by Fama and Jensen, (1983b). From a banking perspective, one of the first papers published on these topics was Glassman and Rhoades (1980) that in line with the well-known agency theory framework (Jensen & Meckling, 1976) propose a situation of concentrated ownership as a governance mechanism that may reduce agency conflicts and costs (Shleifer & Vishny, 1997). Finally, both principle setter and regulators identify executive compensation as a critical issue in banks' soundness and stability since its level and composition may impact on the risk profile of a bank and its managers (Houston & James, 1995; Adams & Mehran, 2003; Webb, 2008; Bebchuk et al., 2010; Gropp & Kohler, 2010; Grove et al., 2011; DeYoung et al., 2013; Chaigneau, 2013). This topic is also being investigated especially following the financial crisis, with the aim of providing a more long-term-oriented awareness in reducing excessive risk-taking behavior by executives. We try to provide a complete overview of the relevant aspects of CG in banks, as identified by previous researches on this topic. In particular, we focus in clarifying the understanding of the relationship between CG and both performance and risk in banks. The reminder of the paper is organized as follows: section 2 explains the procedure of the systematic literature review and the sample composition; section 3 shows the results of the review, based on the three selected area of CG; section 4 concludes by outlining the prevailing theories and suggesting for further investigation in this area of research.

2. METHODOLOGY

The systematic literature review is performed with a specific procedure, composed of different steps: (i) selection of the publication databases²; (ii) restrict the selection to only papers published in journals³ with a peer

² We choose Business Source Complete and ScienceDirect since they are two of the leading databases for economics and management literature researches (Berggren and Karabag, 2012). I conduct an advanced research on these two sources, leading to different results. For instance, the advanced search for the combination of the words "corporate governance" and "banks" in the keywords of the articles published in only academic peer reviewed journal in English language on ScienceDirect returned 253 results, 231 on Business Source Complete.

³ American Economic Review (AER); Applied Economics Letters (AEL); Applied Financial Economics (AFE); Business Strategy & the Environment (BSE); Contemporary Economics (CE); Corporate Governance: An International Review (CGIR); Corporate Ownership & Control (COC); Economic Modeling (EM); Economic Policy Review (EPR); Emerging Markets Review (EMR); European Economic Review (EER); European Journal Economics (EJE); European Journal of Law & Economics (EJLE); Financial Management (FM); International Journal of Business & Management (IJBM); International Journal of Economics & Finance (IJEF); International Journal of Managerial Finance (IJMF); International Review of Economics & Finance (IREF); International Review of Financial Analysis (IRFA); Journal of Accounting & Economics (JAE); Journal of Banking and Finance (JBF); Journal of Business & Social Sciences (JBSS); Journal of Business Ethics (JBE); Journal of Business Finance & Accounting (JBFA); Journal of Corporate Finance (JCF); Journal of Corporate Law Studies (JCLS); Journal of Economics & Business (JEB); Journal of Economics & Finance (JEF); Journal of Financial & Quantitative Analysis (JFQA); Journal of Financial Economics (JFE); Journal of Financial Intermediation (JFI); Journal of Financial Research (JFR); Journal of Financial Services Research (JFSR); Journal of Financial Stability

reviewed evaluation process up to 2015; (iii) perform an advanced search with the inclusion of the keywords "Corporate Governance" and "banks" or "financial institutions"; (iv) read all the abstracts to ensure that the contents are related with the investigated CG topics (e.g. risk management, ownership structure and executive compensation); (v) consolidate results. We obtain a sample of 97 papers on the selected topics, most of which are focused on risks potentially faced by banks and their performance capability in relation with specific CG practices. The first paper included in the sample is Glassman and Rhoades (1980) that explore the ownership structure of banks and its impact on risk performance, thus leading to a 35 years of investigation of academic literature on CG in banks.

3. LITERATURE REVIEW

3.1. Risk Management

The results of the review of the literature on risk management, suggest a constantly increasing relevance of this topic since the last financial crisis. Most of the papers are focused on the functions of the Chief Risk Officer (CRO) in banks. Indeed, Aebi et al. (2012) and Ellul and Yerramilli (2013) find that banks in which the CRO directly reports to the board of directors and not to the Chief Executive Officer (CEO) performed significantly better in terms of both performance and risk measures. Mongiardino and Plath (2010) governance requires a dedicated board-level risk committee, composed of independent members, and that the CRO should be part of the bank's executive board. Barakat and Hussainey (2013) complement this view, by recommending the enhancement of risk disclosures and proposing the establishment of independent specialized national committees or task forces to monitor and advise Pillar 3 disclosures in banks. Another strand of the literature of risk management in banks is focused on the importance of CEOs and their impact in determining performance capabilities and risk profile in banks. In particular, the widest investigated aspect is the impact of the CEO duality in banks (Simpson and Gleason, 1999; Pathan, 2009, Boujelbene and Nabila, 2011, De Jonghe et al., 2012, Rachdi et al., 2013; Cornelli et al., 2013) which is the situation in which the CEO of a bank is also chair of the board⁴. Nonetheless, this research area provides different conclusion and most of the findings are not supported by sufficient significance.

(JFS); Journal of International Business Studies (JIBS); Journal of International Money & Finance (JIMF); Journal of Law & Economics (JLE); Journal of Management & Governance (JMG); Journal of Monetary Economics (JME); Journal of Money, Credit & Banking (JMCB); Journal of Risk Management in Financial Institutions (JRMFI); Pacific Basin Finance Journal (PBFJ); Quarterly Review of Economics & Finance (QREF); Review of Economic Perspectives (REP); Review of Economics & Statistics (RES); Review of Finance (RF); Review of Financial Economics (RFE); Review of Financial Studies (RFS); The Accounting Review (AR); The Journal of Finance (JF).

⁴ See Brogi and Lagasio (forthcoming) which provide an extensive literature review on CEO duality and the other characteristics of the board of directors (size, independence, gender diversity) in banks.

3.2. Ownership structure

Most of the papers related to ownership structure may be classified in two different strands of literature: from a "quantitative" point of view (e.g. ownership concentration), and a "qualitative" point of view (e.g. owners' type). Concerning the first dimension, the prevailing finding is that concentrated ownership helps in better monitoring function, leading to a reduction of risk and improvement of performance (Shehzad et al., 2010; Adnan et al., 2011; Azofra & Santamaria, 2011), even though there are also dissenting views. Beltratti and Stulz (2012) show a strong relationship between concentrated ownership and bank risk-taking especially during the recent financial crisis in US. Busta et al. (2014), find a negative relationship between ownership concentration and performance, as measured by the market value of the banks. The authors also find that their result are strongly related to the institutional settings in which the bank operates (i.e. they find a negative and significant effect in Germany, France and Common law legal tradition Countries). As concerns the "qualitative" investigation of the ownership structure in banks, the predominant result is that managerially owned banks have lower risk (Saunders et al., 1990; Anderson & Fraser, 2000; Anderson & Fraser, 2000; Kabigting, 2011; Berger et al., 2014) and higher performance (Westman, 2011). Many studies focus on CEO ownership (Fahlenbrach & Stulz, 2011; Pathan, 2009; Berger et al., 2014; Aebi et al., 2012; Rachidi et al., 2013), state ownership (Kim & Rasiah, 2010; Barry, 2011; Iannotta et al., 2013) and institutional shareholding (Barry et al., 2011; Erkens et al., 2012; Ellul & Yerramilli, 2013; Knopf & Teall, 1996; Ferri, 2009) without identifying an univocal result on the relationship with both bank risk and performance. As a result, still there is not a clear answer about which is the optimal ownership structure in banks (Lagasio, 2018).

3.3. Compensation

The mainstream literature on corporate governance is based on agency theory (Fama & Jensen, 1983b). As concerns compensation (and in particular its variable part), the agency theory suggests that it may be considered as a mechanism to align managers' and shareholders' interests (Berle & Means, 1932; Holmstrom, 1979; Grossman & Hart, 1983; Murphy, 1985; Erkens et al., 2012; Grove et al., 2011; Acrey et al., 2011). Indeed, this evidence is even stronger when based on executive compensation (Bai & Elyasiani, 2013; Chaigneau, 2013; Cunat & Guadalupe, 2008). Executive compensation has also become a topic of intense debate among principles setters (e.g. OCSE, 2015; 2017; BCBS, 2015; EBA, 2015), regulators (e.g. EP, 2013), and media (e.g. Rajan, 2008; Rajan et al. 2008), with a particular focus on CEO compensation. Indeed, most of the literature regarding executives' compensation in banking is especially referred to CEOs, with a few recent studies (Keys et al., 2009; Aebi et al., 2012; Ellul & Yerramilli, 2013) focused also on

Chief Risk Officers (CROs) compensation in order to determine whether risk managers' activity effectiveness is related to a high level of compensation. Nonetheless, also in this field of corporate governance, some not univocal results may be identified in the literature. Fahlenbrach and Stulz (2011) find no evidence of the relationship between bank performance and both CEO incentives (and ownership) during the credit crisis. Moreover, from an opposite perspective to the agency theory, we find the managerial power theory, stating that the variable pay may misaligns executives' interests from those of shareholders' (Bebchuk et al., 2010; Houston & James, 1995; Adams & Mehran, 2003; Gropp & Kohler, 2010; DeYoung et al., 2013; Acrey et al., 2011). Indeed, as further investigated, there is a wide consensus in the literature regarding executive compensation that its level and composition may increase the risk-taking behavior of bank managers⁵. This is the reason why both principle setter and regulators identify it as a critical issue in banks' soundness and stability. In particular, it should include procedures to avoid conflicts of interest and should also encourages employees to act in the interest of the company as a whole. Moreover, incentives embedded within remuneration structures should not promote excessive risk-taking (BCBS, 2015).

4. CONCLUSION

The understanding of the fundamentals of bank Corporate Governance such as risk management, ownership structure and compensation is increasing rapidly in the last 35 years. We run a systematic literature of the papers focused on the selected topic to identify the prevailing academic results and the possible best practices to adopt for increasing performance and reducing risk in banks. The review is conducted over academic papers published in the period 1980-2015, leading to a sample of 97 papers focused on risk management, ownership structure and compensation of banking institutions. Indeed, from a methodology point of view, further criteria may be adopted when selecting the sample of papers (i.e. including also books) to rely on a more complete sample of academic researches and published theories (Lagasio & Cucari, 2018). Further investigations may also be conducted to verify the the cross-country differences in the relation between corporate governance and both performance and risk in banking.

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⁵ Lagasio (2018) provides an extensive review of the literature on this.

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