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Corporate Governance and Banks: How justified is the match?

Law Working Paper N° 284/2015
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Christoph Van der Elst
Tilburg and Gent Universities and ECGI

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Abstract

Banks and bank governance are different. We critically assess the arguments used to pervade these divergences in operational activities. We also question if and how, in light of the specificity of banking activities, bank governance translates the operational peculiarities in different governance features. We hardly find convincing arguments for the bank governance specificities. We conclude that parts of the particular bank governance legislation and regulation misses appropriate justification, should be, at best, part of a general corporate governance code, and other mechanisms, like stringent capital requirements, are more adequate.

Keywords: corporate governance, codes, bank governance, banking regulation, capital requirements

JEL Classifications: G21, G28, G34, K23, O16

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I. Introduction

1. The financial turmoil dominated the corporate governance discussions over the last decade years. Banks went bankrupt or needed to be bailed out and according to the de Larosière Group Report corporate governance was one of the most important reasons for this financial crisis.[1] The OECD supported de Larosière Group's findings and concluded that *"the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements.*"[2] More recently it is debated whether bad corporate governance is to be considered as a major cause of the financial crisis.[3] Obviously, since the start of the crisis corporate governance of banks is in the frontline of academic research and political debate.

2. In this paper we discuss the specificities of bank governance. We question whether specific banks governance codes and legislation appropriately address the bank's operational peculiarities. In the next section, we provide in a short overview of the development of corporate governance codes within and outside the financial sector. In section III we investigate what makes banks different from companies in other industries and study the arguments that are used to pervade those differences to the different corporate governance features of banks. We find that some of the arguments are only weakly supported by the evidence but some pleas are indeed bank specific. Section IV addresses the question how corporate governance regulators have handled these different corporate governance features. We find only limited support that the most important differences between banks and other industries, like the large number of other stakeholders, are addressed in the bank specific corporate governance codes. We then turn to the European legislator and the method it used to overcome the bank (governance) peculiarities. While it can be argued that many of the European governance rules serve to restore trust in the banking industry after the financial

* I thank Eddy Wymeersch for helpful comments. The views are solely those of the author.
[1] High Level Group on Financial Supervision in the EU, *Report on the future of financial supervision in the EU*, 25 February 2009, Brussels, p. 29.
[2] OECD, *Corporate Governance Lessons from the Financial Crisis*, Directorate for financial and enterprise affairs – Steering Group on Corporate Governance, 23 February 2009, p.2.
[3] K. Hopt, "Corporate Governance of Banks and other Financial Institutions after the Financial Crisis", *Journal of Corporate Law Studies* 2013, 222.

crisis and enhance corporate governance practices, we shed doubt about the effectiveness of the too many (complicated) rules and suggest to turn to straightforward capital requirements in the concluding section V.

II. The development of corporate governance and corporate governance codes

3. The origins of corporate governance are to be traced in the beginning of the use of the corporate form. At the start of the 17th century the shareholders of the Verenigde Oost-Indische Company complained that the board of directors was not accountable for their duties, hardly disclosed any information and directors were even corrupt.[4] Later, in the 18th century, Adam Smith already pointed at the different behavior of a director in comparison with that of an owner of a company: "*The directors of such companies [...] being in charge rather of others people's money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in private copartnery frequently watch over their own*"[5]. Alfred Marshall extended the view of Smith towards other conflicts than those between the directors and the owners: "[…] *joint stock companies are hampered by internal frictions, and conflicts of interest between shareholders and debenture holders, between ordinary and preferred shareholders, and between all these and the directors; and by the need for an elaborate system of checks and counterchecks. They seldom have the enterprise, the energy, the unity of purpose and the quickness of action of a private business*"[6]. While all these examples are illustrations of core corporate governance problems and features, channeling them in corporate governance came into vogue much later. The phrase "corporate governance" was not in use until the 1970s when the topic became an official agenda item in regulations, according to the research of Cheffins.[7] From that moment onwards corporate governance rapidly became a widespread topic in law and in economics.

4. In the mid-1980s the first publications referring to corporate governance were published in Europe. In 1985 Hopt and Teubner edited a book entitled "Corporate Governance and Director's Liability" which discussed a number of corporate governance related features

[4] For an overview of the history of corporate governance see P. Frentrop, *De geschiedenis van corporate governance*, Assen, van Gorcum 2013, 208 p.
[5] A. Smith, *An Inquiry into the Nature and the Causes of the Wealth of Nations*, New York, Random House 1937, p. 70.
[6] A. Marshall, *Principles of Economics*, New York, MacMillan 1948, p. 604.
[7] B. Cheffins, "The History of Corporate Governance", in *The Oxford Handbook of Corporate Governance*, M. Wright, D. Siegel, K. Keasy and I. Filatothev (eds.), Oxford University Press 2013, p. 47.

mainly in a European context. Since the start of the 1990s corporate governance became a popular theme with the proliferation of corporate governance codes, which kicked off with the publication of the UK Cadbury Code in 1992. By the end of the 1990s in eleven of the fifteen Member States of the European Union a corporate governance code was issued and three countries – Germany, Austria and Denmark – followed soon. Only Luxemburg postponed the issuance of a corporate governance code until 2006.

5. In a large majority of the codes, the practices aim to improve companies' performance and accountability of companies listed on a stock exchange and independent from the industry in which the company has its operational activities. Only some of the codes encourage other types of companies to comply with the recommendations.

6. Since the start of the new millennium many other corporate governance codes for other types of entities have been developed. In the financial sector, for different types of trusts, funds and management companies different best practices exist in countries like Japan, the UK, the Netherlands, etc. (table 1).

Table 1: Overview of Corporate Governance Codes for Entities in the Financial Industry (excl. Banks)

Type	Area	Year	Type	Area	Year
Responsible ownership			Pension Funds		
	Denmark	2008		Japan	1998
	UK	2010		UK	2005
	South Africa	2010		Nigeria	2008
AM/Ucits			Micro Finance Institutions		
	France	1997		MFI Council	2005
	US	2004	Islamic Finance		
	Germany	2005		General	2006
	Luxemburg	2009	Insurance companies		
	Ireland	2011		The Netherlands	2010
Private Equity				Singapore*	2010
	UK	2007		Ireland*	2010
	Denmark	2008			

Source: ECGI website

7. In at least ten countries[8] there are also specific corporate governance codes for banks. Already in 1999, in the midst of the period during which many countries developed corporate governance codes for listed companies, the Basel Committee on Banking Supervision, a committee established by a number of central-bank governors, issued its governance principles in the paper "*Enhancing Corporate Governance for Banking Organisations*"[9], and modernized the principles in 2006 and 2010. It can be seen as the start of the industry specific corporate governance development. Some years passed before other organisations in a number of countries started to develop bank-specific corporate governance codes. Table 2 gives some details on the corporate governance codes that have been issued for the banking industry. In the majority of the countries were a code was issued, it was published after the start of the financial crisis. Different from the "regular" corporate governance codes, all but two best practices codes have been developed by the official supervisory agencies of the financial industry. In the Netherlands the code has been developed by the industry itself. However, by an executive instrument the code was identified as the corporate governance code that banks must comply with in accordance with the Dutch law.[10] In Georgia the code was developed by the industry itself.

Table 2: Overview of Corporate Governance Codes for Banks

Area	Issuing body	Year
International	Basel Committee	1999
Guernsey	Financial Services Commission	2004
Nigeria	Central Bank of Nigeria	2004
Singapore	Monetary Authority of Singapore	2005
Jordan	Central Bank of Jordan	2007
Italy	Banca d'Italia	2008
Qatar	Qatar Central Bank	2008
Georgia	Association of Banks of Georgia	2009
UK	HM Treasury	2009
The Netherlands	Nederlandse Vereniging van Banken	2009
Ireland	Central Bank of Ireland	2010

Source: ECGI website; the year is not necessary the same as the year referred to on the ECGI website as in some cases the website contains the more recent, or updated version of the code.

8. This development towards industry-specific corporate governance codes raises the question what these differences can or should be between the corporate governance of banks and the

[8] Considering Guernsey as a country.
[9] The original paper is to be found at http://www.bis.org/publ/bcbs56.htm (last consulted 15 May 2014).
[10] Besluit van 1 juni 2010 tot vaststelling van nadere voorschriften omtrent de inhoud van het jaarverslag van banken, *Dutch Official Journal* 2010, nr. 215.

corporate governance of other companies and whether these differences justify the development of an industry-specific corporate governance code and legislation. In the next section we study the arguments for the development of bank specific corporate governance rules.

III. Specificities of the Banking Industry

9. Empirical studies on the performance of companies often exclude the financial services industry due to the specific nature of these services.[11] Banking is considered a specific kind of activity resulting in high complexity, the involvement of many more stakeholders and rapid developments which does not fit into the (empirical) models of the researchers.[12] This consideration raises two questions related to corporate governance of banks:

1. What makes banks special?
2. Why and how does corporate governance of banks differ?

We briefly address both question in the next subsections.

§1. What Makes Banks Special?

10. Banking is a business, like any other business. It's goal is to make profit[13]. The first set of arguments for the unique position of banks is related to this business. Banks are intermediaries between the savers and the users of capital.[14] However, the position of intermediary does not make a bank special. There are many businesses that serve as an intermediary. The same remark of non-speciality is valid for the argument that as banks are specially treated, in particular by the legislator, the banks are or must be special.[15] First, many other industries, like the pharmaceutical industry and the aviation industry, are specially

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[11] J. de Haan and R. Vlahu, *Corporate Governance of Banks: A Survey*, DNB Working Paper nr. 386, Amsterdam, July 2013, p. 2.

[12] H. Mehran, A. Morrison and J. Shapiro, *Corporate governance and banks: What have we learned from the financial crisis?,* Federal Reserve Bank of New York Staff Reports No. 502, 2001, p. 3.

[13] Unless it is considered as a public service.

[14] B. Bossone, *What Makes Banks Special? A Study of Banking, Finance, and Economic Development*, Worldbank Policy Research Working Paper, November 1999, http://dx.doi.org/10.1596/1813-9450-2408, p.3.

[15] P. Mülbert identifies the specific regulations as one of the seven differences between banks and other firms: "because of their systemic importance and the one hand and their vulnerability to runs on the other hand, banks are heavily regulated and supervised entities." (P. Mülbert, "Corporate Governance of Banks", *European Business Organization Law Review* 2009, 422).

treated. Second, it reverses the argument: due to its special treatment, banks seem to have become special. Some scholars point at the specificity of the services provided. Fama puts the banker's role as transaction service provider to the fore and Kareken stresses the banker's management role in the payment system.[16] Others stressed that banks are not the only providers of these services.[17]

More convincing arguments of the specialty of banks have been put forward by Diamond, Gale and Hellwig, Terlizzese and Goodfriend. According to Diamond banks monitor borrowers' behaviour on behalf of their depositors.[18] Gale and Hellwig add that banks provide in contracts that minimize the risk of default.[19] Banks have the means to diversify the risks through portfolio diversification.

11. Banks also specialize in extracting ex ante information and in screening of borrowers, thus reducing the adverse selection problem.[20] Conversely, deposit holders use the intermediary function of banks entitling them to withdraw the deposits easier than in case of a direct investment in the borrower. However, there is an increasing risk that the bank runs out of liquidities.[21] Banks can be distinguished from mutual funds or undertakings for collective investment in transferable securities (ucits) as depositors in the latter have the right to "*seize a proportion of assets equal to his proportion of total deposits*" making mutual funds and ucits run proof.[22] Hence mutual funds do not create liquidity as banks do and invest largely in liquid assets. Diamond and Rajan argue that banks resolve the illiquidity problem that follows direct borrowing. Goodfriend also claims that "*systems to evaluate credit, monitor and enforce loan agreements, and extend credit on short notice are productive both in originating*

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[16] B. Bossone, *What Makes Banks Special? A Study of Banking, Finance, and Economic Development*, Worldbank Policy Research Working Paper, November 1999, http://dx.doi.org/10.1596/1813-9450-2408, p. 6.
[17] *Ibid.*, p. 6.
[18] D. Diamond, "Financial Intermediation and Delegated Monitoring", *Review of Economic Studies* 1984, 393.
[19] D. Gale and M. Hellwig, "Incentive-Compatible Debt Contracts: The One-Period Problem", *Review of Economic Studies* 1985, 647.
[20] D. Terlizzese, Delegated Screening and Reputation in a Theory of Financial Intermediaries, *Banca d'Italia Temi di Discussione*, No. 111, December 1988, 38 p.; C. Wang and S. Williamson, "Debt Contracts and Financial Intermediation with Costly Screening", *Canadian Journal of Economics* 1998, 573-595.
[21] D. Diamond and P. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity", *Journal of Political Economy*, 1983, 401-414.
[22] D. Diamond and R. Rajan, *Liquidity Risk, Liquidity Creation and Financial Fragility: A Theory of Banking*, NBER Working Paper 7430, 1999, p. 32

loans to nonfinancial borrowers and in managing lending to support an efficient provision of payments services."[23]

Derived from these tasks is the information role of the banks vis-à-vis capital market participants. These participants can make use of the information of bankers' lending decisions in their assessment of the borrower.[24]

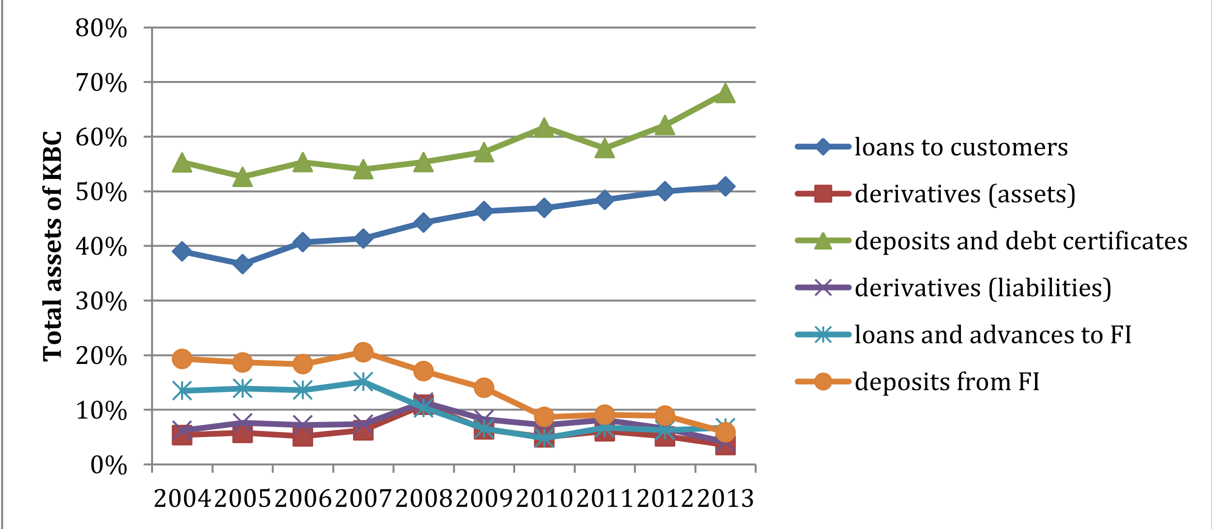
Finally, Bossone identifies the money creation ability of banks, in the form of debt claims on themselves. The author uses the theory of Schumpeter on the economic development through money creation.[25] "*Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money.*"[26]

12. The resolution of the illiquidity problem that banks experience, comes at the cost, or more appropriate, at a risk. Due to the provision of liquidity and the open positions that banks do take, banks are at the same time vulnerable for their own positions but also for the open positions of other banks, thus creating systemic risks, a contagion effect.[27] We illustrate this last effect in Figure 1. We collected the evolution of the loans to financial institutions and investment firms as well as the deposits from credit institutions and investment firms of KBC, one of the largest Belgian banks. Until the financial crisis started, these assets and liabilities were close to 15 per cent, respectively close to 20 per cent of the total assets of this bank. Since the financial crisis, these items decreased to close to 5 per cent of the total assets.
Over the last decades the traditional banking activities, *i.e.* providing loans to lenders and collecting capital from savers have lost a part of their importance. Other intermediary activities as well as other activities gained much more importance[28]. Until the financial crisis started, banks engaged more and more in derivatives trading for their own account as well as for third parties. In Figure 1 it is visualized that the market value of these derivatives

[23] M. Goodfriend, "Money, Credit, Banking, and Payments System Policy", *Economic Review Federal Reserve Bank of Richmond* January/February 1991, 12.
[24] S. Lummer and J. McConell, "Further Evidence on the Bank Lending Process and the Capital-Market Response to Bank Loan Agreement", *Journal of Financial Economics* 1989, 113-134.
[25] B. Bossone, *What Makes Banks Special? A Study of Banking, Finance, and Economic Development*, Worldbank Policy Research Working Paper, November 1999, http://dx.doi.org/10.1596/1813-9450-2408, p.12-13.
[26] M. McLeay, A. Radia and R. Thomas, "Money Creation in the Modern Economy", *Bank of England Quarterly Bulletin* 2014 Q1, p. 1.
[27] J. Devriese, M. Dewatripont, D. Heremans and G. Nguyen, "Corporate governance, regulation and supervision of banks", *Financial Stability Review NBB* 2004, p. 98.
[28] B. Bossone, *What Makes Banks Special? A Study of Banking, Finance, and Economic Development*, Worldbank Policy Research Working Paper, November 1999, http://dx.doi.org/10.1596/1813-9450-2408, p.37.

augmented to over 10 per cent of the total assets of KBC. Recently these percentages dropped to less than 5 per cent of the total assets. It is obvious that these other activities nevertheless require appropriate governance skills.

Figure 1: Asset and Liabilities Items to Total Assets of the Banking Group KBC[29]



Source: own calculation based on the annual reports of KBC

13. Another set of arguments claiming the specificity of the banking industry rely on the consequences of the execution of these banking activities to justify the uniqueness of banks. A first consequence of the banking activities is the opaqueness in comparison with companies in other industries. Unlike the assets of many other companies, the quality of bank loans as well as other bank assets, like CDOs, CDSs and ABSs, is not readily observable. While some do, not all empirical studies confirm the higher level of opaqueness of the financial industry. Flannery, Kwam and Nimalendran found that "*bank stocks are not unusually opaque, although the details differ between small and large institutions*"[30], but admit that the transparency requirements for banks can help to explain the lower than expected opaqueness. Smaller banks are more difficult to assess than the larger competitors. Another moderating aspect of this opaqueness argument can be found in the diverse activities of (listed) holding companies that can be found in many European countries. Many of these holdings, like the Belgian holdings Ackermans en van Haaren and Brederode, have large interests in and sometimes even control banks. As a result, investors and other interested parties are confronted with the same opaqueness problems, even aggravated by the holdings' investments

[29] The data before 2004 are not comparable due to the move to IFRS standards.
[30] M. Flannery, S. Kwan and M. Nimalendram, "Market evidence on the opaqueness of banking firms' assets", *Journal of Financial Economics* 2004, 419-460.

in other industries. The opaqueness of banking companies can thus be specific, but it is not unique. Third, the development of the knowledge economy makes it more and more difficult to assess many intangible assets of companies in other industries as well.

14. Another consequence, this time due to the money creation function, is the size of leverage of an average bank. It is well known that banks are highly leveraged. The shift of equity to debt gradually developed over time. In the 1840s equity funded 55 per cent of American banks' assets. The ratio fell to 20 per cent around the turn of the 20th century and stabilized between 5 per cent and 8 per cent since World War II.[31] While some argue that banks must have a fragile bank structure to perform the buffering function between borrowers and investors and depositors[32], many others argue that the bank must have sufficient equity to absorb losses and shocks and prevent a failure of the bank in case of a run on the bank when the trust of the market in the bank is lost. The debate what constitutes sufficient equity continued until today. The high leverage ratio of banks enhances the agency problem of risk shifting and creates a debt overhang problem, thus further steering the bank towards higher leverage ratios.[33] We believe the leverage ratio and the debt overhang problem are bank specific. Regulatory intervention overcoming these consequential externalities is more than recommendable.
While these functions do illustrate the special role of the banks in the economy, it is still open for debate if these different roles of banks must result in a corporate governance framework that differs from the framework that is used and recommended for companies in other industries. The next section addresses this issue.

§2. Why and How Does Corporate Governance of Banks Differ?

A. Bank Governance Codes

15. In the previous section it was shown that some elements in the business of banking, like the creation of money and solving illiquidity problems, is specific and even unique. The differences of the banking business in comparison of other business does not necessarily have to result in a different corporate governance framework. In this section we identify the

[31] A. Berger, R. Herring, and G. Szego, "The role of capital in financial institutions", *Journal of Banking and Finance* 1995, p. 402.
[32] D. Diamond and R. Rajan, Liquidity Risk, Liquidity Creation, and Financial Fragility: A Theory of Banking", *Journal of Political Economy* 2001, 287-327.
[33] See A. Admati, and M. Hellwig. *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*. New Jersey, Princeton University Press 2013, chapter 3 and 8.

arguments for specific bank governance. First, we analyse the specific bank corporate governance codes identifying the arguments used for the issuance of the code. Next, we address the arguments in the literature and question their validity.

16. Previously we found that the European Corporate Governance Institute identified eleven codes which specifically address the banking industry.[34] The oldest corporate governance code of the Basel Committee on Banking Supervision of 1999 is also the most straightforward code in providing an argument for the necessity of a separate corporate governance code for banks. It states that the work of the supervisory agency is simplified if the banks apply sound corporate governance practices. The argument in the code of the Banca d'Italia is similar. While this argument does not explain why a *separate* code for banks is required the Basel committee adds two other elements, being the access of the banking industry to the government safety nets and the fact that it is a regulated industry. We have already shown that the fact that the banking industry is regulated, does not make the banking industry special, but the provision of the government safety net is.

A common element mentioned in a number of other corporate governance codes is the necessity to provide in trust in the banking industry. A specific code can increase the visibility of the due care for best practices in the bank industry. However, most codes simply prescribe best practices for banks without any specific argument why these recommendations must be industry-specific.

Table 3: Overview of Arguments for a Specific Governance Code for Banks according to these Codes

Country	Issuing body	Argument specific Governance Code for Banks	Year
International	Basel Committee	"Sound corporate governance makes the work of supervisors infinitely easier. Sound corporate governance can contribute to a collaborative working relationship between bank management and bank supervisors." "banking is virtually universally a regulated industry and that banks have access to government safety nets. It is of crucial importance therefore that banks have strong corporate governance."	1999
Guernsey	Financial Services Commission	no special argument	2004

[34] See section II, table 1.

Nigeria	Central Bank of Nigeria	"the retention of public confidence"	2004
Singapore	Monetary Authority of Singapore	"take into account the unique characteristics of the business of banking and insurance, given the diverse and complex risks undertaken by these Financial Institutions and their responsibilities to depositors and policyholders"	2005
Jordan	Central Bank of Jordan	no special argument	2007
Italy	Banca d'Italia	"Banks' organizational and corporate governance structures must not only respond to the corporate interest but also ensure conditions of sound and prudent management, the essential objective of regulation and supervisory controls"	2008
Qatar	Qatar Central Bank	"achieving financial and banking stability, mitigating business risk, and maintaining acceptable capital adequacy ratio"	2008
Georgia	Association of Banks of Georgia	"Given the role and importance of commercial banks in a country's economy, their corporate governance is especially important."	2009
UK	HM Treasury	no special argument	2009
The Netherlands	Nederlandse Vereniging van Banken	indirectly: response to the report "restoring trust"; no direct argument	2009
Ireland	Central Bank of Ireland	no special argument	2010

Source: own assessment

B. Specific Corporate Governance Features of Banks

17. In the literature, the arguments for what is special about banks and what is special about corporate governance of banks, are predominantly approached via the agency theory.[35] Separation of ownership and control and external finance initiates agency distortions and setting up appropriate governance mechanisms can overcome or at least control these distortions.[36] Hopt argues in a recent study that bank governance is special for heterogeneous reasons.[37] He sums up two classes of differences: the bank business and structure and the incentives and competences of the people involved. The first set of differences is related to

[35] It goes beyond the goals of this contribution to develop the different theories (like stewardship, incomplete contracts, etc.) in which corporate governance can be embedded.

[36] J. Devriese, M. Dewatripont, D. Heremans and G. Nguyen, "Corporate governance, regulation and supervision of banks", *Financial Stability Review NBB* 2004, p. 96.

[37] K. Hopt, "Corporate Governance of Banks and other Financial Institutions after the Financial Crisis", *Journal of Corporate Law Studies* 2013, 239-243.

the differences of banks and less with the differences of corporate governance.[38] Second, Hopt claims that the principal-agent conflicts in banks is different for all the incumbent parties: shareholders, boards, management, debt holders and supervisors.

1. Shareholders

18. In his study of corporate governance of banks, Hopt states that the shareholders, as ultimate risk-takers, control the boards of directors, but the intensity of this control depends on the shareholder structure. He argues that as shareholders do not understand the banks' risks and are exclusively interested in the return, and while largely ignoring risks, shareholders encourage boards into more risk-taking activities.[39]

If shareholder structures have an influence on risk taking, the different governance feature of banks must partially lie in the different ownership structure of banks compared to other companies. To test this reasoning we controlled the shareholder structure of banks in five European countries before the financial crisis, *i.e.* in 2005, and compared the findings with the ownership structure of other types of companies. We used our database to present a summary of findings in figure 1.[40]

With the exception of the UK, both stock exchange listed banks with widely dispersed and banks with concentrated ownership structures were identified. In the UK all listed banks have widely dispersed ownership structures. Differently from what could have been expected, more than half of the Italian banks are not majority controlled. The median voting block of the largest shareholder of the Italian bank was only 15%. Half of the German listed banks are de jure controlled, and half of the French and the Belgian banks have a very influential shareholder. The ownership structure of all banks fit perfectly in the ownership structure of companies in other industries. The largest and smallest voting blocks of the largest shareholder of banks fit between the largest and smallest voting blocks of the largest shareholder in other industries. There is only one exception. In Italy, some banks have no major shareholders (passing the threshold of 5 per cent of the voting rights) while in other industries, companies always have at least one shareholder with a voting block of more than 5 per cent. The concentration of ownership in the banking sector *compared to* the concentration

[38] See section III, §1.

[39] There is something ambiguous in this reasoning. When shareholders do not understand the risks the bank engaged in, one can question whether shareholders can further encourage the board and management to engage in more risky activities.

[40] For an overview of the methodology used see C. Van der Elst, "Shareholder Mobility in Five European Countries", in *Corporate Management: Shareholder Rights*, L. Padmavathi (ed.), Hyderabad, Icfai University Press 2009, pp. 191-241.

in other industries differs between the countries. In Italy and the UK the ownership structure is significantly more dispersed in the banking industry, while in Germany it is the opposite. In France and Belgium the concentration in the banking industry is lower although the voting block of the single largest shareholder in both countries is still at a considerable high, most likely controlling, level. Overall there are studies that indicate that the ownership structures in the financial industry is less concentrated due to specific ownership concentration rules in many countries.[41]

19. These findings suggest that the specific ownership structure of a listed bank in a particular country can be matched with an ownership structure of an individual listed company in the same country. As such, the shareholder structure does not require a specific bank governance approach. It is however possible that banks with a specific kind of ownership structure require another monitoring policy than the other types of banks. Overall, the evidence of the influence of the ownership structure on the performance of banks is mixed, like it is for the other industries.[42] Our evidence supports the findings of Becht and others that "*there is, however, no direct evidence as yet that shareholders insisted on more risk-taking—but there is no evidence that they opposed it either*"[43].

[41] L. Laeven, *Corporate Governance: What's Special About Banks*, working paper, s.d., s.l., 30 p.
[42] For an overview of these studies see, J. de Haan and R. Vlahu, *Corporate Governance of Banks: A Survey*, DNB Working Paper nr. 386, Amsterdam, July 2013, p. 28-33
[43] M. Becht, M. Bolton and A. Roell, "Why bank governance is different", *Oxford Review of Economic Policy* 2012, 438.

Figure 2a: Voting Block Largest Shareholder Listed Banks (2005)

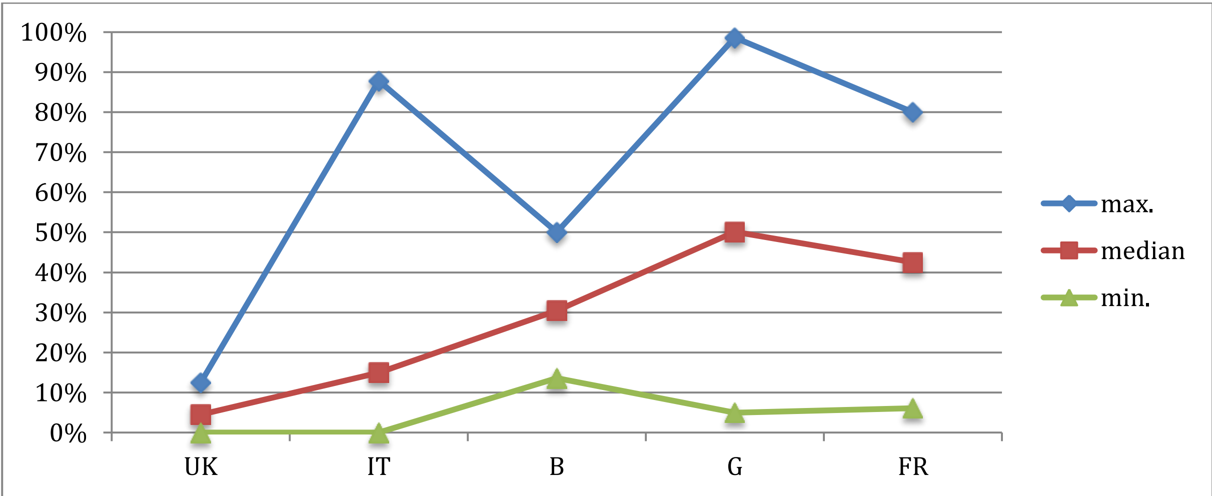
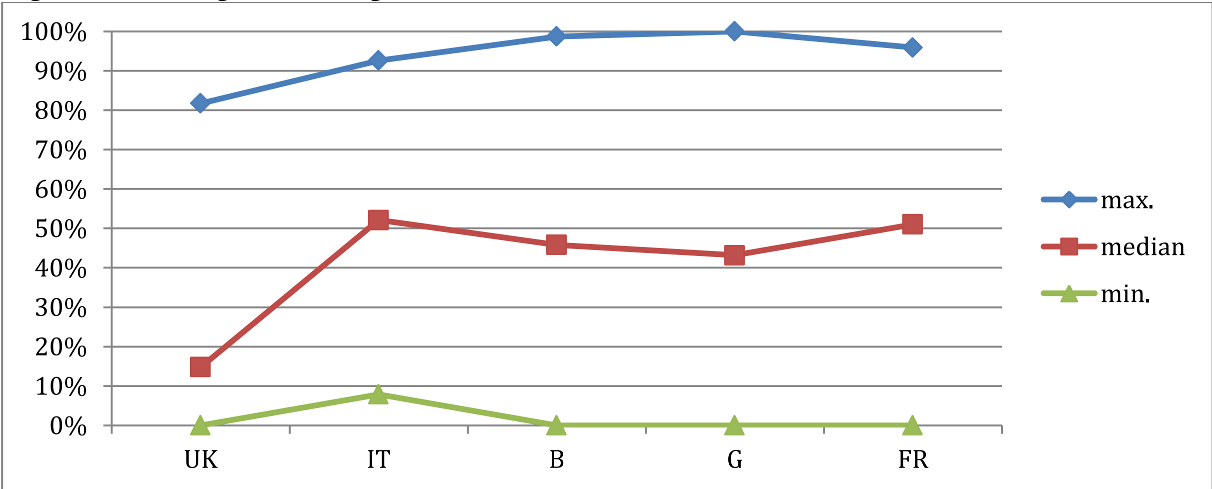


Figure 2b: Voting Block Largest Shareholder in Other Industries (2005)



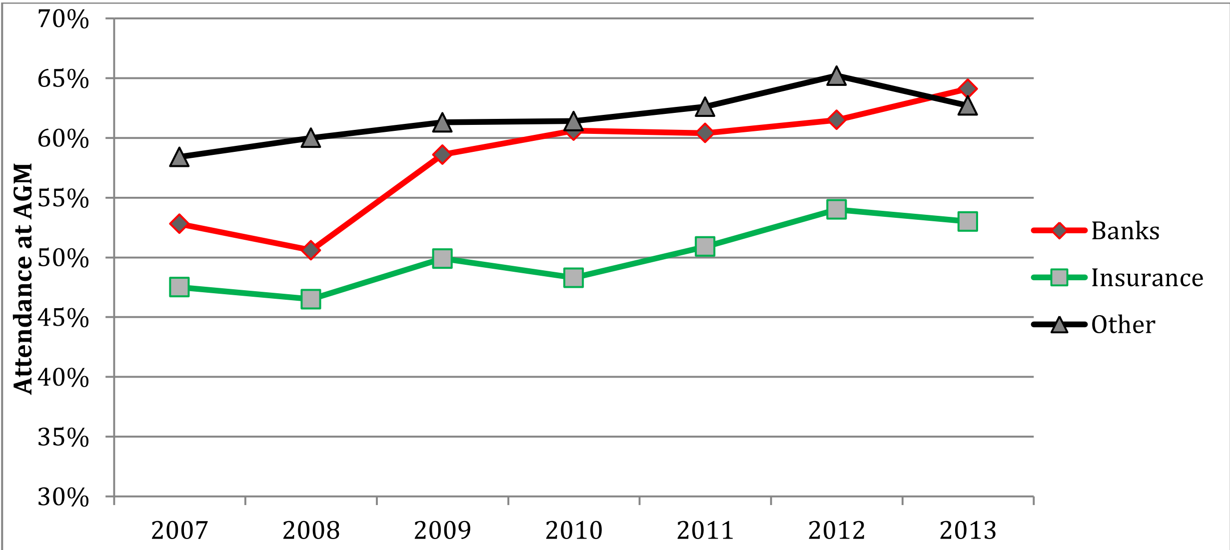
Source: own research based on the disclosure of major shareholdings

20. While the shareholder structure at individual bank level is similar to the ownership structure to be found in companies in other industries, shareholders can behave differently depending on the industry specificities. While shareholder behavior is difficult to be measured, one proxy that is useful to identify shareholder behavior is the attendance of shareholders at general meetings. I collected the data of the attendance at meetings of BEL-20, CAC-40, DAX-30 and Footsie-100 companies from 2007 to 2013 and separated the data of the banks and insurance companies from the other companies.[44] The results of the attendance can be found in figure 3. The overall attendance of shareholders at industrial and commercial companies increased from 58 per cent in 2007 to 65 per cent in 2012, dropping to 63 per cent in 2013. Bank shareholders were less eager to participate in the annual general

[44] Only those companies that disclosed the attendance rate for all years between 2007 and 2013 were withheld. 116 commercial and industrial companies are included in the list, including 10 banks and 9 insurance companies.

meeting (AGM) than shareholders of companies in other industries between 2007 and 2012 with an absolute low in 2008, in the midst of the banking crisis. From 2008 onwards the attendance rates of shareholders at bank AGMs increased from 50 per cent to 64 per cent. In 2013 the attendance rate of shareholders of banks passed the rate of companies in other industries. Only in 2008 the difference in attendance rate was statistically significant.[45] This is different from the insurance companies were less shareholders participated in the AGM. The differences between attendance rates of shareholders of insurance companies and of that of shareholders of other industries is always significant at the 5 per cent level. Overall, the proxy of attendance of shareholders at AGMs does not indicate that bank shareholders behave differently from shareholders of other industries.

Figure 3: Evolution of the Attendance Rate of Shareholders at the AGM of banks, insurance companies and other industries



Source: own research based on the minutes of the meetings of BEL-20, DAX-30, CAC-40 and Footsie 100 companies

2. Boards

21. Hopt also found that the boards of banks are special. Based on empirical research he identified at least three troublesome bank board composition features.[46] Bank boards were lacking expertise in risk management, had often too many shareholder representatives and were more shareholder-friendly, and had too independent boards. All three elements resulted in worse performance. Especially the latter aspect, the number of independent board members

[45] At the 5 per cent level.
[46] K. Hopt, "Corporate Governance of Banks and other Financial Institutions after the Financial Crisis", *Journal of Corporate Law Studies* 2013, 241.

which was emphasized as a major step forward in improving corporate governance, was found to be negatively related to corporate performance.[47] Some studies looked more into the role of the board of directors and in particular in risk management. Ellul and Yerramilli convincingly showed that a strong and independent risk management function helped banks during the financial crisis. The risk management function was calculated as a principal component including the presence of an independent and expert director on the board's risk committee.[48] As the measurement does not distinguish the independence from the expertise, it is more than likely that expertise is the key for board membership, in particular in the banking industry.

22. Boards of banks have been studied in detail by Ferreira Kirchmaier and Metzger.[49] For the year 2006 – before the start of the financial crisis – the authors studied the composition of the boards of directors of more than 600 banks in 31 countries. They found significant differences in and between countries regarding board expertise and board independence. A summary of the findings for some countries can be found in table 4. First, more board members are independent in Anglo-Saxon countries than in continental European countries. The highest levels of independence can be found in the US where approximately 75 per cent of all directors of banks are independent. In France less than one out of eight bank board members is independent. Belgium belongs to the group with relatively few board members being independent. Less than 20 per cent of the bank board members are considered independent directors. The German, Italian and British banks have on average a similar number of independent directors, close to 40 per cent. However the variation in Italy is significantly higher than in Germany, with a standard deviation for Italy of 34 per cent while it is only 12 per cent in Germany. The second part of table 4A presents the ratio of outside directors with prior managerial or top-executive experience in banking over all outside directors. The mean is remarkably low in the United States and Belgium, with many outside directors having banking experience in France and Germany. This finding is striking in light of the Belgian ex ante governmental control of board member elections, which became a common feature all

[47] For an overview of all important studies in that field until 2013, see J. de Haan and R. Vlahu, *Corporate Governance of Banks: A Survey*, DNB Working Paper nr. 386, Amsterdam, July 2013, p. 19-24.
[48] A. Ellul and V. Yerramilli, "Stronger Risk Controls, Lower Risk: Evidence from U.S. Bank Holding Companies", *Journal of Finance* 2013, 1757-1803.
[49] D. Ferreira, T. Kirchmaier and D. Metzger, *Boards of banks*, ECGI Finance Working Paper No 289/2010, 2010, 58 p.

over Europe.[50] Combining both parts of panel A, we find that in France the highest mean of banking experience –with limited variation between the French banks– compensates for the low result on independence, while in the US the highest mean of independence compensates for the low mean of banking experience. In Belgium the number of experienced outside bank directors is very low. Is it not remarkable that all three large listed Belgian banks needed a financial assistance scheme to survive the crisis?

Table 4: Independence and Expertise of the Boards of Banks and Other Companies

panel A: banking industry (2006)							
	Board Independence			Banking Expertise			
	mean	min.	max.	mean	min.	max.	N
Belgium	19,2%	0,0%	42,1%	21,5%	0,0%	47,1%	3
France	12,2%	0,0%	25,0%	56,3%	10,8%	65,0%	5
Germany	38,3%	16,0%	54,5%	55,9%	23,4%	100%	10
Italy	39,5%	0,0%	95,5%	40,1%	13,0%	72,2%	12
UK	44,9%	0,0%	64,3%	36,4%	13,0%	66,7%	15
US	73,8%	0,0%	93,8%	17,8%	0,0%	75,0%	500
panel B: other industries (2010)							
Belgium	43%	0%	83%				65
France	35%	0%	100%				247
Germany	5%	0%	86%				183
Italy	43%	0%	84%				97
UK	34%	0%	100%				1326
US	74%	0%	100%				3799
US	Adams, et al.			22,40%			848
	Drobetz, et al.			25,20%			1860
	Faleye, et al.			18,90%			1528

sources: D. Ferreira, T. Kirchmaier and D. Metzger, *Boards of banks*, ECGI Finance Working Paper No 289/2010, 2010, 58 p.; D. Ferreira and T. Kirchmaier, "Corporate boards in Europe: size, independence and gender diversity", in *Boards and Shareholders in European Listed Companies*, M. Belcredi and G. Ferrarini (eds.), Cambridge, CUP, 2013, pp. 191-224; R. Adams, A. Akyol, and P. Verwijmeren, *Director Skills Sets*, Working Paper, November 2013, 46 p.; W. Drobetz, F. Von Meyerinck, D. Oesch and M. Schmid, *Is Board Industry Experience a Corporate Governance Mechanism*, University of St. Gallen Working Papers on Finance No. 2014/1, January 2014, 73 p.; O. Faleye, R. Hoitashb, and U. Hoitash, *Industry Expertise on Corporate Boards*, Working Paper, July 2013, 53 p.

23. Panel 4B provides insights in the experience and independence of board members in other companies.[51] A significantly higher number of board members are independent in Belgium and France while less board members are independent in Germany and the UK compared to

[50] See for an analysis of the 2002 Belgian regulatory framework, C. Van Acker, "De wet van 3 mei 2002 tot wijziging van de onverenigbaarheidsregeling voor bestuurders van kredietinstellingen en beleggingsondernemingen", in *Financiële regulering: op zoek naar nieuwe evenwichten*, M. Tison, C. van Acker and J. Cerfontaine (eds.), Antwerpen, Intersentia, 2003, pp. 259-290.

[51] The results include banks. However the limited number of banks in the overall sample will not significantly influence the general findings.

the number Ferreira and Kirchmaier found for bank boards.[52] In the US and Italy there are no differences between the board composition of banks and that of other industries with respect to independence. Detailed research on experience of board members in other industries is scarce. The available evidence of US companies found similar, although somewhat higher numbers of board members experience in the other industries.

24. The available data show that the bank board's composition differs both *between countries* as well as, but less outspoken, *between banks and other industries*. As empirical evidence shows that financial knowledgeable members is pivotal for risk management in boards, there is a case for specific governance measures for banks.

3. Management

25. Another difference between banks and other industries is, according to the study of Hopt, related to the management of the company. The principal-agent conflict in banks diverges from that in other companies because the remuneration system of bank management has more perverse effects than in other industries.[53] The remuneration of executives is probably the single most studied and commented corporate governance issue.[54] Both the level of remuneration as well as the composition of the remuneration package is seen as a major risk for the financial stability of the bank and the economy. Previously, the remuneration package incorporated a large part of the upswing of risky investments while ignoring the downside of these investments, thus fueling the risk taking behavior of many executive managers. Some research supports this argument while other studies challenge the statement. There are studies that show that higher compensation results in riskier behavior and the alignment of managers' interests with the shareholders' interests also increased the risk taking of banks. Other research found a positive relationship between short-term performance of banks and executive remuneration but a negative association in the longer run. The problems exacerbate when the CEO is remunerated in stock options according to some studies while other reports highlight the non-equity schemes as the cause for deteriorated performance during the financial crisis.

[52] These differences can be due to the different year it was measured for bank boards and other boards. However it is unlikely that in four years these differences would have disappeared.

[53] K. Hopt, "Corporate Governance of Banks and other Financial Institutions after the Financial Crisis", *Journal of Corporate Law Studies* 2013, p. 240-241.

[54] For an overview of most important studies see J. de Haan and R. Vlahu, *Corporate Governance of Banks: A Survey*, DNB Working Paper nr. 386, Amsterdam, July 2013, p. 33-35.

More recently debt-related compensation is considered an appropriate alternative for decreasing risk taking behavior of management.

Most researchers studied the evolution and composition of the remuneration packages of the CEO and top management of American banks. Barontine and others studied the development of the remuneration package of the CEO just before the financial crisis started and shortly thereafter in a number of European member states and identified a number of differences between financial companies and other companies. Some important findings are reported in table 5. While the median pay of bank CEOs can be found to lie significantly above that of non-financial companies in 2007, it dropped in 2010 to 75 per cent of the total pay of CEOs of non-financial companies. Further the fixed and variable cash part of bank CEOs are both relatively higher than that of other CEOs while the variable part including stock related remuneration of bank CEOs dropped to relatively low levels compared to that of CEOs of non-financial companies in 2010.

Table 5: Evolution of CEO Pay in European Non-Financial and Financial Companies

	Total in 000€	(fixed and variable cash)/Total	(variable cash + stock based)/total	variable cash/total variable	N
Median CEO Pay European Financial Companies					
2007	3544	87,4%	65,8%	70,9%	53
2010	2337**	100%*	39,4%**	56,2%	53
Median CEO Pay European Non-Financial Companies					
2007	3041	74,6%	69,0%	58,7%	192
2010	3117	74,9%	65,2%	52,8%	192

Source: R. Barontini, S. Bozzi, G. Ferrarini and M.-C. Ungureanu, "Directors' remuneration before and after the crisis: measuring the impact of reforms in Europe, in *Boards and Shareholders in European Listed Companies*, M. Belcredi and G. Ferrarini (eds.), Cambridge, CUP, 2013, pp. 251-314. *,** indicate that the difference is statistically significant.

26. Recently the European Banking Authority (EBA) started to collect remuneration details of "High Earners" in the financial industry. The EBA executes thereby the requirements of CRD III.[55] The latest set of available data covers 2012 and some of the results have been provided in table 6. It is clear that there are large differences between the different countries. While only 15 people earned more than 1 mio. € in Belgium, over 2700 were in that position in the UK.[56] A majority of the High Earners are considered to be "identified staff". According to the

[55] Directive 2010/76/ EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, *OJ L* nr. 329, 14 December 2010, p. 3.

[56] In many European Member States there are no banking employees earning more than 1 mio. €.

Committee of European Banking Supervisors "identified staff" are "the members of staff whose professional activities have a material impact on the institution's risk profile"[57]. In Italy, Germany, France and Belgium, between 60 per cent and 80 per cent of "High Earners" have also a material impact on the institution's risk profile. In the Netherlands almost all "High Earners" are in that position, while less than half of the high earners has a risk related profile in the UK.

Compared to the total number of employees, only one out of two thousand employees (for France) to four thousand employees (for Belgium and for Italy) earned more than 1 mio. €, while more than one out of hundred seventy employees was in the same position in the UK. It did not came as a surprise that the UK challenged the strict remuneration package rules in the Capital Requirements Directive (CRD IV)[58].[59] However the European Court of Justice rejected the UK challenge of the bonus cap and the chancellor dropped the case.[60]

These remarkable differences between countries are also visible in the average amount these "High Earners" received and the composition of the remuneration package. The average remuneration package of a Belgian "High Earner" was 1,3 mio. € in 2012 while this amount was close to 2 mio. € for his British colleague.

The data illustrate significant differences in the composition of the remuneration package. French and British "High Earners" receive a multiple of the fixed remuneration as variable remuneration, while the fixed amount is higher than the variable amount in the Netherlands. As a consequence almost 80 per cent of the total remuneration in France and the UK is variable, while less than half of the remuneration package of Dutch bankers is variable. Finally, in the UK, France, Germany and the Netherlands 60 per cent to 2/3 of the remuneration is deferred. In Italy this amount is less than half and in Belgium even less than ¼.

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[57] The identification technique is provided in detail in Committee of European Banking Supervisors, *Guidelines on Remuneration Policies and Practices*, 10 December 2010, number 16, p. 15-17.

[58] For a short comment on CRD IV, see section IV, §2.

[59] B. Fox, "UK launches court challenge against EU bank bonus deal", *EUObserver,* 26 September 2013, http://euobserver.com/political/121563 (last accessed 15 June 2014).

[60] A. Barker, "Osborne gives up on challenge to bank bonus cap, Financial Times, 20 November 2014, http://www.ft.com/cms/s/0/12d1ba3a-7094-11e4-9129-00144feabdc0.html#axzz3LWgP4qv6 (last accessed 10 December 2014).

Table 6: Overview of the High Earners in the Banking industry in 2012.

	Belgium	France	Germany	Italy	The Netherlands	UK
number of high earners	15	177	212	109	27	2714
of which "identified staff"	9	121	146	83	25	1272
number of employees (000; 2011)*	61,2	379,2	663,8	316	105,4	454,1
ratio number of high earners/employees**	0,025%	0,047%	0,032%	0,034%	0,026%	0,598%
Average total remuneration per individual (000)	1292	1567	1558	1651	1469	1952
Ratio variable/fixed remuneration in %	143	375	211	123	76	370
Ratio variable/total remuneration in %	59	79	68	55	43	79
Ratio of deferred/total variable remuneration in %	23	67	66	47	68	60

Source: EBA, *: European Banking Federation, statistics; ** own calculation (it must be noted that the data of the nominator are of 2012, those of the denominator of 2011)

27. These data do not provide evidence that the remuneration packages in the financial industry are significantly different from those that are provided to high executives in other industries. Limited anecdotic evidence suggests that also other industries are familiar with a significant number of "High Earners". In Belgium, 13 out of 16 CEOs of large listed companies received remuneration packages varying between 1,1 and 3,9 mio. €[61], AB Inbev, the largest Belgian brewer, paid its executive committee (excluding the CEO) a fixed base remuneration of 7,40 mio. €, a variable share based remuneration of 9,33 mio. €, complemented with long term share options and to some restricted stock units and additional pension plans as well as some other perquisites.[62] If each of its 12 member executive committee (ex. CEO) receives an equal remuneration package, all twelve members passed the threshold of 1 mio. €, and bringing the composition of the remuneration package in line with the packages that the EBA reported for the Belgian high earning bankers.

28. In short, while some of the aforementioned data suggest differences between the remuneration policy in banks and other industries, other data show no significant discrepancy between banks and other commercial companies. However, all data show that there are major disparities in the financial industry *between* countries and more recently between Europe and the United States.[63] In light of the effects that remuneration packages can have on the behavior of bankers, corporate governance of banks should be different from that of other

[61] S. Michielsen, "Belgische topmanagers leveren 10 procent in", *De Tijd* 30 maart 2013, p. 5.
[62] AB Inbev, *Annual Report 2012*, p. 166-172.
[63] X., "Atlantic gap opens in bank chiefs' pay", *Financial Times* 3 June 2014, p. 15.

industries but it is far from sure that the one size fits all approach which is implemented in the European Union will be the appropriate answer.[64]

4. Debtholders

29. The fourth important difference between corporate governance in banks and that in other industries that Hopt identified is the position of the debt holders. Corporate governance of banks is debt holder oriented. In particular the regular depositors are not in the position to exercise any control over the bank if it engages in risky activities.[65] Not all the literature acknowledges this phenomenon of low debt holder monitoring. In the more theoretical literature there is a trade-off of monitoring between equity and debt.[66] However, recent literature is stating the "*debt as a device for effectively disciplining bank managers is implausible, little more than a myth*".[67] Most debt holders are non-experts[68], making it unlikely that they investigate bank managers' activities.

30. It is easy to see that the position of debt holders in banks is different from that in other industries. Equity is low compared to other equity ratios in other types of industries and obviously only a small fraction of total assets. Equity to total assets of industrial companies is generally higher than 25 per cent whereas for banks the same ratio generally does not pass the threshold of 10 per cent.

31. If we use the definition in the Cadbury report of corporate governance, "the system by which companies are directed and controlled", the involvement of deposit holders in directing and controlling the company is non-existent. A deposit holder enters into a standardized contract with the bank. He cannot negotiate nor protect itself against adverse behaviour – asset withdrawal, underinvestment, claim dilution, etc. – of the bank through inter alia covenants, collateral or other protective mechanisms, neither is there any direct mechanism to act against the behaviour of the company. The absence of any restriction in the contracts with

[64] See section IV, §2.
[65] It must be remarked that the deposit insurance system which is provided in many countries, including the European Member States, aggravates the problem as it further reduces the monitoring by the debt holders (K. Hopt, "Corporate Governance of Banks and other Financial Institutions after the Financial Crisis", *Journal of Corporate Law Studies* 2013, p. 243).
[66] M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", *Journal of Financial Economics* 1976, pp. 305-360.
[67] A. Admati and M. Hellwig, *Does Debt Discipline Bankers? An Academic Myth about Bank Indebtedness*, Working Paper February 2013, p. 6
[68] Of course, there are exceptions like many institutional investors investing in different kinds of debt instruments.

debt holders facilitates the so called "debt overhang problem" identified by Myers according to whom less equity or other (long term) debt instruments are used when the proceeds are likely to accrue to other parties when a company defaults.[69]

32. The depositors cannot be compared with the bondholders which can also be found in other industries. Bondholders and depositors have a number of similar characteristics: large in number, relative small individual amounts, mostly unsecured, and both debt holders. However and contrary to bonds, deposit holders do not have a specific maturity date and cannot trade the deposit over the counter. Deposit holders have no collective rights like bondholders in a general meeting.[70] If we leave aside the deposit insurance scheme which is available for most deposit holders and creditors of banks[71], the absence of any effective and efficient monitoring right, leaves the unprotected deposit holder with only one right, the bank run. A run on the bank can destabilize the overall financial system, requiring government intervention, the last bank governance feature which is mentioned in the study of Hopt.

5. Regulation

33. The last distinguishing feature of bank governance in Hopt's analysis is the bank-specific regulation and supervision that – in particular since the 1930s – has been developed.[72] The regulation should protect the different stakeholders of banks against the specific bank risks, including the vulnerability to a bank run and their systemic importance.[73] Once these risks to the economy were acknowledged, the legislators and regulators established many requirements to make banks accountable. These rules became more and more detailed and complex and interfered with every aspect of organization and strategy to the extent that some scholars claim that banking regulation serves as a substitute for corporate governance.[74] The regulator will represent the interests of those parties, like the public interest, that are unable to protect themselves through private mechanisms due to the absence of appropriate rights or

[69] S. Myers, "Determinants of corporate borrowing", *Journal of Financial Economics* 1977, 147-175.
[70] In Belgium bondholders can call or be called in a general meeting of bondholders to, *inter alia*, take protective measures in common interest or change the rights of the bonds (see article 568 Belgian Companies Code).
[71] But limited to modest amounts.
[72] K. Hopt, "Corporate Governance of Banks and other Financial Institutions after the Financial Crisis", *Journal of Corporate Law Studies* 2013, p. 243.
[73] P. Mülbert, "Corporate Governance of Banks", *European Business Organization Law Review* 2009, 422.
[74] R. Adams and H. Mehran, "Is Corporate Governance Different for Bank Holding Companies?", *FRBNY Economic Policy Review* 2003, p. 124.

incentives.[75] While the long period during which different rules for banks have been developed leaves room for the argument that bank governance is different due to legislation, we believe that the regulation is a consequence and not a part of the specificity of the bank business.

In the next section, we will identify how the different corporate governance features of banks have been addressed in the corporate governance codes and the European legislation.

IV. Stakeholder Protection in Codes and Legislation

34. In the previous section it was shown that banks are special due to their specific connectedness with the economy and their relationship with many stakeholders in society, in particular the depositors, while other elements are less specific for banks than it is sometimes argued in the literature. Many of these specificities are already acknowledged since decades which raises the question how the specific corporate governance codes have addressed the peculiarities in the governance structure of banks. In this section, we study all specific bank governance codes and identify these elements which take into account the bank specific governance issues. Next, we address the new European banking legislation with respect to these specific governance related issues.

§1. Bank Governance Codes

35. In section III we identified eleven specific bank governance codes which all have been issued between 1999 and 2011. All these codes tackle similar topics as the "regular" corporate governance codes: independence of directors, board committees, board effectiveness, etc. The guidelines stress the role of policies to address the tense relationship between the management, the board of directors and the shareholders. However, these connections are not bank specific. A large majority of the principles in these codes can be copied to a general corporate governance code and recommended to companies in all industries. According to our reading more than half of the codes only contain guidelines which similarly are useful in all industries. This comes as a surprise as the guidelines of the Basel Committee, which was the first to issue best practices for banks go beyond the mere regular recommendations and ends: "*Sound corporate governance considers the interests of all stakeholders, including depositors, whose interests may not always be recognised. Therefore, it is necessary for*

[75] K. Alexander, *Corporate Governance and Banking Regulation*, Cambridge working paper 17, 2004, p. 3.

supervisors to determine that individual banks are conducting their business in such a way as not to harm depositors"[76]. The Basel Committee advises that boards of directors and senior management make clear how they lead the bank, can affect the interests of the depositors. Senior management must always hold the reins over all employees, even over the most successful traders. It is obvious that the Basel Committee refers to Nick Leeson, a derivatives broker who made Barings Bank insolvent after a number of risky trades while previously generating up to 10 per cent of the total annual profit of the bank.[77]

Table 7: Bank Specific Best Practice Guidelines in Bank Governance Codes

	Issuing body	Specific governance
1999	Basel Committee	corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, affecting how banks protect: [...] the interests of depositors. Management situations to be avoided include [...] senior managers who are unwilling to exercise control over successful, key employees (such as traders) for fear of losing them. The salary scales should be set, within the scope of general business policy, in such a way that they do not overly depend on short-term performance, such as short-term trading gains.
2004	Central Bank of Nigeria	none
2004	Financial Services Commission of Guernsey	none
2005	Monetary Authority of Singapore	compensation symmetric with risk outcomes (taken from Financial Stability Forum)
2007	Central Bank of Jordan	none
2008	Banca d'Italia	remuneration schemes must not conflict with a bank's prudent risk management policies or its long-term strategy
2008	Qatar Central Bank	none
2009	Association of Banks of Georgia	none
2009	HM Treasury UK	Rec 23: the board risk committee should ensure that account has been taken of the current and prospective macroeconomic and financial environment drawing on financial stability assessments
2009	Nederlandse Vereniging van Banken (The Netherlands)	2.1.3 The members of the supervisory board shall have thorough knowledge of the bank's functions in society and of the interests of all parties involved in the bank. The supervisory board shall carefully consider the interests of all parties involved in the bank, such as the bank's clients, its shareholders and its employees. 3.1.7. … Risk management shall also include a focus on the interests of financial stability and on the impact that systemic risk could have on the risk profile of the bank. 3.2.1 In all of its actions, the bank's executive board shall ensure that it carefully considers the interests of all of the parties involved in the bank, such as the bank's clients, its shareholders and its employees. These considerations shall take into account the continuity of the bank, the environment in society in which the bank operates and legislation, regulations and codes that apply to the bank.
2010	Central Bank of Ireland	none

Source: own analysis of eleven bank governance codes

[76] Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations*, 1999, nr. 31 p. 11.
[77] Retrieved on http://www.nickleeson.com/biography/full_biography.html.

During the next ten years all bank governance codes denied the specificities of the banking industry with its systemic risks and large number of stakeholders. At best, we can state that the Singaporean and Italian code indirectly address the issue through their recommendation of the remuneration of bankers which must take into account the specific risks of the industry. However, we consider these recommendations as too vaguely addressing unacceptable high levels of risks or negative returns and their effects on compensation. Only in the aftermath of the financial crisis new governance codes reconsidered the systemic relevance of banks and stakeholders' interests. The UK Walker review of 2009 emphasized the importance for banks – more specifically for the board's risk committee – to be accountable for the financial stability. The Dutch code added that the interests of all involved parties must be taken into account, including the financial stability. While it explicitly refers to clients, shareholders and employees, we consider it unfortunate that the debt holders are not identified as a separate class in light of their important role for banks and the incumbent party that can make every bank to fail (through a run on the bank). However the Dutch code is the only code that pays attention to both the systemic risks as well as the interests of all stakeholders.

§2. European Bank Legislation

36. The "stakeholders" gap, left by the bank governance codes, provides legislative room for improvement. Indeed, since specific corporate governance for banks took off around the turn of the millennium, legislators started to fine-tune the corporate governance frameworks for banks. The repealed European Directives 2000/12/EC and Directive 2006/48/EC required that banks have managing bodies composed of people of sufficiently good repute and with sufficient expertise[78] and "*robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and adequate internal control mechanisms, including sound administrative and accounting procedures*"[79]. These directives left it to the Member States to issue guidelines accordingly. In

[78] Article 6 of the European Parliament and Council Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, *OJ L* nr. 126, 26 May 2000, p. 1-59. Article 11 of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, *OJ L* nr. 177, 30 June 2006, p. 1–200.
[79] Article 22 of Directive 2006/48/EC. In Directive 2000/12/EC it still sounded in article 17 "Home Member State competent authorities shall require that every credit institution have sound administrative and accounting procedures and adequate internal control mechanisms."

2010 the CRD III[80] further developed this provision and added that the governance arrangement also must include "*remuneration policies and practices that are consistent with and promote sound and effective risk management*".

37. CRD IV[81] reshuffled the bank governance requirements and provides in a list of governance arrangements. The list is long and is in fact a combination of rules considered to be best practices in governance[82]: (1) the role of chairman of the board and chief executive officer must be separated (unless the competent authority approves the combination of functions)[83], (2) a nomination committee (among other committees) composed solely of non-executive directors must be established by all systemic financial institutions[84], (3) management must be of sufficiently good repute and possess sufficient knowledge, skills and experience[85], (4) the composition of the board must reflect an adequate broad range of experiences[86], (5) board members must provide in a sufficient time commitment[87], (6) in systemic banks, directors cannot hold more than four non-executive positions or more than one executive position in combination with two non-executive positions[88], (7) members of the board of directors must be induced and trained[89], (8) diversity in the board must be promoted[90], (9) the remuneration policy should not encourage risk-taking that exceeds the level of tolerated risk of the institution[91], (10) the remuneration package must distinguish between a fixed and variable part[92], (11) variable remuneration related to performance must contain at the same time individual criteria, containing both financial and non-financial elements, business unit and institution wide criteria and must long term oriented[93], (12) the variable remuneration shall not exceed 100 per cent of the fixed remuneration (with a

[80] Directive 2010/76/ EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, *OJ L* nr. 329, 14 December 2010, p. 3.
[81] Directive 2013/36/EU, of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, *OJ L* nr. 176, 27 June 2013, p. 338-435.
[82] Next to other corporate governance provisions provided in other directives, like the requirement to publish a corporate governance statement and establish an audit committee.
[83] CRD IV, Art. 88(1)(e).
[84] CRD IV, Art. 88(2).
[85] CRD IV, Art. 91(1).
[86] CRD IV, Art. 91(1).
[87] CRD IV, Art. 91 (2).
[88] CRD IV, Art. 91 (3).
[89] CRD IV, Art. 91 (9).
[90] CRD IV, Art. 91 (10).
[91] CRD IV, Art. 92 (2) (a).
[92] CRD IV, Art. 92 (2) (g).
[93] CRD IV, Art. 94 (1) (a) and (b).

conditional exception to 200 per cent), be balanced in the instruments used, sufficiently deferred, and provide in malus and clawback arrangements[94], (13) systemic financial institutions must establish a remuneration committee[95], and (14) systemic financial institutions must establish a risk committee[96].

38. According to some, the CRD IV does nothing more than providing in quack corporate governance, harmful for banks, meritless and counterproductive and at best temporarily restoring trust.[97]
It is indeed regrettable that the Directive did not provide in the Basel Committee's stakeholder recommendation by referring explicitly to the duty to protect depositors and society as an element of good governance. That is not to say that CRD IV completely denies the protection of the stakeholders and the overall economy, neither rejects all specificities of bank governance. According to our previous analysis the items (3), (4) and partially (11) and (12) address bank governance specificities. Banks need competent boards and management (items (3) and (4)) and the remuneration of the board and key personnel must provide both in a bonus and in a malus (items (11) and (12)). It cannot be understood that a pivotal element of the economy, the banking industry, is governed by anything less than experienced people. Experience comes at a cost: bankers must be well paid[98] but remuneration should be capped to avoid any risk appetite that endangers the survival of the bank. It should apply both at the individual level of the banker as at the consolidated level of the bank. Supervisory agencies are more than necessary to vigilantly monitor that the risk appetite of banks is under control and that risk tolerances never exceeds the risk appetite of the bank. There can be no acceptance of a tolerance probability for failure.

39. Deposit holders protection takes place via the Capital Requirements Regulation (CRR)[99]. Basically, the protection of deposit holder through the system of capital requirement should

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[94] CRD IV, Art. 94 (1) (g), (l),(m) and (n).
[95] CRD IV, Art. 95.
[96] CRD IV, Art. 76 (3).
[97] L. Enriques and D. Zetzsche, *Quack Corporate Governance, Round III? Bank Board Regulation under the New European Capital Requirements Directive*, ECGI Law Working Paper nr. 249/2014, March 2014, 31 p.
[98] Recenlty, the CEO of Dexia complained that the bad bank cannot attract excellent employees as the remuneration is capped at low levels, the bank is only downsizing and its bad reputation radiates on its employees. The new management team cannot be blamed for the mistakes made in the past. As a consequence the heavily indebted bank must limit its losses and prevent a failure in very difficult circumstances (E. Van Brussel, "CEO Dexia waarschuwt voor vertrek toppers", *De Tijd* 3 June 2014, p. 5).
[99]Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, *OJ L* nr. 176, 27 June 2013, p. 1-337.

be supported. CRR elaborates the capital requirements for banks, which serves as a buffer for the debt holders, and is considered in the very large majority of the empirical research as the appropriate tool for the protection of the debt holders as well as the market. However, CRR wrongfully addresses the required capital threshold as well as the calculation of this required capital. Part II of the regulation provides in detailed provisions of the own funds of a bank. The rules of own funds of the bank distinguish common equity tier 1 capital, additional tier 1 capital, and tier 2 capital. Clarifying the instruments belonging to the different kinds of capital as well as those that need to be excluded from the capital required not less than 28 pages in the regulation. The common equity tier 1 capital must be at least 4,5 per cent, the tier 1 capital at least 6 per cent and the overall capital at least 8 per cent of the total risk exposure amount. Calculating the latter amount is – to say the least – rather complicated as it takes in the CRR hundreds of articles with complicated formulae. Mayes and Stremmel investigated the effectiveness of different capital adequacy measures[100] in predicting bank distress in a model that takes into account financial, operational and management strength and weaknesses and found that "*risk-weighted measures do not outperform a simple leverage ratio. This does not imply that there should be any reduction in the use of risk-weighted measures in deciding how much capital a bank should hold in normal times but that when things start to go wrong, a simple leverage ratio, which is transparent and more difficult to manipulate, would be the better indicator of problems*."[101] As risk-weighting will always contain an element of subjectivity, the probability of "window dressing" of the measures in difficult times, are too high a risk and advocate for a simple ratio.

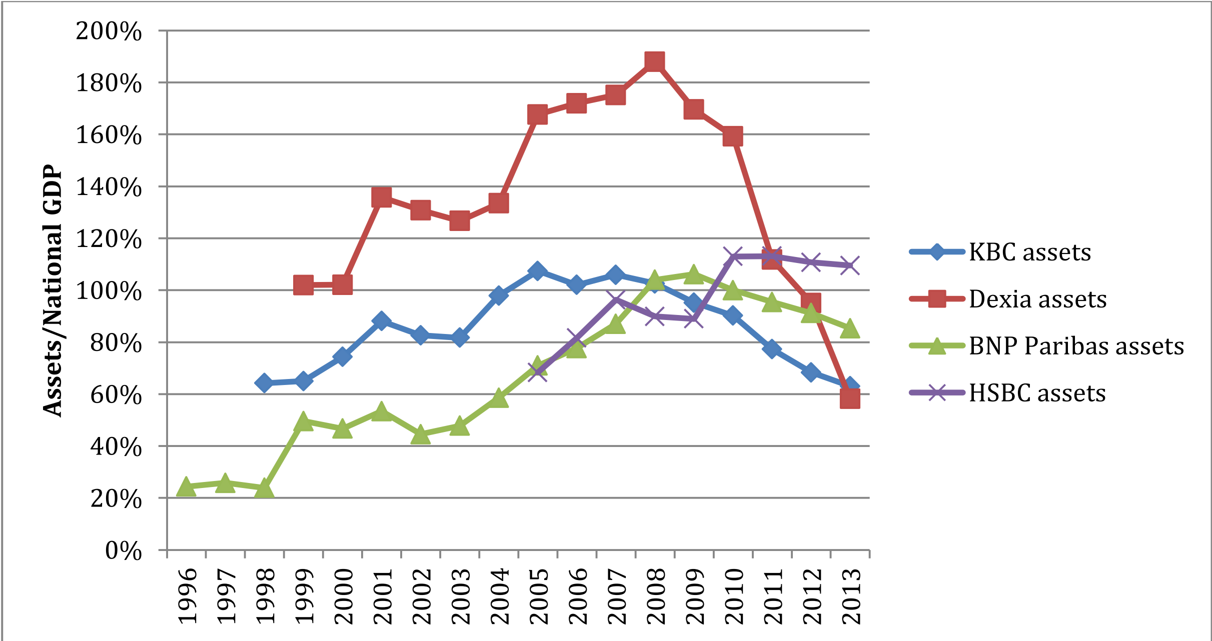
Next, it is obvious that this total risk exposure regulation of CRR creates a significant compliance risk, shifting every opportunity for investors of banks to monitor the bank's financial position to the supervisory agencies.[102] It cannot well be expected that a new financial crisis will be prevented by shifting the trust in the financial system and banks to the trust in the monitoring agencies.

40. Next, the capital adequacy requirements are more than likely not addressing the major problem of the leverage ratchet effect, *i.e.* the shareholders' favoritism towards higher levels

[100] The measures are classified in capital adequacy (C), asset quality (A), management competence and expertise (M), earning ability and strength (E), liquidity (L) and sensitivity to market risk (S), and identified as CAMELS.
[101] D. Mayes and H. Stremmel, *The effectiveness of capital adequacy measures in predicting bank distress*, working paper University of Auckland, 2012, 46 p.
[102] For an analysis of the European Monitoring System, E. Wymeersch, *The Single Supervisory Mechanism or "SSM", Part One of the Banking Union*, Financial Law Institute Working Paper 2014/1, 81 p.

of debt.[103] Neither does it address the fact that in the aftermath of the financial crisis a limited number of banks have grown into or remained "too huge to fail" banking institutions. In figure 4 we show the relationship between the total assets of three large banking groups to the national general domestic product (GDP). The value of the assets of HSBC passed the threshold of 100 per cent of the GDP of the UK in 2010 and stayed above this threshold ever since. The development of the assets of BNP Paribas is even more remarkable. While the assets of BNP Paribas had only less than ¼ of the value of the GDP of France at the end of the 1990s, they soared to 106 per cent of GDP in 2009 and fell back to 85 per cent in 2013. After a steep climb from around 2/3 of Belgian GDP in 1998, the value of the assets of KBC peaked in 2005 with 107 per cent of the GDP and dropped to 63 per cent in 2013. Dexia experienced a similar although much more outspoken development. In the view of some recent authors it is only to wait until the next crisis if the capital requirements are not linear and straightforward strengthened to levels of 20 to 30 per cent of overall liabilities.[104]

Figure 4: Evolution of Bank Assets to National GDP



Sources: own calculations based on data from annual reports KBC, Dexia, BNP Paribas and HSBC and Insee, National Banks and Tradingeconomics

[103] A. Admati, P. DeMarzo, M. Hellwig and P. Pfleiderer, *The Leverage Ratchet Effect*, Stanford Working Paper, December 2013, 49 p.

[104] A. Admati, *Debt Overhang and Capital Regulation*, INET presentation, 23 April 2013.

V. Concluding Remarks

41. In this paper we provided in a brief overview of the specificities of the banking industry and addressed bank governance particularities. Bank activities are special to the extent that more stakeholders are involved, in particular debt holders and society as a whole and banks are systemic for the economy. Bank governance is also different although the literature identified many of these so-called specificities which can also be found in other industries. According to our data this is the case for the shareholder structure of banks which is to be found in other industries as well. Bank boards seem to have less expertise in some countries compared to other industries which is, at least for Belgium, in contrast with the ex ante supervision of the composition of bank boards that already was in place. These rules of ex ante board member assessment by supervisory agencies are strengthened in CRD IV but it is too early to assess the effects.[105] Some findings show that (part of) the remuneration package of bankers is also different to that of incumbents in other companies and industries. In light of the effect of remuneration on behavior, government intervention seems legitimate. However, the new rules that have been endorsed in CRD IV are very strict and question whether it was the only mean to reach the goal of the alignment of the behavior of bankers with all stakeholders of banks. Probably there is no other industry where stakeholder governance is so pivotal. Debt holders and public interest have no voice in the bank governance system and should be represented by the legislator and the regulator.[106] We agree and found evidence in line with the finding of Becht and others that "*depositors and bondholders contribute almost all of a bank's capital, yet most decisions are taken by managers, boards, and shareholders. Bank executives do not have to seek permission from depositors before changing a bank's risk profile.*"[107] We also found that in the bank governance codes regulators did not address the interests of the stakeholders appropriately. While the Basel Committee already identified very clearly that the interests of the depositors must be taken into account, only a few have addressed this issue explicitly in their code. It questions the benefits of this instrument. Finally, the legislator enacted new and very prescriptive bank governance rules. Again we see that there is hardly any corporate governance best practice to act in the interests of all stakeholders, and in particular the debt holders and society. The indirect rule is to be found in

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[105] The replacement of rules with stricter rules to overcome the shortcomings of the previous rules is not necessarily successful. The one size fits all solution is unlikely to provide the appropriate answer. Besides, the new set of rules might be a hindrance to find "better" board members.

[106] An alternative could be that the legislator changes the governance of banks to introduce "voice" of these interests in the governance of banks.

[107] M. Becht, M. Bolton and A. Roell, "Why bank governance is different", *Oxford Review of Economic Policy* 2012, 438.

the remuneration policy which should not allow risk-taking that exceeds the level of tolerated risk of the institution. The stakeholder interests must be protected through the capital requirements, measured in relation to the total risk exposure. Measuring this relationship is experts' work and stakeholders need to trust the supervisory agencies in their assessment of the appropriate own funds. The manpower and resources of supervisory agencies (as well as internal control, audit and risk management departments of the banks) are scarce and the responsibility is huge. It is open for debate why, at least at the European level, it is not opted for an easier, straightforward and clear bank own funds approach, like a simple ratio of own funds to total assets instead of the complicated total risk exposure amount. This ratio would require the allocation of huge amounts of money for which a sufficient transition period had to be provided. The supervisory agencies could monitor the transition phase. The amounts to be allocated would definitively be massive but the cost of the recent failures were massive too and trust in the financial market is priceless.[108] It remains to be seen if the current capital requirements and the "quack" corporate governance rules will be sufficient to restore and keep the trust in the viability of a bank when a new crisis will occur.

[108] Belgium, France and Luxemburg had to provide in state guarantees of more than 70 bn. € for Dexia (P. Claerhout, "Staatswaarborgen Dexia weer boven 70 miljard", *Trends*, 23 april 2013, http://trends.knack.be/economie/nieuws/finance/staatswaarborgen-dexia-weer-boven-70-miljard/article-4000285739238.htm#, last accessed June 6, 2014). While a guarantee is obviously no equity, it is close to 20 per cent of the total assets of Dexia at the end of 2012.

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