

# NEW CHALLENGES IN BANK CORPORATE GOVERNANCE: THEORY AND PRACTICE. DOES THEORY SPEAK TO PRACTICE?

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## Keynote speech / Summary

“Alongside adequate capital and organization, the third factor of the stability of the banking system is the quality of corporate governance” (Draghi, 2008).

“The ultimate responsibility for the safety and soundness of a financial institution resides with its board. As such, supervisors are more focused today on the quality of an institution's risk governance framework, risk management, risk culture and the role that the board plays in ensuring they are appropriate and effective” (FSB, 2014).

“Governance is the first line of defence of a bank's soundness, whereas capital is the last on” (Angeloni, 2017).

Based on a recent systematic literature review,<sup>1</sup> corporate governance can be broadly defined as processes and relations by which firms are managed (Brogi & Lagasio, 2019a). In the last two decades,

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<sup>1</sup> The review is based on 143 published in top academic journals from 1980 to 2015. Results show that the most investigated topics are: board structure (32%), risk management (27%), ownership structure (22%) and compensation (18%). Even though the evidence is somewhat mixed, nevertheless regulators and supervisors consider bank governance important and therefore impose regulations as concerns how decision-making bodies should be composed (fit and proper assessment for board members), the structure and metrics to be used for managers' remuneration and certain key activities to be performed by the board (risk appetite framework, internal capital allocation assessment process, recovery plan and so on). (Brogi & Lagasio, 2019a).

non-binding principles have been issued by various international organisations (Brogi, 2008) (such as stock exchanges, international organisations, associations, institutional investors mainly) for listed and unlisted companies, in order to preserve the effectiveness and the soundness of the corporate governance frameworks of the companies worldwide. As concerns banks, the quality of corporate governance is one of the requirements for the stability of the banking system (Draghi, 2008). The Basel Committee has over the years published various versions of its corporate governance principles for banks. With respect to non-financial companies, bank corporate governance has some important peculiarities linked to the specificities of banks (Allen, 2001; Allen & Santomero, 2001). Banks are risk-takers, carry out activities with externalities, are fundamental in supporting the economy, in providing liquidity to the system, in the transmission of monetary policy (Brogi & Lagasio, 2017). Corporate governance in banks therefore also affects the governance of non-financial companies and their sound and prudent management (Francis, Hasan, Koetter, & Wu, 2009). Furthermore, banks present specific risks due to their interconnectedness. Because of their role within the economy, banks are capital constrained, i.e. they are subject to a prudential supervisory discipline mainly focused on capital adequacy. In this context, corporate governance plays a fundamental role in determining the allocation of capital (i.e. the decision to increase capitalization through seasoned equity offerings capital increases or retained earnings). Furthermore, it is essential for banks to consider all the stakeholders (Bianchi, 2009), from supervisors to investors and customers.

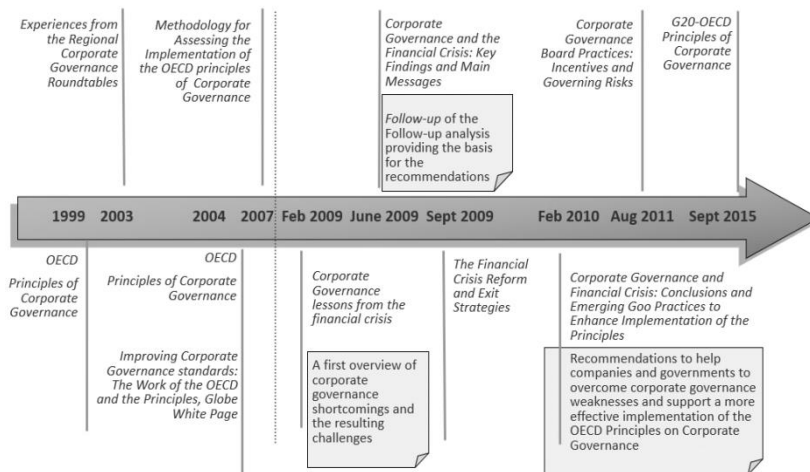
*Challenges, old and new:*

1. Board dynamics and risk culture: together with the role and responsibilities of the Board of Directors, corporate governance in banks must also oversee the risk management activities. International principle setters agree that bank corporate governance played a role in the 2008 financial crisis (OECD, 2009a; 2009b; FSB, 2013, 2014) and better governance can also play a role in preventing future crises (Nouy, 2018) in particular by focusing on two aspects that may have contributed to the crisis and which must, therefore, be subject to significant improvements:

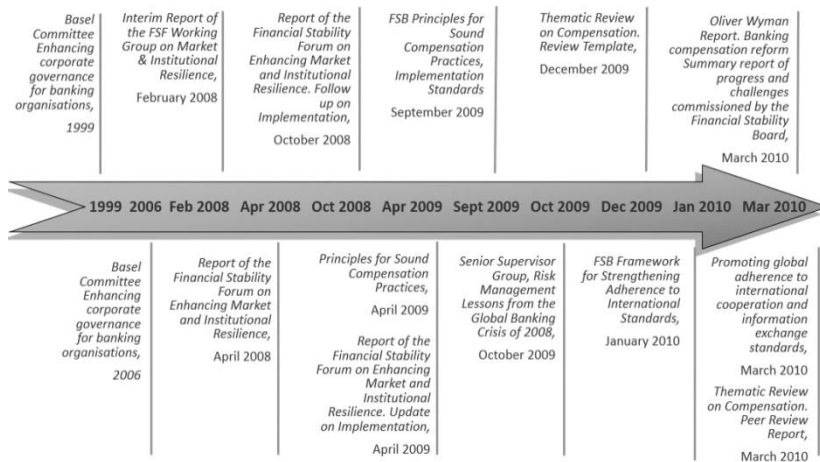
- the relationship between the board of directors and risk management which has determined the assumption of increasing and excessive risks;
- policies related to compensation and bonuses.

Though policymakers and regulators have paid increasing attention to corporate governance (Figure 1) and to bank corporate governance (Figure 2a and 2b) in the last period, and the debate will remain lively in the incoming years.

**Figure 1.** The on-going debate on the role of corporate governance



**Figure 2a.** The on-going debate on the role of bank corporate governance (Part1)



**Figure 2b.** The on-going debate on the role of bank corporate governance (Part2)



2. Remuneration and sanctions: Though bank compensation issues are often addressed in the literature, little research focuses on board responsibility, reputation, name shame and hence on the role that well-designed administrative sanctions could play in the discipline of board members and top executives. Remunerations have been often considered as incentives that foster the alignment of the top executives' interests with those of shareholders. From a theoretic standpoint since sanctions erode remuneration achieved by top executives, they can be considered as disincentives and should, therefore, be included within the framework of corporate governance;
3. Digital and Cyber risks: One of the most widely debated issues in recent years is cybercrime (Arcuri, Brogi, & Gandolfi, 2018), as with the technological advancement, technological and cyber risks are inevitably accompanied, which is why it is necessary to consider that digital security is, to date, a fundamental element within the financial system (Nouy, 2018);
4. CSR and ESG: Corporate social responsibility (CSR) and environmental, social, and governance (ESG) are receiving constantly growing attention by policymakers and stakeholders worldwide and a growing number of companies (both industrial and financial companies) is dealing with the implementation of this practices (Brooks & Oikonomou, 2017; Friede, Busch, & Bassen, 2015; Brogi & Lagasio, 2019b).

Corporate governance is a broad and important topic. Broad, as the field of investigation, extends beyond the research relating to the Board of Directors. Important, as academics can make a contribution to the debate engaging principle setters, policymakers and practitioners.

Research has not yet found the magic formula for board composition as results are at best ambiguous and sometimes even contradictory due to intrinsic problems of endogeneity, choice of performance indicators, excessive simplification and difficulties in obtaining data. The hyperspecialization of research and the fragmented view of the phenomena that does not consider the whole can lead to underestimating the negative effects deriving from interrelations. Instead, a holistic approach to problems seems to be more effective: refining the techniques is not related to having better results if interconnections are not considered. However, the most obvious limitation is that governance is made by people, and their dynamics, their degree of mutual trust, their willingness to collaborate together are not necessarily well summarized by the characteristics of the board members. Very competent directors can actually contribute little to the decisions even though they have skills (Brogi, 2015).

At least three areas emerge in which, looking ahead, researchers can make a contribution, drawing inspiration from the reflections currently in progress at an international level:

1. Simplify the structures while strengthening oversight of the entire financial system. Clear tasks and responsibilities need to be defined. With regard to the reform of the rules for the financial system, it is necessary to strengthen governance, capital and organization of banks but also to regulate the shadow banking system and the derivatives market (Brogi & Lagasio, 2019c). Adequate transparency and disclosure policies should also be designed (Brogi & Lagasio, 2018).
2. Work to develop new best practices bearing in mind that there is no single recipe (Tuominen, 2018), as there is no "one size fits all and forever", from this point of view we need to think about both procedures and, above all, people. From this standpoint, an increasing number of researchers are exploring behavioural perspectives of corporate governance.

According to behavioural theory (Cyert & March, 1963; Van Ees, Gabrielsson, & Huse, 2009) the decision-making process within the Board's organs is critical to achieving corporate purpose. The choices of directors are also subject to the mode of interaction between the various actors. Moreover, one of the differences from one company to another is related to ownership structure. Within the literature, family businesses are one of the most investigated types of companies<sup>2</sup> and could provide food for thought also for banks;

3. Because governance is made primarily by people, it is necessary to spread ethics in all sectors of the economy and finance.

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<sup>2</sup> "Some of the reasons for the decline of public companies and the success of alternatives may prove temporary.... The next decade may not be as easy for the emerging-world's family conglomerates as the past decade. But there is also something more fundamental going on: these various corporate forms have all learned how to manage their problems better than public companies have, while continuing to exploit their advantages." (The big engine that couldn't. *The Economist*, May 19, 2012). For examples of research on this topic see Minichilli, Brogi, & Calabrò, 2016 and Calabrò, et al., 2018.

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