# Understanding the Role of Corporate Governance in Financial Institutions: A Research Agenda

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The author presented a previous version of this paper as inaugural lecture to the Chair of Governance of Financial Institutions at Radboud University of Nijmegen on May 10, 2016. The paper is forthcoming in Ondernemingsrecht 2017/13.

## Abstract

After the 2008 financial crisis, a substantial part of the blame for the numerous bank failures that occurred as a result of the crisis has been put on corporate governance. Consequently, regulation and supervision have been enhanced both as a complement to the corporate governance of financial institutions and as a substitute for the same in areas where governance failures appear more evident. In this paper, I argue that the swinging of the pendulum between corporate governance and financial regulation may have gone too far, as a result of the 'nirvana fallacy' that often affects reformers. I suggest, therefore, that corporate governance should recover some of the lost grounds, possibly through spontaneous enhancement of the role of boards by financial institutions and cautious deregulation of the governance mechanisms by supervisory authorities. I also suggest that proposals to reform corporate law for financial institutions, for instance by restricting the scope of the business judgement rule, should be rejected, as this would affect entrepreneurship and stifle innovation in the financial sector.



Keywords: Corporate governance; financial institutions; banks; banking regulation; financial regulation; financial supervision; business judgement rule; fiduciary duties; regulatory duties; bankers' compensation

JEL Classifications: G34, G38, K20, K22



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# Understanding the Role of Corporate Governance in Financial Institutions: A Research Agenda[1]

## Abstract

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## I. Introduction

After the 2008 financial crisis, a substantial part of the blame for the numerous bank failures that occurred as a result of the crisis has been put on corporate governance. Consequently, regulation and supervision have been enhanced both as a complement to the corporate governance of financial institutions and as a substitute for the same in areas where governance failures appear more evident. In this paper, I argue that the swinging of the pendulum between corporate governance and financial regulation may have gone too far, as a result of the 'nirvana fallacy' that often affects reformers.[2] I suggest, therefore, that corporate governance should recover some of the lost grounds, possibly through spontaneous enhancement of the role of boards by financial institutions and cautious deregulation of the governance mechanisms by supervisory authorities. I also suggest that proposals to reform corporate law for financial institutions, for instance by restricting the scope of the business judgement rule, should be rejected, as this would affect entrepreneurship and stifle innovation in the financial sector.

In paragraph II, I consider the main types of financial institutions focussing on their functions and the risks undertaken by the same. In addition, I examine the "specialness" of financial institutions and their governance with respect to non-financial firms. In paragraph III, I analyse the main lessons drawn from the 2008 financial crisis, showing that "good" corporate governance – i.e. effectively aligning the interests of managers and shareholders – can lead to risk-taking by financial institutions far in excess of what is socially optimal. As a result, the corporate governance of financial institutions must be organized and regulated with a special focus on risk governance, a concept that emphasizes the central role of risk management and board oversight on the relevant activities. In paragraph IV, I introduce the global principles in this area, which highlight risk governance, particularly with respect to systemic institutions, but also with regard to non-systemic ones. However, the principle of proportionality applies, under which a differentiated treatment is reserved to smaller and/or less complex institutions. In paragraph V, I ask from a policy perspective to what extent corporate governance should be regulated at financial institutions. In particular, I examine the ways in which corporate governance and financial regulation work as either

[2] See H. Demsetz, "Information and Efficiency: Another Viewpoint", Journal of Law and Economics (1969), 12, 1, stating: "The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing "imperfect" institutional arrangement. This *nirvana* approach differs considerably from a *comparative institution* approach in which the relevant choice is between alternative real institutional arrangements".

complements or substitutes and consider how to strike a balance between the two. In paragraph VI, I study the impact of financial regulation on corporate law, asking whether and to what extent the latter should be changed with regard to financial institutions. In paragraph VII, I suggest directions for further research in this area and conclude.

## II. Financial Institutions: Basic concepts

Compared with corporate governance in general, the scholarly literature has paid relatively little attention to the corporate governance of financial institutions,[3] which is however not only important, but also unique.[4] Banks in particular have a strong impact on economic development, so that their corporate governance is crucial for growth.[5] Moreover, bank lending is a major source of external finance for other firms, especially in Continental Europe and in developing economies. Sound corporate governance of banks is therefore important for bank managers to allocate capital efficiently and enhance the performance of the economies.[6] In this paragraph, I introduce some general concepts relating to financial institutions, including their types, the risks faced by them and their specialness.

### 1. Types

Financial institutions are enterprises that provide financial services. They perform the following main functions: transformation of financial assets; broker-dealer services; asset management. Three types of financial institutions are consequently identified: financial intermediaries; investment firms; asset managers.[7] I would add financial market infrastructures as a special type of financial institution, whose relevance is on the rise on today's financial markets.[8]

Financial intermediaries transform financial assets acquired through the market and constitute them into a different type of asset, more widely preferable, which becomes their liability. Financial intermediaries include banks of all types and credit unions; insurance companies; pension

[3] F. Song and L. Li, 'Bank governance: concepts and measurements', in J. Barth, C. Lin and C. Wihlborg (eds), *Research Handbook on International Banking and Governance*, Elgar 2012,17.
[4] R. Levine, 'The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence', World Bank Policy Research Working Paper 3404, September 2004; K. Hopt, 'Better Governance of Financial Institutions', ECGI Law Working Paper No. 207/2013, April 2013.
[5] R. Levine, 'Financial development and economic growth: Views and agenda', Journal of Economic Literature (1997), 35, 688.
[6] Song and Li, note 2, 17.
[7] F. Fabozzi, F. Modigliani and F. Jones, *Foundations of Financial Markets and Institutions*, Pearson, 4th ed. 2014, 23 ff.
[8] G. Ferrarini and P. Saguato, 'Regulating Financial Market Infrastructures', in N. Moloney, E. Ferran and J. Payne (eds.), *The Oxford Handbook of Financial Regulation*, OUP, 2015, 568.

funds; investment funds; and finance companies. Their transformation function involves at least one of the following: "(i) providing maturity intermediation; (ii) reducing risk via diversification; (iii) reducing the costs of contracting and information processing; and (iv) providing a payments mechanism".[9] Banks generally provide all of these functions. Insurers offer the first three, while pension funds and investment funds provide risk diversification and transaction costs' reduction. Specialised institutions offer payment services in addition to banks.

Investment firms provide broker-dealer functions, such as exchanging financial assets on behalf of customers and/or for their own account, and/or underwriting functions (i.e. they assist their clients in the creation of financial assets, which they then offer to market participants). Asset managers provide investment advice to other market participants (including financial intermediaries) and/or manage their assets.

Financial market infrastructures are established as multilateral systems among participating institutions, including the operator of the system, for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions. They foresee a set of common rules and procedures for all participants, a technical infrastructure, and a specialised risk-management framework. Through the centralisation of specific activities, they allow participants to manage their risks more efficiently and, in some instances, eliminate certain risks.[10]

## 2. Risks

Financial institutions are in the business of taking risks and managing them. In so doing, they face the following 'idiosyncratic' risks:[11]

i) *credit risk* is the risk that the obligor of a financial instrument held by a financial institution will fail to fulfil its obligation on the due date or at any time thereafter;

ii) *settlement risk* is the risk that when there is a settlement of a trade or obligation, the transfer fails to take place as expected; it is a form of credit risk and of liquidity risk;

iii) *counterparty risk* is the risk that a counterparty in a trade fails to satisfy its obligation;

iv) *liquidity risk*, in addition to being part of settlement risk, has two forms: market liquidity risk, i.e. the risk that a financial institution is unable to transact in a financial instrument at a price near its market value; funding liquidity risk, i.e. the risk that a financial institution is unable to get the funding needed to satisfy its obligations;

v) *market risk* is the risk that results from an adverse movement in the market price of assets owned by a financial institution;

[9] Fabozzi, Modigliani and Jones, note 1, 24.
[10] CPSS – IOSCO, *Principles for financial market infrastructures,* 2012.
[11] Fabozzi, Modigliani and Jones, note 1, 30.

vi) *operational risk* is "the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events"[12] and includes *legal risk*, i.e. the risk of loss resulting from failure to comply with laws, prudent ethical standards and contractual obligations. The Basel *Corporate Governance Principles* specifically identify risks stemming from the mis-selling of financial products to retail and business clients; the violation of national and international tax rules, anti-money laundering rules, anti-terrorism rules, economic sanctions, etc.; the manipulation of financial markets, e.g. the manipulation of Libor rates and foreign exchange rates.[13]

However, the great financial crisis has restored the importance of *systemic risk* in the financial sector, as distinguished from idiosyncratic risk. A common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences, which could include a chain of financial institution and/or market failures.[14] While an idiosyncratic shock will affect only a single institution or asset, systemic risk focuses on the danger of the entire financial system collapsing, causing a major downturn in the real economy. Indeed, the consequences of a systemic financial crisis are more devastating than those of other economic crises because of the role that finance plays in the economy.[15]

Connected with the concept of systemic risk, is that of systemically important financial institutions. SIFIs are firms whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.[16] The FSB recommends that financial institutions that are clearly systemic in a global context (G-SIFIs) should have higher loss-absorbency capacity than the minimum levels agreed in Basel III. These institutions must also be subject to more intensive co-ordinated supervision and resolution planning to reduce the probability and impact of their failure.

## 3. Specialness

Financial intermediaries in general are different from non-financial firms for several reasons that matter from a corporate governance perspective. Firstly, they are more leveraged, with the consequence that the conflict between shareholders and fixed claimants, present in all corporations,

[12] Basel Committee on Banking Supervision, Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches, June 2011

[13] Basel Committee on Banking Supervision, Corporate governance principles for banks, July 2015, 5.

[14] S. Schwarcz, 'Systemic Risk', Geo. L.J. (2008), 97, 193.

[15] See the definition offered by the Systemic Risk Centre, London School of Economics, at www.systemicrisk.ac.uk/systemic-risk.

[16] Financial Stability Board, Reducing the moral hazard posed by systemically important financial institutions, Recommendations and Time Lines, 20 October 2010.

is more acute for them.[17] Secondly, banks' liabilities are largely issued as demand deposits, while their assets (e.g. loans) often have longer maturities. The mismatch between liquid liabilities and illiquid assets may become a problem in a crisis situation, as we vividly saw in the recent financial turmoil, when bank runs took place at large institutions, threatening the stability of the whole financial system. Thirdly, despite contributing to bank runs' prevention, deposit insurance generates moral hazard by incentivizing shareholders and managers of insured institutions to engage in excessive risk taking. Similarly, the expectation that governments will bail-out large financial institutions without letting them fail enhances moral hazard of the managers, while reducing monitoring by creditors. Fourthly, asset substitution is relatively easier in financial firms than in non-financial ones. This allows for more flexible and rapid risk shifting, which further increases agency costs between shareholders and stakeholders (bondholders and depositors) and moral hazard of managers. In addition, banks are more opaque, i.e. it is difficult to assess their risk profile and stability. Information asymmetries, in particular for depositors, hamper market discipline and, in turn, increase moral hazard of managers.

Insurers are different from non-financial firms for reasons that are not entirely similar to those applicable to banks. Insurance covers risk for financial and corporate undertakings, and households. Unlike most financial products, it "is characterised by the reversal of the production cycle insofar as premiums are collected when the contract is entered into and claims arise only if a specified event occurs. Insurers intermediate risks directly. They manage these risks through diversification and risk pooling enhanced by a range of other techniques".[18] In addition to *business risks*, insurers bear *technical risks*, which concern the liability side of their balance sheet and relate to the actuarial and/or statistical calculations used in estimating liabilities. They also incur risks from their investments and financial operations, including those arising from asset-liability mismatching.[19]

These preliminary comments show, on one side, the importance of corporate governance for financial institutions; and, on the other, the uniqueness of banks and insurers' governance as a reflection of their specialness.[20] Banks, in particular, are inherently fragile given the liquid nature of

[17] J. Macey and M. O'Hara, 'The Corporate Governance of Banks', FRBNY Economic Policy Review, April 2003, 91.
[18] See International Association of Insurance Supervisors (IAIS), Insurance core principles, updated November 2015.
[19] Ibidem.
[20] For a critical view, see C. van der Elst, Corporate Governance and Banks: How Justified is the Match, Law Working Paper No 284/2015, who hardly finds convincing arguments for bank governance specificities.

deposits and the illiquid nature of their assets, which makes them especially prone to crisis. [21] Other institutions, like asset managers, are less fragile, to the extent that they undertake risks on behalf of investors, while their activities are more similar to other professional activities, including those of lawyers and accountants.[22] The corporate governance of asset managers, albeit important, is less special than in the case of banks and is mainly focused on the quality of services offered to clients and on the prevention of conflicts of interest.[23]

## III. Lessons from the financial crisis

Corporate governance reforms follow either corporate scandals or financial crises. In this century, two waves of reforms have already taken place. The first was determined by the Enron bankruptcy and similar scandals, which led to extensive reform of the audit profession and board governance, including executive compensation, for corporations in general. The second wave of reforms was determined by the great financial crisis, which mainly involved financial institutions and caused wide changes of their corporate governance and compensation practices, in addition to enhancing prudential regulation and crisis management regimes for financial institutions. In the present paper, I focus on the great financial crisis and the ensuing reforms.

### 4. Empirical studies

Official policy documents issued after the 2008 crisis argued that the malfunctioning of corporate governance at banks and other financial institutions contributed to their collapse in the financial turmoil. The de Larosière Report stated that corporate governance was one of the most important failures in the crisis.[24] An OECD paper and a Commission Green Paper similarly argued that boards of directors rarely comprehended either the nature or scale of the risks they were facing.[25] The same documents argued that the recourse to flawed remuneration structures, including

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[21] R. Dale, 'The Regulation of Investment Firms in the European Union, in G. Ferrarini (ed.), *Prudential Regulation of Banks and Securities Firms*, Kluwer, 1995, 28 (comparing the regulation of banks with that of securities firms).
[22] See J. Binder, 'Governance of Investment Firms under MiFID II', in D. Busch and G. Ferrarini (eds), *Regulation of the EU Financial Markets: MiFID II & MiFIR*, Oxford University Press, 2017, 49.
[23] See J. Franks, C. Mayer and Oxford Economic Research Associates Ltd., *Risks and Regulation in European Asset Management: Is There a Role for Capital Requirements*, January 2001; J. Franks and C. Mayer, *Risk, Regulation and Investor Protection: The Case of Investment Management*, OUP, 1989.
[24] See the Report by The High Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, 25 february 2009.
[25] G. Kirkpatrick, The Corporate Governance Lessons from the Financial Crisis, in OECD Journal of Financial Market Trends, 2009/1, 61; EU Commission, Green Paper, Corporate governance in financial institutions and remuneration policies, Bruxelles, 284 final, 2010.

the excessive use of short-term incentives for managers and other risk-taking employees, contributed to the failure of many banks and other financial institutions.

Similar arguments have been criticized by empirical studies showing that good governance is not enough for bank soundness. A notable example is a paper by Andrea Beltratti and René Stulz, who investigate possible determinants of bank performance measured by stock returns, for a sample of ninety-eight large banks across the world, during the crisis.[26] The authors find no evidence that failures and weaknesses in corporate governance arrangements were a primary cause of the financial crisis. In particular, they find no evidence that banks with better governance performed better during the crisis. On the contrary, banks with more pro-shareholder boards performed worse. In their opinion, bank balance sheets and bank profitability in 2006 explain the performance of banks in the following two years better than governance and regulation. Indeed, banks with the highest returns in 2006 had the worst returns during the crisis. In addition, banks that had a higher Tier 1 capital ratio in 2006 and more deposits generally performed better during the crisis.

Another paper by Rüdiger Fahlenbrach and René Stulz on bank CEO incentives analyses a sample of ninety-eight large banks across the world and finds "no evidence that banks with a better alignment of CEOs' interests with those of their shareholders had higher returns during the crisis."[27] The authors rather identify "some evidence that banks led by CEOs whose interests were better aligned with those of their shareholders had worse stock returns and a worse return on equity." According to their study, CEOs had substantial wealth invested in their banks, with the median CEO portfolio including stocks and options in the relevant bank worth more than eight times the value of the CEO's total compensation in 2006. Similar equity holdings should have led CEOs to focus on the long term, avoiding too much risk and excessive leverage for their banks. Instead, the study shows that a bank's stock return performance in 2007-2008 was negatively related to the dollar value of its CEO's holdings of shares in 2006, and that a bank's return on equity in 2008 was negatively related to its CEO's holdings in shares in 2006.

Almost paradoxically, therefore, "good" corporate governance (i.e. aligning the interests of managers and shareholders) simply led bank managers to engage in more risky activities. However, this is explained by the fact that in financial intermediaries a major part of the losses are externalized to stakeholders, while gains are fully internalized by shareholders and managers (if properly aligned by the right incentives). It is therefore the task of prudential regulation and supervision to reduce the excessive risk propensity of shareholders and managers in order to

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[26] A. Beltratti and R.M. Stulz, 'The credit crisis around the globe: Why did some banks perform better?', Journal of Financial Economics (2012), 105(1), 1.

[27] R. Fahlenbrach and R.M. Stulz, 'Bank CEO Incentives and the Credit Crisis', Journal of Financial Economics (2010), 99 (1), 11.

guarantee the "safety and soundness" of financial institutions.[28] Capital requirements, in particular, should reduce the incentives of shareholders to undertake excessive risks, while providing a cushion for the protection of depositors and other stakeholders, including the taxpayers to the extent that the chances of a bailout are diminished.[29]

## 5. Role of risk management

Nonetheless, there is a role for corporate governance in constraining excessive risk-taking by financial institutions beside prudential supervision. A study by Ellul and Yerramilli shows that the organization of risk management at banks, including the role of boards in oversight of the same, are important in predicting risk taking by the institutions concerned and their performance over time.[30] The authors examine the organizational structure of risk management at Bank Holding Companies (BCH) in the U.S. by constructing an index (Risk Management Index = RMI) that measures the importance attached to the risk management function within each BCH and the quality of risk oversight provided by the BHC's board of directors. RMI consists of two sets of variables: the first is intended to measure the importance within the organization of the Chief Risk Officer (CRO), i.e. the officer charged with managing enterprise risk across all business segments; the second is intended to capture the quality of risk oversight provided by the BCH's board of directors, with particular reference to either the risk management committee or the audit and risk management committee. Their main hypothesis is that BCHs with strong and independent risk management functions should have lower tail risk, all else equal. In fact, a strong risk management function correctly identifies risks and prevents excessive risk-taking, which cannot be controlled entirely by regulatory supervision or external market discipline.

Ellul and Yerramilli examine, in particular, whether BHCs that had strong internal risk controls in place before the financial crisis fared better during 2007 and 2008. They find that BCHs with higher pre-crisis RMI had lower tail risk, a smaller fraction of nonperforming loans and better operating performance and stock return performance during the crisis years. They also examine the association between RMI and tail risk taking over the 1995 – 2010 period and find that BCHs with higher RMI (strong organizational risk controls) in the previous year have lower risk in the following one. On the whole, their paper highlights that weak risk management at financial institutions may have contributed to the excessive risk-taking that brought about the financial crisis.

[28] L. White, 'Corporate Governance and Prudential Regulation of Banks: Is There Any Connection?', in Barth, Lin and Wihlborg (eds), note 2, 344.
[29] A. Admati and M. Hellwig, *The Bankers' New Clothes*, Princeton University Press, 2013.
[30] A. Ellul and V. Yerramilli, 'Stronger Risk Controls, Lower Risk: Evidence from U.S. Bank Holding Companies', Journal of Finance (2013), 68, 1757.

Indeed, they show that banks with internal risk controls in place before the onset of the financial crisis were more judicious in the tail risk exposures and fared better, in terms of both operating performance and stock market performance, during the crisis years.

To conclude, aligning the interests of boards, managers and shareholders is not enough for limiting risk-taking by financial institutions to an optimal level from a societal perspective. Indeed, the quality of risk management systems and effective board monitoring over these systems definitely contribute to the safety and soundness of financial institutions.[31]

## IV. Global principles

The financial crisis has led to a restatement of the global principles concerning the corporate governance of financial institutions in the belief that governance failures contributed to these institutions' failures in the crisis. Similarly, international principles and standards on sound compensation practices were adopted. Both sets of principles emphasize the relationship between governance and compensation, on one side, and risk management by financial institutions, on the other. While the OECD and the Basel Committee on Banking Supervision (BCBS) adopted the corporate governance principles on technical grounds and over an extended period of time, the Financial Stability Forum (FSF)/Financial Stability Board (FSB) issued those on sound compensation practices rather hastily and under strong political pressure in the wake of the financial crisis.

### 6. Corporate governance

The work of international organizations in this area started just before the end of the last century. In 1999, the OECD published the *Principles of corporate governance*, which focus on publicly traded companies, both financial and non-financial. The Principles were subsequently updated and are now available in their 2015 edition, which has been issued under the auspices of G 20/OECD.[32] The BCBS took the first edition of the Principles as a basis for drafting its Guidelines on *Corporate governance principles for banks* in 1999.

Originally, the BCBS Guidelines were directed to assist supervisors in the promotion of sound corporate governance practices, with the belief that "through sound corporate governance,

[31] See R. Stulz, 'Risk-Taking and Risk Management by Banks', Journal of Applied Corporate Finance (2015), 27, 8; A. Ellul, 'The Role of Risk Management in Corporate Governance', Annual Review of Financial Economics (2015), 7, 279, who reached similar conclusions, in line with the official reports cited above, at least for what concerns risk management failures before and throughout the financial crisis.

[32] See G20/OECD Principles of Corporate Governance, 2015, downloadable at www.oecd.org/corporate/principles-corporate-governance.htm.

bank supervisors can have a collaborative working relationship with bank management, rather than an adversarial one". In their 2015 edition, however, the Guidelines underline that "effective implementation of sound corporate governance requires relevant legal, regulatory and institutional foundations" and encourage supervisors "to be aware of legal and institutional impediments to sound corporate governance, and to take steps to foster effective foundations for corporate governance where it is within their legal authority to do so". No doubt, this exhortation reflects and/or explains the post-crisis shift of many legal systems from a supervisory to a regulatory approach to bank governance.

One of the main goals of the 2015 BCBS Guidelines is to emphasize the role of risk governance in banks. Indeed, their main purposes are "to explicitly reinforce the collective oversight and risk governance responsibilities of the board" and "to emphasize key components of risk governance such as risk culture, risk appetite and their relationship to a bank's risk capacity". Moreover, the Guidelines identify "the specific roles of the board, board risk committees, senior management and the control functions, including the CRO and internal audit". These statements reflect the findings of the *Thematic review on risk governance* issued by the FSB in 2013 as part of its peer reviews. The FSB found that national authorities and banks needed to do more work to establish effective risk governance frameworks. Banks also needed to enhance the authority and independence of CROs, while national authorities needed to strengthen their ability to assess the effectiveness of a bank's risk governance and risk culture.

The *OECD Guidelines on Insurer Governance* follow a path similar to that of the BCBS Guidelines and were "designed in light of the overriding objective of an insurance undertaking, which is to provide benefits to the insured in accordance with the contracts concluded with them, and satisfy its shareholders (member-policy holders in the case of mutual insurers)". [33] Their rationale is explained accordingly: "(…) insurers are expected to have sound governance practices and effective risk management so that they will be in a position to provide promised benefits to policy holders (and any relevant beneficiaries) and thus fulfil their insurance function in the economy".[34]

## 7. Executive pay

[33] See OECD Guidelines on Insurer Governance, 2011, 13. The Guidelines were established as an OECD Recommendation in 2005 and were revised in 2011. They complement the OECD Recommendation of the Council on Core principles of Occupational Pension Regulation and the OECD Principles of Corporate Governance.

[34] OECD Guidelines, note 32, 43, arguing that insurers "as financial institutions accepting funds in return for promised future payments (…) may have an incentive to engage in risky behaviour or practices that have short-term benefits but do not properly consider policyholder interests or, more broadly, the reputation of the industry".

The topic of financiers' compensation is more politically charged than that of corporate governance as it involves issues that are especially salient from the voters' perspective particularly in times of crisis. The legislative and regulatory responses to similar issues depend on the type of equilibrium found in each country between the different interests at stake. Where public criticism of financiers and hostility to their remuneration practices are strong, the risk of regulatory capture is lower and a tougher regime for executive pay may emerge. Culture may contribute to similar outcomes, given that high levels of executive pay are less tolerated in some countries. However, no domestic regulatory solution can be effective without agreement at international level, which explains why international principles for sound compensation practices were adopted after the crisis at the initiative of G20 and the FSB.[35]

Nevertheless, these international fora tend to dilute the conflicts of interest concerning issues like financiers' pay. First, interest groups, including large financial institutions, are relatively weaker in the international arena, given that they face large coalitions of governments; the G20 consists of 19 governments and the EU, while the FSB is made up of 36 members, including 24 countries. Second, the types of financial firms and their problems differ according to the regions in which they are based. The problems of executive pay arose mainly with reference to US and UK institutions, while firms in other countries either did not undergo similar crises or did not experiment excessive compensation. Third, the international financial standards are usually formulated at some level of abstraction, which allows for the smoothing of conflicts between the various interests at stake and introduces some flexibility in the implementation of the standards in individual jurisdictions.[36]

The FSB principles are addressed to 'significant financial institutions', which more than others deserve an internationally uniform regime. Compensation structures are considered by the principles along lines that reflect, to a large extent, general best practices already followed before the crisis. Indeed, the role and limits of equity-based compensation, as well as the potentially perverse effects of short-term incentives, have attracted much attention over the last twenty years. However, pre-crisis practices mainly emphasised the alignment of managers' incentives with shareholder wealth maximization. The principles break new grounds by requiring financial institutions to align compensation with prudent risk taking. Accordingly, compensation should be

[35] Financial Stability Forum (FSF), Principles for Sound Compensation Practices, 2009, available at www.financialstabilityboard.org/publications /r_0904b.pdf; Financial Stability Board (FSB), Principles for Sound Compensation Practices: Implementation Standards, 2009, available at www. financialstabilityboard.org/publications/r_090925c.pdf.

[36] G. Ferrarini and M.C. Ungureanu, 'Lost in Implementation: The Rise and Value of the FSB Principles for Sound Compensation Practices at Financial Institutions', Revue Trimestrielle de Droit Financier (2011), 1-2, 60.

adjusted for all types of risk, including those considered difficult-to-measure, such as liquidity risk, reputation risk, and capital cost. Compensation outcomes should be symmetric with risk outcomes.[37]

Similar to other international financial standards, the principles remain at a sufficient level of generality and allow for flexibility in implementation. In several instances, financial institutions are permitted to depart from a given principle or standard, if application of the same would lead to unsound consequences. States are free to implement the principles through either regulation or supervision and, if they adopt a supervisory approach to implementation, the interference with remuneration structures might be softer. Nonetheless, the existence of detailed principles and standards will inevitably shape supervisory actions producing results not entirely dissimilar from those of ad hoc regulation.

In a similar vein, the FSB adopted Principles for An Effective Risk Appetite Framework, which aim to enhance the supervision of SIFIs, but are also relevant for the supervision of financial institutions and groups more generally, including insurers, securities firms and other non-bank financial institutions.[38] The FSB Principles set out key elements for an effective risk appetite framework, an effective risk appetite statement, risk limits, and defining the roles and responsibilities of the board of directors and senior management. For non-SIFIs, supervisors and financial institutions may apply the Principles proportionately so that the Risk Appetite Framework is appropriate to the nature, scope and complexity of the activities of the financial institution.

## 8. Proportionality

The Basel Committee's *Corporate Governance Principles for Banks* clearly enounce the overarching principle of proportionality by specifying that their implementation "should be commensurate with the size, complexity, structure, economic significance, risk profile and business model of the bank and the group (if any) to which it belongs. This means making reasonable adjustments where appropriate for banks with lower risk profiles, and being alert to the higher risks that may accompany more complex and publicly listed institutions." Proportionality, therefore, works in two directions, either weakening or reinforcing the governance requirements of the institutions concerned on the basis of their risk profile and business model. Other circumstances are also relevant, such as size and complexity, so that smaller institutions and/or less complex ones can

[37] G. Ferrarini and M.C. Ungureanu, 'Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks', Vanderbilt Law Review (2011) 64, 2, 431.

[38] FSB, Principles for An Effective Risk Appetite Framework, 18 November 2013.

be treated differently in the implementation of the individual standards, which could be either displaced or applied in a different way.

Moreover, banks that qualify as systemically important financial institutions (SIFIs) are "expected to have in place the corporate governance structure and practices commensurate with their role in and potential impact on national and global financial stability". Indeed, SIFIs' distress or disorderly failure can cause significant disruption to the wider financial system and economic activity, because of their size, complexity and systemic interconnectedness. This is why the FSB framework for reducing the moral hazard of SIFIs has been adopted.[39] The objective of this framework is to address the systemic risks and the associated moral hazard problem for institutions that are seen by markets as too big too fail. Amongst the various measures foreseen, intensive and effective supervision of all SIFIs is required, including through stronger supervisory mandates, resources and powers, and higher supervisory expectations for risk management functions, data aggregation capabilities, risk governance and internal controls.[40] Also the FSF (now FSB) *Principles for Sound Compensation Practices* "are intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms".[41]

As a result, the international principles touching upon corporate governance and related issues establish a hierarchy of firms, depending on their systemic relevance (G-SIFIs, SIFIs) or on their significance, complexity and size. However, the implementation of the principles and the choice how to model them with respect to such hierarchy are left to individual jurisdictions. We know that the European Union has neglected proportionality to a large extent, particularly in the CRD IV provisions concerning the corporate governance of banks and compensation practices, which tend to follow a one-size-fits-all approach that is creating problems to smaller and/or less complex institutions.[42]

## V. Corporate governance and prudential regulation: Complements or substitutes?

Prudential regulation aims to maintain the solvency of financial intermediaries, which are generally leveraged enterprises. Leverage magnifies the gains and losses of a financial intermediary. Therefore, combined with limited liability, leverage may distort the incentives of the firm's owners toward taking on more risk than would be the case if they bore the full burden of the

[39] FSB, *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions*, 2010.
[40] FSB, *Policy Measures to Address Systemically Important Financial Institutions*, 2011.
[41] See note 34.
[42] See G. Ferrarini, 'Regulating Bankers' Pay in Europe: The Case for Flexibility and Proportionality', in Festshrift für Theodor Baums, 2016.

downside losses.[43] The extent of the distortion depends on the amount of the financial institution's capital relative to the potential risk-taking activity. If the capital is small and the risks are large, limited liability may well encourage excessive risk-taking.

Leverage and limited liability justify prudential regulation of financial intermediaries. The creditors of a leveraged firm need to be protected. This is particularly true in the case of financial institutions for many of their creditors (such as depositors and policy holders) are unable to protect themselves adequately also in consideration of such institutions' opaqueness. In this paragraph, we focus on the interrelationship between corporate governance and prudential regulation and ask to what extent they are complements or substitutes to each other.[44]

## 9. Corporate governance as a complement

Governments and regulators rely on corporate governance as a complement to financial supervision, which explains why regulation is on the rise in this area. In brief, regulation requires boards of directors and their risk committees to oversee the undertaking and management of risks by financial institutions. Board members of financial institutions are subject to regulatory duties, which specify their monitoring tasks and the ways in which they should perform the same in the interest of financial stability. In the absence of regulation, financial institutions would undertake more risks than is socially optimal, for they would act exclusively in the interest of shareholders who do not internalize the social costs, but only the private costs of their firm's failure.

Corporate governance therefore serves the purposes of supervisors, to the extent that it should prevent the undertaking of excessive risk by financial institutions. No doubt, also the interests of shareholders are protected. However, wealth maximization by financial institutions is constrained whenever regulation or supervision foreclose the assumption of risk which would be in the interest of shareholders to assume, but could endanger creditors or even threaten systemic stability. A difficult trade-off is therefore struck between the maximization of the value of financial firms and the social interest to systemic stability.

Regulators, on their turn, complement the monitoring by boards and risk committees through public supervision on governance mechanisms and risk management by financial institutions. The EBA *Guidelines on common procedures and methodologies for the supervisory*

[43] White, note 27, 351.
[44] The same question was posed and lively debated at the 2010 conference of the Transatlantic Corporate Governance Dialogue, "Corporate Governance and the new Financial Regulation: Complements or Substitutes?" (www.ecgi.org/tcgd/index.php).

*review and evaluation process (SREP)*, drawn up pursuant to Article 107(3) of CRD IV, offer a good example. They are addressed to competent authorities and are intended to promote common procedures and methodologies for the SREP referred to in Article 97 et seq. of CRD IV and for assessing the organisation and treatment of risks referred to in Articles 76 to 87 of that Directive. The common SREP framework introduced in these guidelines is built around business model analysis; assessment of internal governance and institution-wide control arrangements; assessment of risks to capital and adequacy of capital to cover these risks; and assessment of risks to liquidity and adequacy of liquidity resources to cover these risks. The specific elements of the SREP framework are assessed and scored on a scale of 1-4. The outcome of the assessments, both individually and considered as a whole, forms the basis for the overall SREP assessment, which represents the up-to-date supervisory view of the institution's risks and viability.

The monitoring of corporate governance by bank supervisors can be usefully explained from the perspective of the "representation hypothesis" developed by Dewatripont and Tirole.[45] In their opinion, prudential regulation is primarily motivated by the need to "represent" small depositors (and small customers of non-bank financial institutions) and to bring about appropriate corporate governance. The two authors see the import of corporate governance ideas as a way to enrich the financial regulation debate. In brief, they see that financial institutions tend to be regulated under the following circumstances: "First, the claimholders are somewhat unsophisticated or free-riding (small depositors, insurance policyholders, pensioners) and/or cannot conceivably thoroughly monitor their counterparts due to the number of such parties and to the time scale involved (interbank depositors, traders on securities markets). Second, no mechanism of private representation is (or can be?) set up that would dispense the claimholders from having to monitor, write covenants, and interfere".[46] Dewatripont and Tirole argue however that "despite some differences, the philosophy of prudential regulation strongly resembles that of loan agreement covenants".[47] Standard loan agreements demand capital adequacy, include liquidity and early warning systems, and provide for the handling of failures. In the case of covenant violation, the creditor may face roughly the same choices as a banking regulator: "forbearance, liquidation, or renegotiation". The latter results in debt forgiveness, which is the analogue of government financial assistance, or in a debt-equity swap, which is the analogue of government ownership.

## 10. Regulation as a substitute

[45] M. Dewatripont and J. Tirole, 'The Prudential Regulation of Banks', MIT Press, 1994.
[46] Ibid. 44.
[47] Ibid. 88.

However, post-crisis reforms have extended prudential regulation to areas, which are not easily reduced to the covenants analogy and reinforce the idea of financial regulation as a substitute for corporate governance. One of these areas is incentive compensation. The FSB principles and standards interfere with the structure of compensation in ways that restrict the autonomy of boards.[48] Compensation structures are considered by the principles along lines that reflect, to a large extent, general best practices already followed before the crisis. Indeed, the role and limits of equity-based compensation, as well as the potentially perverse effects of short-term incentives, have attracted much attention over the last twenty years. However, pre-crisis practices mainly emphasised the alignment of managers' incentives with shareholder wealth maximization. The FSB principles break new grounds by requiring financial institutions to align compensation with prudent risk taking. Accordingly, compensation should be adjusted for all types of risk, including those considered difficult-to-measure, such as liquidity risk, reputation risk, and capital cost. Compensation outcomes should be symmetric with risk outcomes.

Deferment of compensation, traditionally used as a retention mechanism (on the basis that a 'bad leaver' would generally lose unpaid deferrals), should make compensation pay-out schedules sensitive to the time horizon of risks. In particular, a substantial portion of variable compensation (i.e. forty to sixty per cent) should be payable under deferral arrangements over a period of not less than three years, provided that this period is correctly aligned with the nature of the business, its risks, and the activities of the employee in question. Furthermore, a substantial portion (i.e. more than fifty per cent) of variable compensation should be awarded in shares or share-linked instruments, as long as the same create incentives aligned with long-term value creation and the time horizons of risk. In any event, awards in shares or share-linked instruments should be subject to an appropriate retention policy.

The principles also tackle concerns relative to bonuses, which famously emerged during the recent crisis. They require 'malus' and 'clawback' mechanisms, which enable boards to reduce or reclaim bonuses paid on the basis of results that are unrepresentative of the company's performance over the long term or later prove to have been misstated. They consider 'guaranteed' bonuses (i.e. contracts guaranteeing variable pay for several years) as conflicting with sound risk management and the pay-for-performance principle. Severance packages need to be related to performance achieved over time and designed in a way that does not reward failure.

## 11. Policy issues

[48] Ferrarini and Ungureanu, note 36.

Given that corporate governance is a complement to regulation in assuring the stability of financial institutions, an important question for policy research is to what extent and under what conditions regulation should work either as a complement or a substitute for corporate governance. While an answer can only be given in specific circumstances, I would suggest three general criteria. First, the autonomy of boards should be protected, for they represent the main governance mechanism in today's enterprises. Therefore, regulation should abstain from replacing the determinations of boards in areas which traditionally pertain to corporate governance also in non-financial firms. In previous work, I have argued, for instance, that mandating remuneration structures might unduly interfere with the setting of managerial incentives by boards, also considering that supervisors do not necessarily possess the required professional competences and the right incentives to make the relevant choices.[49] A similar argument can apply to risk management, to the extent that boards should maintain their oversight functions over risk management systems without being unduly constrained by regulation.[50] Therefore, prudential regulation should avoid setting the details of risk management processes, letting institutions free to design these systems under the supervision of boards, save for the general requirements of regulatory law and the periodic checks of supervisors over the adequacy of these systems from a safety and soundness perspective.[51]

Second, prudential regulation should abstain from setting too detailed requirements as to the organization and functioning of boards. Indeed, similar requirements often assume that boards' functioning can be improved merely by increasing the specificity and intensity of regulation, while ignoring that information asymmetries and other problems may affect the board as an institution and foreclose a perfect functioning of the same.[52] Moreover, various regulatory provisions "petrify existing corporate governance best practices, and in so doing impose costs on banks that would be better off adopting (or maintaining) a different solution (such as a chairman/CEO or a board in which also a busy professional director with the right expertise keeps his seat)".[53]

[49] Ibidem.

[50] R. Stulz, 'Risk-taking and Risk Management by Banks', Journal of Applied Corporate Finance' (2015) 27, 1/8,11: "… regulators impose restrictions on banks' ability to take risks on the asset side and require banks to satisfy minimal capital requirements. And this of course means that banks choose their level of risk subject to external constraints. But the critical point is that such constraints do not change our earlier conclusions: namely, that there is an optimal level of risk for a bank—one that affects the interests and concerns of both bank regulators and bank investors—and that that level of risk differs across banks in ways that reflect their business models".

[51] The relevant arguments are fully developed in L. Enriques and D. Zetzsche, 'The Risky Business of Regulating Risk Management in Listed Companies' (2013) European Company and Financial Law Review, 10, 271.

[52] O. Williamson, 'Corporate Boards of Directors: In Principle and in Practice' (2007) Journal of Law, Economics and Organization, 247.

[53] L. Enriques and D. Zetsche, 'Quack Corporate Governance, Round III? Bank Board Regulation Under

Third, we should distinguish between a regulatory approach and a supervisory approach to the corporate governance of financial institutions. To the extent that the latter approach is followed, flexibility can be maintained particularly in the implementation of the international principles.[54] Indeed, supervisors can develop their standards while exercising supervisory activities and adapt them to different circumstances. If a regulatory approach is followed, the risk of too detailed rules being issued is relevant and supervisors loose discretion as a result. From the perspective of the supervised entities, however, the regulatory approach is preferable to the extent that the applicable rules are known *ex ante*, whereas the supervisory approach leaves some uncertainty as to the standards that will be applied in specific circumstances. Therefore, a trade-off exists between flexibility in surveillance and the firms' uncertainty as to the criteria to be followed. In order to solve this trade-off, the costs of a more bureaucratic approach to supervision must be compared with those of the relative unpredictability of surveillance criteria.[55]

## VI. A special corporate law for financial institutions?

A second question for policy research is whether corporate law should be different for financial institutions. I briefly analyse three aspects of this question. First, I ask whether the corporate governance of financial institutions is a type of stakeholder governance as a result of the impact of regulation. Second, I ask whether the business judgement rule should apply to director's liability for negligent oversight over risk management in financial institutions or some type of enhanced liability would be preferable, as argued by a number of scholars. Third, I examine the case of related party transactions and show how regulation complements corporate law in this area.

### 12. Stakeholder governance?

There is no clear-cut, generally accepted definition of corporate governance.[56] The dominant approach in finance focuses on the relationship between firms and suppliers of funds (debt and equity). Scholars argue that corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return to their investment.[57] This view is sometimes criticised as being too narrow, for other stakeholders (employees, clients, local communities) have

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the New European Capital Requirement Directive', Theoretical Inquiries in Law, 16.1 (2015), 211, at 240.

[54] I tried to develop this argument in Ferrarini, note 41.

[55] L. Kaplow, 'Rules versus Standards: An Economic Analysis', Duke Law Journal (1992), 42, 557.

[56] M. Belcredi and G. Ferrarini, 'Corporate Boards, Incentive Pay and Shareholder Activism in Europe: Main Issues and Policy Perspectives', in M. Belcredi and G. Ferrarini (eds), *Boards and Shareholders in European Listed Companies.* Facts, Context and Post-crisis Reforms, Cambridge University Press, 2013, 1.

[57] A. Shleifer and R. W. Vishny, 'A Survey of Corporate Governance', Journal of Finance (1997) 52, 737.

an interest in how the firm is run.[58] Under a broader definition, 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.[59] However, the presence of multiple principals blurs corporate objectives and may ultimately compound agency problems, providing the management with an ad hoc rationale to explain any decision whatsoever.[60]

Recent EU policy documents are rather ambivalent and fluctuate between the two approaches just described. The 2011 Green Paper remarks that corporate governance is traditionally defined as the system by which companies are directed and controlled, and as a set of relationships between a company's management, its board, shareholders and other stakeholders. Under this approach, corporate governance centres on the agency relation between boards (agents) and shareholders (principals). Other stakeholders are protected by contracts and/or regulation (concerning bankruptcy, competition, labour, etc.), rather than by traditional corporate governance institutions.[61] The second part of the Green Paper's definition reflects a stakeholder view, similar to that found in the OECD Principles of corporate governance. These Principles highlight that different classes of shareholders may exist and need to be treated in an equitable manner, and other stakeholders may possess rights established by law or through mutual agreements, which may extend also to corporate governance institutions (e.g. employees may get board representation and have a say in specific corporate decisions). From a similar perspective, corporate governance institutions do not concern exclusively the relationship between managers and (undifferentiated) shareholders. Rather, they must solve the potential trade-offs between different kinds of agency problems, which may justify regulating, for instance, the composition and role of the board of directors.

The question therefore arises whether and to what extent the board and/or shareholders' powers should be regulated to reflect other stakeholders' interest. The Basel Principles offer the bank regulators' view of corporate governance. They define it as "a set of relationships between a company's management, its board, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set, and the means of attaining those

[58] M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century*, The Brookings Institution, Washington D.C., 1995; M. Blair and L. Stout, 'Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law', University of Pennsylvania Law Review, (2001) 149, 1735.
[59] M. Becht, P. Bolton and A. Roell, 'Corporate Governance and Control', ECGI Finance Working Paper 02/2002.
[60] O. Williamson, *The Economic Institutions of Capitalism*, The Free Press, New York,1985, 298; J. Tirole, *The Theory of Corporate Finance*, Princeton University Press, 2006, 15.
[61] However, shareholder primacy has come under closer scrutiny in the last few years, particularly in financial institutions where corporate governance arrangements have been criticised for distorting managerial incentives and/or contributing to the financial crisis: see Kirkpatrick, note 24; Beltratti and Stulz, note 25; Fahlenbrach and Stulz , note 26.

objectives and monitoring performance. It helps define the way authority and responsibility are allocated and how corporate decisions are made." Moreover, the Principles underline the stakeholders' primacy in bank governance from a supervisory perspective: "The primary objective of corporate governance should be safeguarding stakeholders' interest in conformity with public interest on a sustainable basis. Among stakeholders, particularly with respect to retail banks, shareholders' interest would be secondary to depositors' interest."

I submit that such an approach is justified only from a regulatory viewpoint and should not be accepted in corporate law.[62] Banking supervisors rationally advocate the primacy of depositors' interest and define regulatory duties from the perspective of depositor protection and financial stability. Similar arguments hold *mutatis mutandis* for insurance supervisors and other financial authorities. However, most corporate laws either follow a shareholder value approach to corporate governance or at least assert shareholder primacy with respect to other stakeholders, including depositors in banks.[63] Dutch law and German law may be different to the extent that management has to act in the interests of the firm, including the interests of debt holders.[64] Yet, as Klaus Hopt noted, "this proved not to make a difference for the risk-taking of banks before the financial crisis."[65]

## 13. Business judgement rule?

The differences between corporate law and financial regulation are reflected in the distinction between fiduciary duties and regulatory duties. The former respond to the interests of shareholders and creditors, while the latter are dictated mainly from a public interest perspective

[62] On the difficult relationship between corporate governance and banking regulation, see P. Mülbert, Corporate Governance of Banks after the Financial Crisis - Theory, Evidence, Reforms (April 2010), ECGI - Law Working Paper No. 130/2009.

[63] See H. Hansmann and R. Kraakman, 'Toward a Single Model of Corporate Law', in J. McCahery et al. (eds), *Corporate Governance Regimes*, Oxford University Press, 2002, 56.

[64] See R. Novak, 'Corporate Boards in the Netherlands', in P. Davies, K. Hopt, R. Novak, G. van Solinge (eds), *Corporate Boards in Law and Practice. A Comparative Analysis in Europe*, Oxford University Press, 2013, 431, at 435 (noting that the members of the management board and the supervisory board have to be guided by the interests of the company and its purpose); M. Roth, 'Corporate Boards in Germany', ibidem, 256, at 263, stating however that given the mixed views in academia and the German Corporate Governance Code "it is appropriate to say that German company law follows an enlightened shareholder value approach". A similar view is found in the Dutch Corporate Governance Code (new edition, 8 December 2016) providing: "The management board is responsible for the continuity of the company and its affiliated enterprise. The management board focuses on long-term value creation for the company and its affiliated enterprise, and takes into account the stakeholder interests that are relevant in this context. The supervisory board monitors the management board in this" (unofficial translation of Principle 1.1).

[65] K. J. Hopt, 'Corporate Governance of Banks after the Financial Crisis, in E. Wymeersch, K. J. Hopt, G. Ferrarini (eds.), *Financial Regulation and Supervision.* A Post-crisis Analysis, Oxford University Press 2012, 337.

and respond to financial stability concerns.[66] Some scholars argue, however, that the difference between the two types of duties is blurred in the presence of financial stability concerns and that the directors' duty of care should be enhanced for financial institutions also from a corporate law perspective. Macey and O'Hara, in a 2003 paper, advanced the thesis that the US corporate governance of banks followed the "Franco-German model", which gives weight to long-term stakeholder constituencies like employees and banks (in industrial corporations).[67] They made reference to US judicial cases showing that bank directors have expanded fiduciary duties and concluded: "… a clear case can be made for bank directors being held to a broader, if not a higher, standard of care than other directors."[68] The two authors reiterated their view in a more recent paper, where they argue that the increased complexity and greater opacity of banks requires greater expertise on the part of directors, and propose new "banking expert" and "banking literacy" requirements akin to the financial expert requirements imposed on audit committee members by Sarbanes-Oxley.[69]

Armour and Gordon similarly argue that the business judgement rule protection leads to excessive risk-taking in a systemically important firm.[70] They propose "a framework in which the board has oversight responsibility for the level of risk-taking by the firm, including risk-taking in operations as well as strategy, not just its compliance with applicable legal norms". Moreover, they suggest "a standard of liability that is negligence-based, because the risk-neutral heuristic associated with the business judgement rule is inappropriate when systemic risks are concerned". The goal of such a reform would be deterrence, i.e. "to induce board 'ownership' of the firm's risk".[71]

The arguments advanced in the present paper point in a somewhat different direction. Indeed, financial institutions are enterprises and the business judgement rule protects entrepreneurship in risk-taking, which is essential for firms' development and sustainability.[72] If the rule were removed or limited in its scope, financial entrepreneurship and innovation would be negatively affected. Moreover, it is the role of financial regulation and supervision to limit risk-

[66] On fiduciary duties, see Easterbrook and Fischel, *The Economic Structure of Corporate Law*, Harvard University Press, Cambridge Mass., 1991, 90. On regulatory duties, see J. Black, 'Regulatory Styles and Supervisory Strategies', in N. Moloney, E. Ferran and J. Payne (eds), *The Oxford Handbook of Financial Regulation*, Oxford University Press, 2015, 218.
[67] Macey and O'Hara, note 91.
[68] Ibidem, 102.
[69] J. Macey and M. O'Hara, Bank Corporate Governance: A Paradigm for the Post-Crisis World, Economic Review, Federal Reserve Bank of New York (2016) 22, 84.
[70] J. Armour and J. Gordon, 'Systemic Harms and Shareholder Value', Journal of Legal Analysis (2014), 6, 35.
[71] Ibidem, 64.
[72] See H. Spamann, Monetary Liability for Breach of the Duty of Care, ECGI Law Working Paper No. 300/2015 (arguing that equity pay already provides fairly good incentives, courts have difficulties evaluating business decisions, and the agency conflict in standard business decisions is limited).

taking by directors and officers in furtherance of the public interest.[73] As a result, regulatory duties complement fiduciary duties by requiring a greater effort in risk management and oversight.[74] There is no need for corporate law to enhance the duty of care and increase the potential for directors' civil liability, given that financial regulation already provides enforcement mechanisms to this effect.[75]

Also US courts, in a number of cases following the 2008 crisis, held that the business judgement rule does apply to financial institutions' directors. In *Citigroup Inc. Shareholder Derivative Litigation*[76] the plaintiffs essentially claimed that Citigroup's directors should be personally liable to the company because they failed to recognise the risk posed by subprime securities. The Delaware Court of Chancery applied the business judgement rule to excuse defendants, using *inter alia* the following argument: "Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a 'wrong' business decision would cripple their ability to earn returns for investors by taking business risks".[77]

### 14. Related party transactions

The interaction between fiduciary duties and regulatory duties is made clear by the treatment of related party transactions. Fiduciary duties are directed to fulfil shareholder interests, while regulatory duties are designed to protect financial stability. The former are sanctioned through civil liability, whereas breaches of the latter give rise to administrative sanctions. The fiduciary duty of loyalty aims to protect corporate assets from conflicted transactions, which could result in a transfer of wealth from shareholders to related parties.[78] The regulatory duties in this area are directed to reduce the risks deriving from conflicted transactions to the stability of financial institutions, as in the case of loans extended by a bank's managers to related parties.[79]

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[73] P. Muelbert and A. Wilhelm, 'CRD IV Framework for Banks' Corporate Governance', in D. Busch and G. Ferrarini, *European Banking Union*, Oxford University Press, 2005, 155, at 188.

[74] See P. Mülbert, 'Managing Risk in the Financial System', in N. Moloney, E. Ferran and J. Payne (eds), note 7, 364.

[75] L. Enriques and D. Zetsche, note 52, at 225.

[76] In re Citigroup Inc. Shareholder Derivative Litigation, Civil Action No. 3338-CC, Court of Chancery, Delaware, February 24, 2009, downloadable at http://courts.delaware.gov/opinions/download.aspx?ID=118110.

[77] Ibidem, 31. See also In re The Goldman Sachs Group, Inc. Shareholder Litigation, Civil Action No. 5215 – VCG, Court of Chancery, Delaware, October 12, 2011, downloadable at http://courts.delaware.gov/opinions/download.aspx?ID=161650

[78] See L. Enriques, G. Hertig and H. Kanda, 'Related-Party Transactions', in R. Kraakman et al., The *Anatomy of Corporate Law* (2009) 2nd ed., Oxford University Press, 153.

[79] On insider lending and its limits, see R. Carnell, J. Macey and G. Miller, *The Law of Banking and Financial Institution*s, 4th ed (2009), Aspen Publishers, New York, 304.

Shareholders might be willing to undertake a level of risk from related party transactions higher than that allowed by supervisors, when the relevant activity is profitable for them. However, supervisors might object to it for reasons concerning financial stability, which may be endangered by transactions that appear to be in the interest of shareholders on profitability grounds. Eloquently, Principle 20 (5) of the Basel Committee's *Core Principles*[80] allows for limits to be set to related party transactions in banks by stating: "Laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralisation of such exposures. When limits are set on aggregate exposures to related parties, those are at least as strict as those for single counterparties or groups of connected counterparties."

## VII. Concluding remarks

### 15. Main outcomes

This paper has advanced three main theses. First, "good" corporate governance (in the sense of aligning the interests of managers and shareholders) may lead the managers of financial institutions to engage in more risky activities, as shown by the recent financial crisis where banks which were more prone to risk-taking, more aggressive in incentivizing their managers through variable remuneration and more profitable before 2008 were also the ones which miserably failed in the crisis.[81] At the same time, the institutions that fared better throughout the crisis devoted more resources and efforts to risk management. Therefore, "good" governance requires effective risk management systems and board monitoring over the same, in addition to aligning the interests of managers and shareholders. In the case of financial institutions, these systems are run under regulatory constraints targeting financial stability, which are becoming uniform on a global scale.

Second, it is the task of prudential regulation to reduce the excessive risk propensity of shareholders and managers in order to guarantee the "safety and soundness" of financial institutions. However, regulation should not excessively constrain boards' autonomy, for instance by dictating the remuneration structures that they should use with their managers and employees. The main functions of boards should rather be protected and boards should be free to exercise the same in a true spirit of entrepreneurship. Regulatory constraints should mainly apply to the capital

[80] Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (September 2012).

81 See I. Cheng, H. Hong, and J. Scheinkman, 'Yesterday's Heroes: Compensation and Risk at Financial Firms', Journal of Finance (2015), 70, 839.

structure of financial institutions and to the conditions for exercising their activities in a safe and sound manner, for instance in the case of related party transactions.

Third, financial regulation does not (and should not) modify corporate law as applicable to financial institutions. In particular, fiduciary duties should be kept separate from regulatory duties, and also the sanctions for their breaches should be different, i.e. civil liability in the case of fiduciary duties and administrative penalties in the case of regulatory ones. Moreover, the business judgement rule should apply to the duty of care, in order not to chill the entrepreneurship of boards and managers, and induce a bureaucratic approach to the running of financial institutions.

## 16. Further perspectives

Corporate governance effectiveness does depend not only on rules and their enforcement, but also on ethics and culture within the firm. As argued by Douglass North from a general perspective, "… formal rules, in even the most developed economy, make up a small (although very important) part of the sum of constraints that shape choices; a moment's reflection should suggest to us the pervasiveness of informal constraints. In our daily interaction with others, whether within the family, in external social relations, or in business activities, the governing structure is overwhelmingly defined by codes of conduct, norms of behaviour, and conventions".[82] In a similar setting, culture plays a fundamental role for it "defines the way individuals process and utilize information and hence may affect the way informal constraints are specified. Conventions are culture specific, as indeed are norms".[83]

This explains the emphasis put on culture in post-crisis corporate governance discussion, which underlines the roles that ethics and the relevant monitoring play in the financial services sector: "With over $100 billion in fines imposed on the largest financial institutions since the financial crisis, there is now a growing suspicion that ethical lapses in banking are not just the outcome of a few bad apples – deviant rogue traders – but rather a reflection of systematic weaknesses in governance".[84] There is no doubt, therefore, that future research on the governance of financial institutions should not be restrained to legal and economic analysis, but extend to the role and impact of culture and ethics in financial firms from a broad social sciences perspective.[85] In

[82] D. North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press (1999), 37.
[83] Ibidem, 42.
[84] A. Takor, 'Corporate Culture in Banking', in Federal Reserve Bank of New York, Economic Policy Review (2016), 22, 1/5.
[85] A. Lo, 'The Gordon Gekko Effect: The Role of Culture in the Financial Industry', FRBNY Economic Policy Review (August 2016), 17.

this way, sociology, psychology and anthropology will help understanding the "informal constraints" which determine financial institutions' behaviour and complement their regulation and supervision.[86]

[86] A. Morrison and J. Shapiro, Governance and Culture in the Banking Sector, Working Paper, February 2016, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2731357.

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