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# Corporate Governance of Banks after the Financial Crisis

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## Abstract

Corporate governance of banks differs considerably from general corporate governance. For banks the scope of corporate governance goes beyond the shareholders (equity governance) to include debtholders (debt governance). From the perspective of bank supervision debt governance is the primary governance concern. Equity governance and debt governance face partly parallel and partly divergent interests of management, shareholders, debtholders, and supervisors. Failures in the corporate governance of banks contributed to the financial crisis. Corporate law reforms are less suited for bank governance, strengthening supervisory law requirements is more promising. Prominent proposals include clearer separation of the management and control function, possibly by a two-tier board as in Switzerland and Belgium; establishment of a separate risk committee of the board or an independent chief risk officer; dealing with the problem of complex or opaque bank structure; and group-wide corporate governance in single entities as well as in the bank group. Appropriate supervisory law requirements are needed for bank-internal procedures, specifically for risk management, internal control and compliance, and internal and external auditing. Supervisory fit and proper tests for the board, the management and major shareholders of banks are useful. Qualification and experience of bank board members is at least as important as independence. But the severe requirements of bank regulation and bank supervision must not spill over to the corporate governance of the firm.

## Keywords

Corporate governance of banks; equity governance vs. debt governance; financial crisis and bank reform proposals; supervisory requirements as to bank governance; separation of management and control by a bank two-tier board; bank group-wide corporate governance; bank risk management; fit and proper test for the board; the management and major shareholders of banks; experience vs. independence of board members; the danger of spillover of bank governance reforms to the corporate governance of the firms.

### Survey





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a) Control within the corporation
b) Control from the outside
c) Regulation and supervision of banks
d) One size does not fit all: Sector-specific corporate governance and governance codes

II. Corporate governance of banks

1. Corporate governance of banks and the financial crisis
a) Corporate governance failures in banks as evidenced by the financial crisis
b) The irrelevance theory and the major cause theory in view of these failures

2. Equity governance and debt governance: Parallel and divergent interests of management/board, shareholders, debtholders, and regulators/supervisors
a) The directors
b) The shareholders
c) The debtholders
d) The regulators and supervisors

3. The ambiguous role of deposit insurance and bail-out

III. Internal corporate governance of banks: Corporate and supervisory law reform measures under discussion

1. Less suited corporate law reforms (stakeholder governance, stakeholder goal, duties and liabilities; hybrid capital)
a) Stakeholder governance for banks?
b) Stakeholder goal for banks?
c) Strengthening legal duties?
d) (Financial) liability?
e) Hybrid capital

2. Supervisory law requirements for board and bank structure and internal procedures
a) Two-tier board for banks
b) Group-wide corporate governance for banks
c) Less opaque and, if possible, less complex bank structure
d) Risk management and internal control

3. Supervisory law requirements for people
a) Profile and practices of the bank board
b) Profile of the bank management
c) Fit and proper test for major shareholders
d) Appropriate incentives or at least eliminating bad incentives: the case of remuneration

4. Conclusion: Co-regulation for corporate governance of banks and no general spillover of bank governance requirements to firm governance

IV. Summary and theses

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IV. Summary and theses

*I. Corporate governance of firms and its relevance for banks*

1. Corporate governance is the system by which companies are directed and controlled (Cadbury). This concept is appropriate for banks, too. Yet for banks, the scope of corporate governance goes beyond the shareholders (equity governance) to include debtholders (debt governance).

2. For firms, both internal and external corporate governance are relevant. From the perspective of bank supervision, internal governance of banks is at the center stage. External corporate governance, in particular by the market of corporate control, is more important for firms than for banks, at least under continental European practice.

3. Not only banks are special. Sector-specific corporate governance and governance codes also exist for family enterprises, public enterprises, and nonprofit organizations. Specific corporate governance needs exist not only for banks, but also for insurance companies and other financial institutions. All players in the financial markets must be supervised, though not necessarily regulated. For some, mere disclosure may suffice, at least initially.

*II. Corporate governance of banks*

4. Whether failures in the corporate governance of banks were a major cause of the financial crisis is highly controversial. The fact is that there were wrong incentives inspired by compensation practices, deficiencies in board profile and practices (especially but not exclusively in state-owned banks), and risk management and internal control failures. This was exacerbated by complex and opaque bank structures. While these deficiencies did play a certain role, there were many other and more important causes that led to the financial crisis.

5. Equity governance and debt governance face partly parallel and partly divergent interests of management, shareholders, debtholders, and supervisors. Management tends to be risk-averse for lack of diversification, but may be more risk-prone because of equity-based compensation, in end games and under similar circumstances. Shareholders are risk-prone and interested in corporate governance. Debtholders are risk-averse and interested in debt governance.



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Supervisors are risk-averse and interested in maintaining financial stability and in particular in preventing systemic crises.

6. Deposit insurance and bail-out have an ambiguous role. Both encourage undue risk-taking and free-riding, but they are indispensible for depositor protection and mastering systemic crises. This trade-off requires careful balancing. Whether this succeeds depends on the details and the concrete situation.

*III. Internal corporate governance of banks: Corporate and supervisory reform proposals under discussion*

7. Corporate law reforms are less suited for bank governance. Labor codetermination in the board does not benefit debtholders. Representation of the debtholders or of the deposit insurers in the board is also of doubtful use. Particular problems exist in state-owned banks. Directors of firms and banks already have far-reaching duties and liabilities under the present law. The problem is rather enforcement. Enforcement is being stepped up in the wake of the financial crisis.

8. Strengthening supervisory law requirements is more promising. Regarding board and bank structure, prominent proposals include the following: clearer separation of the management and control function by a two-tier board, as in Switzerland and Belgium; establishment of a separate risk committee of the board or an independent chief risk officer (CRO); dealing with the problem of complex or opaque bank structure; and group-wide corporate governance in single entities as well as in the bank group.

9. Appropriate supervisory law requirements are needed for bank-internal procedures, specifically for risk management, internal control and compliance, and internal and external auditing. Facilitating the exercise of shareholder rights can be left to the corporate governance of the firm.

10. In the end, everything depends on the people. Supervisory law requirements need to address foremost the profile and practices of the board. The traditional wisdom of corporate governance of the firm is to have independent non-executive directors (NEDs). Yet the experience of the financial crises and recent empirical studies show that qualification and

experience of bank board members is at least as important, if not more important. This has been demonstrated particularly in the failures of state-owned banks. Professionalization, continuous formation, and external evaluation are therefore important desiderata to be monitored and enforced by bank supervision.

11. In addition, fit and proper tests for the management and major shareholders of banks are useful. So are appropriate incentives and the elimination of negative incentives, in particular as far as compensation of the board, the management, and key personnel is concerned. Among them are more long-term orientation and shareholders' say on pay. Numerical limits for compensation may – or may not – save taxpayers money in the case of state-assisted banks.

*IV. Spilling over of bank governance to firm governance?*

12. There is growing concern that the severe requirements of bank regulation and bank supervision will spill over to the corporate governance of the firm. It is true that there is such a phenomenon in relation to risk-prevention standards, requirements on the profile and practices of the board and compensation. Yet general supervision of corporations is out of question, apart from the already-existing securities markets supervision, and a more general spilling over of bank governance requirements to the general firm would lead to overregulation and impair the fair play of the market.

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