CORPORATE GOVERNANCE IN BANKING INDUSTRY: REVIEW AND RESEARCH PERSPECTIVES

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Abstract: *Banks have an essential role in the development of the economy. The following characteristics of banks distinguish them from all other companies: opacity: the quality and characteristics of bank assets, and in particular of loans, are not easy to assess by outsiders; regulation: the banking sector is traditionally ruled in a very strict way; maturity and risk transformation: banks facilitate the matching between demand and supply of capital by making risk appetite and liquidity of the surplus units which offer funds (typically households) compatible with that of the deficit unit which ask for funds (typically companies); mitigation of the asymmetric information problems between surplus units and deficit units; negative externalities: crisis of a single intermediary can sometimes extend to the entire financial system turning a circumscribed problem to a situation of systemic instability.*
This paper aims to review the recent academic research concerning the corporate governance (henceforth CG) in the banking sector along the following theme areas: a)study of the relation between the CG indicators and the performance of banks; b) investigating the relation between CG and the risk appetite of banks; c) study of the relation between the type of CG and performance or success of M & A.
The present paper suggests some ideas for future research by identifying some interesting areas which are little or unexplored at all. The first interesting theme area could be the study of the relationship between CG and the intensity of regulation/supervision on the banking sector. The presence of a strong governance and an effective internal control systems could make a strict regulation unnecessary, which on the one hand seems necessary to prevent abuse at the expense of competitors and investors, yet on the other could make the markets which adopt it unattractive. A second potential source of empirical research could be the analysis of the relation between CG parameters and types of funding instruments or types of lenders in order to figure out which is the most efficient form of financing and what kind of governance can attract a certain type of lender and / or the greater amount of funding in absolute terms.

Keywords: *Financial intermediation, Corporate finance, Banking Industry.*

1. INTRODUCTION

The academic research concerning the corporate governance (henceforth CG) in the banking sector has developed along the following axes: study of the relation between the CG indicators and the performance of banks; investigating the relation between CG and the risk appetite of banks; study of the relationship between the type of CG and performance/success of M & A. For each of these areas of study this paper will proceed to an analysis of the more recent and significant contributions grouping them in as many sections as the theme areas identified.

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This paper is focused on the most recent research by selecting those published from 2000 onwards.

2. CORPORATE GOVERNANCE AND PERFORMANCE OF BANKS

Studies in this research domain share the attempt to find, through an empirical analysis, a link between the characteristics of banks, in terms of governance, and their performance. In some cases, the empirical analysis of banks was carried out during the financial crisis (2007-2010) involving the banks, in other cases, in the immediate aftermath of the banking crisis, when it seemed to transform into a crisis of sovereign debt of some European peripheral countries. Some authors point out that strong governance goes hand in hand with good performance while others find that this relation is not significant or even inverse.

In this area it is worth mentioning the work of [1] which, by analyzing a sample of 62 US commercial banks included in the S & P 1500 during the crisis from 2005 to 2010, shows that a strong corporate governance has had a positive effect on the performance of institutions. Yet the results of the analysis of the relationship between corporate governance and the returns of listed shares of the institutes do not seem unambiguous. Another interesting study place able in this area was carried out in 2011 by [2], analyzing a sample of 236 US commercial banks in the 2005-2008 period obtained mixed results about the relationship between strong CG and performance. In particular, CG indicators (including the degree of ownership concentration, the size of the board, the age of the board members, the presence of anti-take-over devices, the frequency of meetings of the board) individually studied, may show significant relations with performance, but considered as a whole reveal an ambiguous effect on performance itself. The authors however, based on the results of their study question the inevitability of conflict of interest between ownership and managers by stating that a rapport of trust between shareholders and management is still possible. This study also provides empirical support for the need to provide banks with an adequate amount of equity capital, by noting a negative effect of leverage on performance, and the need for the rewards and incentives of managers are weighed against risks. Another article about these issues is the one by [3], that by examining a sample of 69 large commercial banks from 6 different OECD countries find a positive and significant relation between board size and performance, proportion of non-executive board members and performance, as well as the number of annual meetings of the board and performance. In substance, the authors find that a greater emphasis on these three prerogatives of the board improves the quality of supervision of managers by the board and reduces conflicts of interest. The fact that the relation between performance and respectively the size of the board and the proportion of non-executive members of have a parabolic form, confirms there is an optimum point for both the size and the number of non-executive members; after this point the value and the profit performance of the bank diminish rather than increase. Financial businesses characterized by a strong ownership concentration than others in the pre-crisis period showed no negative performance during the crisis.

[4] investigate the relationship between the CG and the operating performance of a sample of 68 US bank holdings in 2007. The performance is measured through the CAMEL indicator which synthesizes 5 parameters (capital adequacy, asset quality, management, earnings and liquidity) also used by the Federal Deposit Insurance Corporation, in its reports come to the conclusion that all corporate governance indicators negatively affect the operating performance of the BHC except for the number of board committees and for the role of the auditor which shows a positive association with the performance. The explanation for the negative association is attributed to the fact that non-executive board members have little knowledge of the

operational dynamics of the BHC and the banking sector. [5] try to investigate the reasons for the disappointing performance in a sample of 164 large banks belonging to countries adopting schemes of deposit insurance during the period of the crisis (2007-2008) .The authors come to the conclusion that those reasons have little or nothing to do with the quality of corporate governance; performance (thus considered as the dependent variable) rather showed an inverse relation with the extent of leverage and risk. The researchers show that countries with less strict supervision and regulations, higher GDP, a more concentrated banking sector, and without schemes of deposit insurance, are those which have performed worse. Paradoxically, the concept of being “shareholder friendly”, which conventionally is considered an indicator of the quality of governance, implies the poorest performance, and fails to obtain commendable implications of conduct and guidelines for the governance policies

3. CORPORATE GOVERNANCE AND RISK-APPETITE BY BANKS

In this theme area, academic studies share the attempt to find, through an empirical analysis, a link between the characteristics of banks in terms of governance and their risk appetite. The study of the existence and direction of the causal relation has produced divergent outcomes.

Standard agency theories suggest that ownership structure influences corporate risk taking [6]. Bank managers with private benefits of control will tend to advocate for less risk taking than stockholders; so greater cash flow rights by the largest owner are associated with greater risk.

The Basel Committee on Banking Supervision (2010) point out that poor corporate governance may contribute to bank failures and the ownership structure plays a key role in this dimension.

The best governance practices recommended by the Basel Committee to face banking risks are: having a risk-dedicated board committee; having a majority of independent BoD members; and CRO be part of the bank’s executive board. It is possible to group Bank Risk in four main categories [7]: insolvency risk of the counterpart (credit and settlement risk); operative risk; market risk sortable in interest risk for liabilities in general and non listed securities, price risk for listed securities and exchange risk; and inflation risk. Earlier literature on risk management did not include the interdependence between the various risks. Only in the 1990s, the academic literature started to focus on an integrated view of risk management.

[8] focused on outcomes in terms of risk stemming from the conflict of interest between ownership and managers in a sample of 300 banks from 48 different countries. The two scholars showed that a greater power of the owners in terms of governance and a greater concentration of ownership of the bank corresponds to a greater risk appetite of the bank itself, by measuring risk through the index Z Score. The authors state that regulation affects the relationship between risk appetite and the bank's governance structure; in particular the relation between strength of governance and risk tolerance, although still positive, appears weaker in economies with stricter rules for the protection of shareholders. [9] analyzed the relation between the use of governance garrisons against the risk and the performance on a sample of 372 US banks during the 2007/2008 crisis. The authors deduced that in those governance structures where the CRO reports to the CEO, equity returns and ROE are significantly higher than others, yet they are likely to not pay adequate attention to risk in the management agenda because of the potential conflict of interest between the CEO and the CRO. The banks whose boards took more risks before the crisis witnessed a performance below average during the crisis. Relations between the other CG indicators and performance do not appear significant, and even in the case of size and independence of the board they are negative. The authors suggested putting the CEO and

the CRO on an equal footing; in doing so, they can both report directly to the board, although this is likely to entail a slight deterioration in performance.

[10] examines in more detail the effects of the board structure on the extent of the risks assumed by banks in reference to a sample of 212 US bank holding companies. This scholar found that strong boards (with more distinctly aligned behavior with shareholders interests) determine a greater risk propensity; the opposite happens with a stronger CEO than the board. In summary the author suggested submitting those banks in which the interests of managers and shareholders are more aligned to a closer monitoring since shared interests would expose banks to excessive risk.

[11] analyze a sample of 249 western European banks in the period 1999-2005; the authors pointed out that in the case of concentrated shareholding banks in which a clear separation between ownership and management does not occur and in which for the shareholders it is relatively easy to monitor the performance of management, the ownership structure influences the risk appetite. Risk appetite and likelihood of default are higher in banks in the shareholding of which institutional investors or non-financial companies have a greater weight compared to those in which individuals, families or other banks have a predominant role. This, according to the two authors, is due to the fact that the latter have a lower chance of diversifying its investment portfolio compared to institutional investors and therefore fewer incentives to take risks. They show that changes in the ownership structure in banks with a broad shareholder base do not influence the risk.

4. THE TYPE OF CG AND PERFORMANCE/SUCCESS OF M & A

Most of studies on M & A reveal disappointing returns for the shareholders of acquiring banks involved in M & A which would stem from poor governance arrangements that fail to adequately safeguard shareholders from the adverse effects of M&A bids [12], although standard economic theory, argues that M&A occurs because of their potential in cutting costs and/or increasing revenues.

The Agency Theory succeeds in finding a number of possible explanations for the disappointing outcomes of performances of M & A: firstly, it can be assumed that senior executives overestimate their ability to perceive and realize the potential gains from a merger (Hayward and Hambrick, 1997); the second one is that managers engage in M&A in order to pursue their own self-interests even jeopardizing the corporate value [13]. The third is that, since senior executives cannot diversify their human capital invested in one single firm, they try to diversify the portfolio activity of the firm through M&A in order to minimize the variance of company's returns and consequently the risk of losing their job [14]. Shareholders who, on the contrary, have the opportunity to diversify their portfolios, consistent with CAPM's theory, [15] receive no benefit from such a company's specific risk mitigation strategy.

The authorities' sensitivity of the importance of banks for systemic stability implies that, almost universally, hostile takeovers are a rarity in banking as most banks bids require regulatory approval.

The disappointing results of M & A in the banking sector, especially in view of the shareholders of the incorporating bank, have often been attributed to an ineffective CG, unable to adequately protect shareholders. [16] have analyzed some large-scale European or US banking mergers and discovered that nine of them report a negative outcome, one a positive outcome, and three a neutral outcome. The negative results of these studies are difficult to reconcile with the standard economic theory, which suggests that M & As have an intrinsic potential for cost reduction and revenue growth. The Agency theory has produced a number of possible explanations of reasons why managers can use their discretion to undertake M & A which is not maximizing the value of the banks involved as above summarized. The most important governance variables that can re-align the interests of bank executives to those of shareholders, as identified in the US market, can be grouped into three categories:

I. *Executive remuneration* [13]: long-term management remuneration incentives could function as an insurance, for shareholders of the incorporating bank, against excessive merger premiums. II. *Board composition* [17]: in order that a BoD can effectively counteract egoistic managerial behavior - as in is the case of acquisitions at the expense of shareholder wealth - its independence from management must always be guaranteed [18] by balancing insider and outsider members of the board [19]. In the banking sector, supervisory bodies assume the role of external controllers, while independent directors (entitled to the control of management discretion in most other economic sectors) have a very limited role in reducing agency costs [17]. Ultimately, the independent BoD members do not appear able to protect shareholders from the negative effects in terms of value of mergers between banks.

III. *Board diversity* [20]: in the case of non-financial firms, empirical evidence suggests that diversity (ethnicity, gender) in board composition increases the effectiveness of monitoring and attenuates agency costs [20]. However, in extant literature, it is still difficult to find an analysis of the effects that the variety in the composition of the BoD has on a bank's performance. A possible solution to strengthen the role of the board could be to provide specific M & A. Committees within the national self-discipline codes of the CG M & A committees should be part of the board and consist of independent directors. It is conceivable that the M & A committees put additional pressure on management in order to evaluate the effects of acquisitions in terms of value more accurately. Secondly, supervisory authorities should consider loosening some of the restrictions on types of M & A transactions executable by banks.

5. CONCLUSION

At the end of this review although brief, yet we hope sufficiently exhaustive, about governance in banking, we would like to suggest some ideas for future research by identifying some interesting areas which are little or unexplored at all.

The first interesting theme area could be the study of the relationship between CG and the intensity of regulation/supervision on the banking sector. The presence of a strong governance and an effective internal control systems could make a strict regulation unnecessary, which on the one hand seems necessary to prevent abuse at the expense of competitors and investors, yet on the other could make the markets which adopt it unattractive [21]; this is particularly true at a time of extreme capital mobility where states and their national markets are driven to compete almost as private companies to get caught up capital. From this perspective, it might be interesting to study relations between types of CG frameworks in the banking industry and the efficiency of the financial markets or the cost of capital. This approach would help identify the most efficient geographic areas or states and their peculiarities, thus providing useful policy suggestions to those states which want to increase their attractiveness to investors.

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