TILBURG UNIVERSITY LAW SCHOOL

Master Thesis for the International Business Law LLM

Corporate Governance of Banks:

A closer look at the Boards of Directors

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Introduction

Corporate governance of banks became a hot topic since the last financial crisis. One must think of banks as big financial conglomerates which have the ability to influence the entire world economy. There are two main reasons why it has been decided to analyze this particular topic separately from the corporate governance of non-financial companies: their unique importance and their particular characteristics. It has been noticed that banks play an important role for the industrial expansion, corporate governance of non-financial firms and also capital allocation. Therefore, if banks fail to work efficiently companies will raise less capital and there will be less capital formation and productivity growth. If banks management applies sound corporate governance principles it will increase the chances for efficient capital allocation and overall growth. It is actually necessary for banks to apply sound corporate governance principles because they need to gain and to maintain the people's trust in the institution. Also, the application of corporate governance principles without any real impact on the economy contributes to bank failures and hence to people distrust.

The author intends to write this paper as possible guidelines for the developing countries that also need to apply corporate governance principles since their financial institutions are also part of the whole financial system. In addition, there are several reasons why corporate governance principles should be of much importance in the developing countries: banks have a dominant position in these countries and help for economic growth and they finance both the population and the companies.

The paper has the purpose to take into account the specifics of the banking industry related to corporate governance and to focus on the board of directors. It starts by explaining the theories that support corporate governance and the models that it had until now.

For a good understanding of banking corporate governance there was a need to clarify the specific characteristics of the financial sector regarding the enforcement of the corporate governance principles, with a focus on the types of banks and its functions (monitoring, counseling, consumption rationalization, proving liquidity, accountability and prudent regulation).

Afterwards some aspects of corporate governance of banks are underlined and how over regulation, reduced transparency and risk management can influence it. It is also taken into consideration the role that the central bank plays in the enforcement of corporate governance and also what are the international initiatives, binding wording or recommendations.

In the second part of the paper the accent will be on the characteristics of the board of directors: size, diversity, composition, number of board memberships, committees and on the author's critics and suggestions.

Corporate Governance and why is it such a hot topic?

During the last years it has been more perceivable than ever that big corporations play an important role in the global economy. In the early 2000 cases like Enron, Parmalat and Eurotunnel have proved the impact the collapse of big non-financial corporations can have. Later on, in the second part of 2000s' the effects of financial crisis showed what huge circumstances bad functioning of the financial corporations can have on people that although seemed not connected, they still face unemployment, financial insecurity or they have maybe lost their savings.

Among the multitude of reasons for the appearance of the financial crisis, which are to be or already have been discussed by professionals in other papers, it is considered that corporate governance also played a role by failing to make banks' managers accountable to the shareholders. On the contrary as the expected outcome of its application, the later form of corporate governance determined bankers to take excessive risks. As a result of the fact that bankers were not affected by the probability of failure of theirs' strategies, they were incentivized to have a short-term performance approach (due to the remuneration structure) which was aloud by a week monitoring from the shareholders' behalf.

But in order to truly understand the weight corporate governance has in the financial crisis one must comprehend the dimensions of corporate governance, the theories behind corporate governance, its models and its differences from financial to non-financial firms.

Theories that support corporate governance

There are a series of theories that stay behind the concept of corporate governance and they are listed by Hawley and Williams[1] as agency theory, transaction cost theory, stewardship theory and stakeholder theory. Since only agency theory and stewardship theory enjoyed a higher popularity in the followings there will be a focus on just those two. To keep it short I will present the main differences between agency and stewardship theory using a table used by Vargas[2] in his paper *Agency theory vs. Stewardship theory*.

	Agency Theory	**Stewardship Theory**
Managers as	Agents	Stewards
Approach to governance	Economic	Sociological and psychological
Model of man behavior	Individualistic Opportunistic Self-serving	Collectivistic Pre-organizational Trustworthy
Managers motivated by	Their own objectives	Principal's objectives
Manager's and Principal's interests	Diverge	Converge
Structures that	Monitor and control	Facilitate and empower
Owners' attitude	Risk aversion	Risk propensity
Principal – Manager relationship based on	Control	Trust

Source: Vargas, A., *Agency Theory versus Stewardship Theory*, http://www.uhu.es/alfonso_vargas/archivos/EURAM%202004.pdf

[1] Hawley J., Williams A T, *Corporate Governance in United States: The Rise of the Fiduciary Capitalism, found at:* http://www.lens-library.com/info/papers96/first/firstcontents.htm

[2] Vargas Sanchez A, *Agency Theory versus Stewardship Theory*, Available at: http://www.uhu.es/alfonso_vargas/archivos/EURAM%202004.pdf

Corporate Governance Models

The owners of a company do not usually involve directly in its activity, but they find ways to achieve control over the business by selecting, incentivizing and monitoring a board of directors that have the aptitudes to run the business. Yet, each business has different characteristics and these characteristics have different needs. A study by Robert DeYoung[3] tries to observe whether standard corporate governance practices affect in a different manner the financial performance of banks. It is underlined that corporate governance structures vary a lot not just in different sectors of economy but also in between the banking industry. Banks can be either independent or affiliated to a bank holding company; private or public traded; family-owned with a family management or outside management or highly dispersed ownership; and can have different tax statuses and informational environment. Having all these differences, Robert DeYoung says that his findings suggest that one size doesn't fit all and that corporate governance best practices should vary among the banks.

The effect that globalization had pinned even more the differences of corporate governance. Globalization has increased the competition between corporations on an international level and this new dimension affects corporate governance as well. Each country has its own economic standard, own politic and cultural inheritance which determined the development of an own management system and this fact slows the process and makes it difficult for the big corporations to implement its own methods and norms in different countries. There have been several tries by the European Commission to align the standards in the European Union but the conditions do not allow a complete harmonization of company law in Europe.

There are still some models of corporate governance that have showed good applicability and results. In 1997 Kaplan[4] has divided the economic systems in two: *market oriented* and *bank oriented*. The *market oriented* model is used by countries such as the United States of America and the United Kingdom and it is characterized by individuals who invest their savings in shares and usually companies are financed by the capital market. The other model, *bank oriented*,

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[3] DeYoung R, *Corporate Governance at community banks: one size does not fit all,* Corporate Governance in banking. A Global perspective by Beneton E. Gup, University of Alabama, 2009, pp. 62-75

[4] Kaplan S., *The Evolution of U.S. Corporate Governance: We are all Henry Kravis Now*, Journal of Private Equity, 1997, pp. 7-14, available at: http://faculty.chicagobooth.edu/steven.kaplan/research/holmkap2003.pdf

suggests that financing is made usually by financial institutions. It is used in countries such as Germany and Japan, where banks play a significant role and commercialize a much broader series of financial products than the banks from the *market oriented system*. Yet, there are still noticeable differences between the German and the Japanese model[5].

As an important difference between the financial institutions in the United States and the ones in Germany is that the last ones have access to information and are able to monitor and discipline the companies that they financed. German banks therefore play a very important role in the corporate governance of companies.

Both German and Japanese banks are minority shareholders in the companies that they have financed. Although the maximum stake that the German banks can have is 6%, they show a great power of influence in the administration process.

The *bank oriented* governance model is mostly found in Continental Europe and it is important to understand its characteristics because this way one can see what great power banks have and how important is that they are properly governed.

In both Germany and Japan there is frequent monitoring and audit actions made by the banks in the companies that they have financed. In the audit actions also participate the employees of the company. The control that banks have is exercised through the shares that banks hold. This kind of behavior may lead to conflicts between majority and minority shareholders.

On the other side, the *market oriented* corporate governance model is characterized by capital market financing and the interest of increasing the value of the shares. The control and monitoring is different made, not in a direct way as in the bank oriented model, but with the help of best practice codes, audit reports and corporate governance codes. The banks play a more passive role because their financing is for a short period of time and used for different purposes. This time the conflicts that may arise are between shareholders and managers.

These differences explain why during the recent period of time both continents have made reforms in the financial regulation, but with some important differences. Although both the

[5] Nichitean A.L., *Corporatii, corporatism si guvernanta in activitatea bancara*, Universitatea Alexandru Ioan Cuza Iasi, 2011.

Dodd-Frank Act and the European Green Paper on corporate governance in financial institutions are evolving in the same direction the first one applies to all kind of companies (financial and non-financial) and the latter focuses only on banks and financial institutions. Because of how banks are run and the role they play in the economy life the US legislator assumes that the problems in banks governance are related to the general failures of corporate governance to guarantee effective monitoring of management and the EU institutions look at banks as special situation.

In other words one might say that bank oriented corporate governance models use an *insider* system, where the market oriented ones use an *outsider* system. Clark T in his paper[6] explains the differences and the specific characteristics of each one. The differences are to be explained with the help of the table below.

Characteristics	**Outsider System** **US, UK**	**Insider system** **Europe, Asia**
Ownership	Dispersed	Concentrated
Control	- Separation between ownership and control - Reduced incentives for the investors to engage in monitoring	- Association between ownership and control - Monitoring is made by stakeholders (banks, companies, shareholders)
Financing	- Reduced indebtedness - Reduced share of debt into equity - Use of diversified and complex financial instruments	- High indebtedness - High share of debt into equity - Less use of complex financial instruments

[6] Clark T., *International Corporate Governance. A comparative approach*, Routledge Taylor&Francis Group, New York, 2007, p. 10;

Growth	Through mergers and acquisitions	Internal growth
Takeovers	Hostile	Friendly
Behavior	Short-termism	Long-term approach
Management orientation	- Support shareholders interest - Focus on growth of shareholders value	- Support stakeholders interest - Focus on adding value to the stakeholders
Strategy	- Long term engagement of the investors is reduced - Competitive strategy, focused on market and profits	- Long term and active engagement of the stakeholders - Strategy that is focused on quality
Stakeholders	Interest is focused on the shareholders	Interest is focused on the groups of stakeholders
Weaknesses	- Takeovers lead to monopolies - Managers might act on their own interest	- System might generate conflicts

Mechanisms to reduce agency costs

Different governance mechanisms have been contoured for efficient corporate governance that will lead to a good performance of the firm. Several mechanisms reducing agency costs can be simultaneously applied at an optimal level, or just the focusing on just one of them can have the costs of other mechanisms.

One way to mitigate agency costs is to have high equity ownership by insiders (managers and directors). When a high proportion of the personal wealth of the insiders is linked to the value of the firm, then the managers and directors will be incentivized to act in the interests of the outside shareholders. In an opposite scenario, outside shareholders may easily prove that owner-managers impose agency costs on other shareholders and then the market value of the firm will be reduced and consequently the owners' wealth will decrease[7].

Another mechanism used to mitigate agency cost is the block holder ownership. It is also translated into the best way to handle free riding problems. If there are only a huge amount of shareholders each with little stake, then there will be no incentives for those owners to have a proper monitoring because it is a high costly process and the gains are considerably reduced comparing to the costs. But one or more shareholders that have a large stake into a company will support the costs of monitoring and this way they refute managers from engaging in moral hazard behavior. The block holders can discipline managers and directors by facing them the threats of proxy fights and takeover bids[8].

Having a big proportion of outside directors is also a possibility of reducing agency For a proper functionality it is considered that the board has to be independent from the management team. Outside directors are to be trusted because they are interested in protecting their reputation of effective and independent decision makers. The problem following this mechanism is that it is very costly to have a significant number of outside directors; that involves fee-expenses for traveling or stock options. Therefore, this mechanism will be avoided at the gain of the before mentioned mechanisms[9].

A study by Andres and Valellado[10] also shows that outside directors improve the value of the firm, but when the number of outside directors gets high the effect is reverse. The authors of the article consider that in banking specific information and inside directors are more important for a board to perform efficiently.

Development of Corporate Governance during the crisis

[7] Belkhir M., *Board structure, ownership structure and firm performance: evidence from banking*, October 2004. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=604523

[8] Belkhir M., *Board structure, ownership structure and firm performance: evidence from banking*, October 2004. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=604523

[9] *Idem*

[10] Andres P., Vallealdo E., *Corporate Governance in Banking: the Role of the Board of Directors*, Available at:http://www.uam.es/personal_pdi/economicas/paalonso/Archivos/AndresVallealdo2008JBF.pdf

In order to obtain a good assessment of the corporate governance of banks one must have a clear and broad image of the role that corporate governance has in developing the financial crisis and then in gaining back the economic equilibrium. The wrongful management and the risky behaviors that nowadays are very frequent should stimulate a responsible behavior.

The analysis starts from the idea that corporate governance represents the way in which companies are run. History has shown that during the last decades a lot of bankruptcies had as their reasons the violation of the corporate governance principles. Unethical behaviors such as fraudulent or incomplete financial reporting represented the reason for most of the collapses. How it was possible is explained by the specificity of banking and financial industry where the transparency is much lower than in other sectors and the activities are much more complex.

In the late 2000 most of the countries started to be concerned with the impact and effect that globalization has on the financial system and that a kick on one side of the globe might easily affect the rest of the map. Novel innovative financial instruments have been introduced to the market which made the system even more complex and difficult to monitor. In the middle 2000 there have been such high profits and benefits in the banking and financial industry that the warnings about the risks were overlooked[11].

The beginning of the crisis was considered to have its roots in the banks' high risk activities. It is therefore normal that corporate governance became such a hot topic when through its agency theory, corporate governance focuses a lot on the risk management of the companies.

International institutions reacted to the crisis through a series of legislative initiatives on the implementation of the corporate governance principles. One example is the Basel Committee which has published *Principles for enhancing corporate governance*[12] and it gives a great importance to risk management and the role of internal and external auditors.

Most of the provisions that had the purpose of passing the crisis have focused on the crisis control and the effort to stop the domino effect of the financial market. Some of the measures

[11] Nichitean A.L., *Corporatii, corporatism si guvernanta in activitatea bancara*, Universitatea Alexandru Ioan Cuza Iasi, 2011.

[12] Bank for International Settlements, available at: http://www.bis.org/publ/bcbs168.pdf

that have been taken are: reducing the interest for granting credits, governmental support given to the banks that might become bankrupt, granting capital to the financial institutions. The measures that have been taken represent the instrument that has helped in maintaining the world economy stability.

In Europe, both the European Commission and the member states have developed policies in order to alleviate the financial crisis. It has been a target to avoid the banks bankruptcies and to maintain the people's trust in banks and the financial market.

The role of the central bank in enforcing corporate governance of banks

The banking system is divided on two levels: commercial banks and the central bank. The central bank is different from the other category because of its unique responsibilities and capacities. It has a monopoly of note issue and it is engaged in a lending process and it has the power to influence the economy of a particular state. On top of those attributions, central banks also oversee the monetary system and policy and focus on goals such as currency stability and low inflation[13].

Central banks are owned by the government but they are separate from the finance ministry and are not to be influenced by different governmental politics. Though the ownership might make one believe that is the reason why central banks have this great power in a state's economy, actually it is the legislative system that have granted this specific role to the bank of issue/central bank[14].

In order for a monetary stability to exist all banks must pay great attention to a good corporate governance of their institution because a too risky behavior or doubtful practices might lead to a decrease of people's trust into the financial system and banks. Keeping and increasing people's trust is one of the central bank's main responsibilities and it can only be accomplished through the commercial banks which have a direct access to the people.

[13] Nichitean A.L., *Corporatii, corporatism si guvernanta in activitatea bancara*, Universitatea Alexandru Ioan Cuza Iasi, 2011.
[14] Ibidem

The central bank strengthens the corporate governance principles through a series of actions[15]:

- It issues regulation that comes to complete corporate governance enforcing regulation (remedy the gaps and insufficiencies);
- It encourages the implementation of sound bank's corporate governance principles which involves assuring that the company has respectable members in the board of directors and experienced, well trained executive managers(good organizational structure);
- It outlines the responsibility that board of directors have for the problems that banks face and for a proper monitoring;
- It must be informed and aware of the problems and weaknesses that a bank faces by conducting periodical external audit and proper monitoring;
- It enhances cooperation between banks directors and managers and the monitoring and supervision authorities;

It tries to reduce the impact that overregulation on the firms and therefore encourage competition in the field.

International initiatives for Corporate Governance of Banks

- **OECD Principles**

During the years around the world organizations have tried to establish corporate governance principles that would help in addressing a right attitude towards the governance of the corporations. The most known corporate governance principles are the ones elaborated by the Organization for Economic Co-operation and Development (OECD)[16].

It wasn't the initial scope of the organization to enunciate corporate governance principles but after the Asian financial crisis the OECD and the World Bank initiated this project to improve corporation's management[17]. The OECD Corporate Governance principles are the only ones that

[15]Central Bank of Kuwaiti, *The Role of Central Banks in defining Corporate Governance in Banks,* Available at: http://www.cbk.gov.kw/pdf/Book6Eng/Sub9.pdf

[16]Organisation for economic co-operation and development, available at: http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf

[17] Nichitean A.L., *Corporatii, corporatism si guvernanta in activitatea bancara*, Universitatea Alexandru Ioan Cuza Iasi, 2011.

are world-wide recognized and they are used to represent a starting point in the national regulations and in each company's tailor made corporate governance policies.

The OECD principles cover main areas of corporate governance importance: the rights of shareholders and key ownership functions, equitable treatment of shareholders, the role of the stakeholders of a company, disclosure and transparency, the responsibilities of the board. The principles are what is called "soft law"; they are only suggestions and non-binding instruments that all the countries no matter their level of development can implement. Thus, the intention is to provide guidance and assistance to governments and regulations, as suggested above, but also to individuals like investors, to stock exchanges (to obtain easier the true value of the shares) and, of course, to corporations[18]. Using the same principles and guidelines it may happen that with time there will be harmonized corporate governance standards.

- International Corporate Governance Network (ICGN)

ICGN is a global organization consisted mostly out of institutional investors, but also companies, financial intermediaries, academics with the purpose to raise standards of corporate governance worldwide[19]. They consider the OECD Corporate Governance Principles an important starting point in approaching correctly corporate governance, but consider them not enough; therefore they offer amplifications[20] of these principles, in the sense of clear, concrete guidance to give them sufficient force.

- Council of Institutional Investors (CII)

It represents a nonprofit association of pension funds, other employee benefit funds, endowments and foundations that has as its mission to be the voice of effective corporate governance and strong shareowner rights[21].

- Basel Principles

[18] Voicu D.D., *Highlights for a history of corporate governance*, European Journal of Management, March 2008. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1114045

[19] International Corporate Governance Network, available at: https://www.icgn.org/about-icgn

[20] The Amplifications can be found here: http://www.ecgi.org/codes/documents/icgn_principles.pdf

[21] Council of Institutional Investors, available at: http://www.cii.org/about_us

“The Basel Committee is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters.[22]” In 1998 because of globalization and its consequences that favored specific countries, the Basel Committee conceived the first Basel Accord (Basel I) that was supposed to regulate capital requests. Later in 2001, the diversification of the banking products leaded to the design of Basel II. Its purpose was to create an international standard for how much capital banks need to keep in order to be able to face different types of financial and operational risks. Regulation between countries should have the same standard in order to avoid competitive inequality between banks that work on an international level. Basel II has 3 pillars.

Pillar 1 **Minimum capital requirements**	**Pillar 2** **supervision of capital adequacy**	**Pillar 3** **Market discipline**
quantitative approach to prudential requirements	qualitative approach to prudential requirements	necessary tool in prudential supervision
Flexible and advanced rules for determining minimum capital requirements for:	active role of supervisors in evaluating banks' internal procedures regarding capital adequacy risk profile	detailed requirements for reporting information to the national bank and the public on:
Credit risk	verification of banks' internal procedures of the supervisory authority	ownership structure risk exposure capital adequacy risk profile
Market risk	requiring that credit institutions to hold capital in excess of the minimum level indicated by the Pillar 1	
Operational risk		

Source: Nichitean Andra Lavinia[23], 2011

[22]Bank for International Settlements, available at: http://www.bis.org/bcbs/about.htm

[23] Nichitean A.L., *Corporatii, corporatism si Guvernanta in activitatea bancara*, Universitatea Alexandru Ioan Cuza Iasi, 2011.

- Green Paper

On both continents, America and Europe, after relevant events that produced the financial crisis arise regulators tried to offer new mandatory guidelines to prevent from future similar situations. The approaches were rather different. The Dodd-Frank Act focuses on corporate governance of companies in general, where the European Green Paper created special regulation that is focused only on the corporate governance on financial firms.

After the financial strike in 2008 the European Commission decided to examine financial institution's corporate governance rules and propose regulation or just make recommendation regarding the corporate governance system of banks. The Green Paper appears to support the sustainable growth of the financial industry.

There are more actors to blame for not playing the perfect role in corporate industry: board of directors, shareholders, auditors, supervisory authorities. All aspects of corporate governance are highly important, but the focus will only stay on the board of directors since it has been proven to be an important element that weakened the corporate governance of banks which together with other factors led to crisis environment.

The European Commission clearly stated that boards of directors of the financial institutions didn't manage to correctly play their roles of control and decision-making body. There are a series of reasons that might have determined the wrongly attitude of the boards:

- Members of the board of directors, especially the non-executive directors haven't spent the necessary needed time in handling the board matters nor did they interfere with the positions or propositions of the chief executive officer
- There was a lack of diversity of backgrounds in terms of gender, culture and education.
- There was no serious evaluation of the board members
- There was no insurance for proper risk management framework and risk appetite

Members of the board failed to see the risks and therefore to take actions in that sense.

Why CG of financial and non-financial firms are different

As it has been in many paper discussed, there is no one-size fits all corporate governance structure. This is even deeper underlined when it comes to different company models, such as financial and non-financial. Banks represent a specific type of companies that presents a series of particularities which should be taken into account when discussing about corporate governance.

As Adams and Mehran[24] showed in their paper the attention should be focused on two key differences: the higher number of stakeholders that a bank has and the complexity of the bank industry and operations.

- **High number of stakeholders**

From the incipient times of the banking industry banks have collected money from depositors which give up over their economies in order to receive them later with an interest. They are mostly small participants, but they are representing a huge number. The money that was deposited in a bank represents the debt of that bank. In case of the insolvency of the bank, all the stakeholders would be affected. Among the costumers there are also other connected stakeholders that take an interest in the well functioning of the bank, such as insurance authorities, competitors, shareholders and also the state.

Each of them has main interests which are driven by specific bank characteristics. While the debt holders, regulators and insurance authorities are interested in a low volatility and take longer term views, the shareholders look for a high volatility and short term views. Yet, the shareholders are the ones mostly controlling the company. Debt holders are usually subject of free riding; they have also transferred the monitoring to the bank and the fact that they have access to a state funded safety net make them less sensitive to the taken risk than other investors[25].

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[24] Adams R, Mehran H, *Is Corporate Governance different for Bank Holding Companies?*, March 2003. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=387561

[25] [25] Adams R, Mehran H, *Is Corporate Governance different for Bank Holding Companies?*, March 2003. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=387561

Key players	Responsibility for risk management	Importance for policy level	Importance for operational level
Systemic			
Legal and Regulatory Authorities	Optimize	Critical	-
Bank Supervisors	Monitor	Indirect monitoring	Indirect
Institutional			
Shareholders	Appoint key players	Indirect	Indirect
Board of directors	Set policy	Critical implementation	Critical
Executive management	Test compliance with board policies and provide assurance regarding corporate governance, control systems and risk management process	Indirect compliance	
Audit Committee/ Internal Audit	Evaluate and express opinion	Indirect (evaluation)	
External Auditors			
Consumer	Act responsibly		Indirect
Outside/stakeholders/public	Act responsibly		Indirect

Source: Van Greuning, Bratanovic (2003)

- **Opaqueness**

Transparency and disclosure are important for corporate governance, but the lack of it or reduced transparency don't seem to affect good performance of the banks. It is in banking's nature to be more opaque because of its operations. Taking advantage of the fact that they are "too big to fail", banks risks to get bankrupt are much reduced than other firms[26].

The paper *Corporate Governance of Banks after the Financial Crisis* explains how the quality of banks loans is much harder to assess rather the quality of assets from another industry, where physical assets are easily quantifiable by third parties. On top of that, banks don't only work with

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[26] Cocris V, Ungureanu M.C., *Why are banks special? An approach from the Corporate Governance perspective*, Universitatea "Al.I.Cuza" 2007. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1090291

loans, but also with other banking products of high complexity and opaqueness, such as: Asset-Backed Securities, Collateralized Debt Obligations, and Credit Default Swaps.

It is difficult not only for the outsider (third parties) to assess the quality and the riskiness of a bank's performance, but also for banks to analyze the riskiness of other banks[27].

Morgan D. completes in his paper *Rating Bank: risk and uncertainty in an opaque industry* that the financial assets create agency problems. The fore mentioned loans are given to small, opaque borrows. Banks, due to their specificity of activity and knowledge is supposed to be monitoring on behalf of the depositors for whom a monitoring process would be too expensive. But this delegation only sounds good in theory, because it inevitably creates the consequence: "lending to opaque borrowers may cause opaque banks"[28].

Among those two problems, there are attributes, some similar to the non-financial companies and some special that have an impact on the corporate governance of banks.

- **Principal – agent framework**

Not just regular companies, but banks also face the classical principle-agent problem. It is represented by the conflicts arising from the attitude between shareholders and managers regarding the risks. Bank owners are incentivized to increase leverage, where managers are more willing to adopt a risk-averse approach.

As Cocris also underlines in his paper[29], the principal agent problem is accompanied by other aspects specific to the banks situation:

- Managers need to keep in mind that bank failures lead to great negative externalities with a contagious effect
- Depositors and other stakeholders are free riders and apply insufficient monitoring on the banks
- There isn't a strong information flow due to the opaqueness of the environment
- Overregulation of banking system

[27] Mulbert P.,*Corporate Governance of Banks after the Financial Crisis: Theory, Evidence, Reforms*, April 2010, ECGI – Law Working Paper No. 130/2009. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1448118

[28] Morgan D., *Rating Banks: risk and uncertainty in an opaque industry*, May 2000, FRB of New York Staff Report No. 105. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=933681

[29] Cocris V, Ungureanu M.C., *Why are banks special? An approach from the Corporate Governance perspective*, Universitatea "Al.I.Cuza" 2007. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1090291

- The diversity of banking products leads to a stronger agency problem between insiders and small shareholders

- **Capital structure**

One of the major characteristics that differentiate banks from other non-financial firms is the capital structure. According to Macey and O'Hara[30] banks present 2 special features: reduced equity and ability to crate liquidity.

As for the first feature, although it is common for other industries as well to be financed out of debt, only banks receive around 90% of its financing through debt. Secondly, banks liabilities usually consist out of deposits. These deposits can be used at demand, and when not, the assets are used as loans with longer maturities for other individuals. Thus, banks are able to create liquidity by holding assets and issuing liquid liabilities. Yet, the liquidity process can cause problems when depositors want to take their money back because banks only keep limited reserves of money. This creates the so called bank run[31].

- **Equity ownership**

It presents a different structure from the other firms. When banks have a concentrated ownership, it becomes more difficult for the small shareholders to really have an influence on the management. The control of just one or a few shareholders affect the large scale of other stakeholders involved that don't have too much to say.

Ownership can tend to be either concentrated or highly dispersed. A highly dispersed ownership is preferred because of its ability to exert corporate control through the voting rights directly and the actions of the board of directors indirectly. Yet, not all of the shareholders might fully understand the opaque and complex processes of the banking system, so information asymmetries might become even stronger and hence it becomes difficult for the shareholders to exercise effective control.

On the other hand, concentrated ownership has a better effect on controlling and monitoring the company due to a better information flow. Concentrated ownership is preferred because it is

[30] Macey J., O'Hara M., *The Corporate Governance of Banks*, Economic Policy Review, Vol 9, No. 1, April 2003. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=795548

[31] *Idem*

considered to have more control over the management because of their use of rights and yet sometimes large shareholders might exploit their own interest in the firm[32].

Enforcing corporate governance principles in banking management

There are special characteristics of the financial institutions that don't allow a mere enforcement of the classic corporate governance principles in the financial sector.

Among these characteristics specific to the banking sector is what Freixas and Rochet have mentioned in their article *Macroeconomics of Banking*. They have noticed that most of the time the banks clients occupy two positions (creditor and debtor) and make use of more than just one banking product[33].

Additionally, there is something to say about the banking shareholding. In most of the business sectors the shareholders have access to proper information about the business and therefore receive proper counseling. This is not the situation in banking where because of the dispersed ownership the shareholders don't closely monitor the banking sector. This together with the problematic brought by the new financial instruments that aren't facile to understand create a reduced information transparency.

Since these characteristics are not a possible subject of change, a proper current and harmonized legislation must be created.

A study by Llweyellyn[34] proves that the official attitude about monitoring and publishing the results play an important role for the quality of the shareholders/stakeholders monitoring. Llweyellyn believes that what is considered to be alternatives to a specific attitude or behavior towards the mechanism of a bank might in fact be complementary actions within an overall regulatory strategy. Therefore he cumulates seven elements which should be present in the

[32] Cocris V, Ungureanu M.C., *Why are banks special? An approach from the Corporate Governance perspective*, Universitatea "Al.I.Cuza" 2007. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1090291
[33] Freixas X., Rochet J., *Microeconomnics of Banking*, Available at: bib.convdocs.org/v34301/?download=1
[34] Llewellyn D., *A regulatory regime for the financial stability,*Available at: http://www.oenb.at/de/img/wp48_tcm14-6134.pdf

regulatory regime of a financial institution. The components of the regime should be (as mentioned in the article):

- Legislation (rules established by regulatory agencies)
- Monitoring and supervision
- Incentives structures
- Market discipline and monitoring
- Bank failures arrangements
- Internal corporate governance mechanisms
- Arrangements applied to regulatory agencies

All the seven fore mentioned elements must be introduced in the regulatory strategy in order to avoid financial institution's bankruptcies and hence to contribute to the sustainable economic stability[35].

One might believe that the costs between shareholders and management aren't that high because the two of them have similar interests, including the growth of the economic results through the mitigation of the agency costs using corporate governance mechanisms. But the companies facing corporate governance problems aren't the non-financial firms alone. The powerful regulation of the financial system determines managers to take risky actions.

A study by Prowse[36] discovers two weaknesses of the corporate governance of the banking systems in comparison with the corporate governance of the other non-financial firms: hostile takeovers and the intervention by the board of directors. Prowse shows that hostile takeovers, which by its threat of being taken and management dissolved or replaced would have represented a way of disciplining the management don't have the same effect on banks they are very rare due to the regulation and hence it does not influence the quality of the management.

Friendly acquisitions also don't have a disciplinary role because even though they are more frequent they happen between profitable banks hence creating no threats.

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[35] *Ibidem*

[36] Prowse D., *Alternative Methods of Corporate Control in Commercial Banks*, at http://dallasfed.org/assets/documents/research/papers/1995/wp9507.pdf

The intervention of the board of directors has been noticed also to be less effective when dispersed ownership and more effective by better monitoring when there are some majority shareholders involved.

One more study that shows that corporate governance is different applied to financial and non-financial firms is written by Adams and Mehran[37]. They succeed in picturing a complex analysis regarding the specificity of the financial sector. They compare different aspects of corporate governance between a bank and a factory and discover that a financial firm has a larger board of directors with more external directors and the number and frequency of the board meetings is higher than in a factory. On the other side, in a factory the managers receive more often as remuneration stock and the value and number of the shares are usually higher than in a bank.

These facts lead to the conclusion that both management and corporate governance structures are designed for the specificity of the industry/sector.

One more special characteristic of the banks is that in comparison with the non-financial firms, the ownership in banks is constituted in a largely part by the states. Papers, such as Shleifer's, La Porta and Lopez-de-Silanes *Government ownership of banks*[38] outline the fact that the mentioned situation, of large government ownerships is present all over the world, but mostly in the developing countries. They argue in their paper that a tight regulation of the banking industry will lead to less financial growth and a slow development of the industry.

The opinions whether government ownership is a good factor that creates economic growth are both pro and contra. Scholars as Greschenkron in his paper *Economic backwardness in Historical Perspective*[39] and Myrdal in *Asian Drama*[40] support the theory that this structure helps, where Konrai in *Resource-constrained vs. demand-constrained systems* and Shelifer and

[37] Adams R, Mehran H, *Is Corporate Governance different for Bank Holding Companies?*, March 2003. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=387561

[38] La Porta R, Lopez-de-Silanes F, Shleifer A., *Government ownership of banks,* Available at: http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/docs/publications/LaPorta%20PDF%20Papers-ALL/Govt%20Ownershi-Banks-All/Govt%20Ownership%20of%20Banks.pdf

[39] Gerschenkron A, *Economic Backwardnessin Historical perspective*, Available at: http://isites.harvard.edu/fs/docs/icb.topic572311.files/Mon%2022%20June%20-%201/Gerschenkron.pdf

[40] Konrai J, *Resources-constrained vs demand-constrained systems,* 1979, Available at: http://kornai-janos.hu/Kornai1979%20Resource-constrained%20vs.%20demand-constrained%20systems%20-%20Econometrica.pdf

Vishny in *Politicians*[41] *and firms* consider that the active role that the government is playing hinder the existence of a proper competitive environment and diminishes the efficiency of the system.

A study concerning the relationship between the shareholding structure and the specificity of the banking industry was made by Thomsen and Pedersen[42] . In order to make this study they used also corporate governance elements, including the quality of the institutional environment. This study comes to support the evidences mentioned before with the following conclusions:

- The shareholders structure differ depending on the type of activity the company has
- There is a direct connection between how dispersed the ownership is and how developed the market is
- There is also a direct proportionality the private shareholders and the diversity of classes of shares

The executive compensation, which is also an issue related to financial firms corporate governance specificity, varies within the sector and depending on the size of the firm. Bank directors usually have a higher salary than directors of companies from other economic field and the amount of the salaries varies from region and country to country. Studies[43] have shown that a good performance of a company doesn't necessarily lead to an increase of the compensation packages of the directors, like in other industries. Using a comparison of bonuses for performance in the banking sector and other industries it is shown that bonuses for managers' performance that work in a factory are much higher than the ones that work in a bank and this is caused by the heavy regulated financial sector. Another observation is that the value of the bonuses decreases when banks get bigger, so there is an indirect proportionality between the size of the bank and the value of the managerial bonuses[44].

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[41] Shleifer A, Vishny R, *Politicians and firms*, Quaterly Journal of Economics, no. 109, Available at: http://qje.oxfordjournals.org/content/109/4/995.abstract
[42] Thomsen S, Pederson T, *European Patterns of Corporate Ownership*, 1997. Available at: http://www.jstor.org/stable/155493
[43] Murphy K, *Executive Compensation*, handbook of Labor Economics, 1999
[44] John K, Saunders A, Senbet L, *A Theory of Bank regulation and Management Compensation*, The review of financial studies, no 13, pp. 95-125, Available at: http://people.stern.nyu.edu/kjohn/bankmgt.pdf

Why Board of directors is that important for corporate governance of banks

This paper tries to argue that board of directors is an important element in the corporate governance of banks and that a proper design can positively influence banks activity. The author takes into account the literature, assesses its findings and brings critics and suggestions.

In the case of banks the directors not only have to focus on the protection of the shareholders' assets and how to offer them good returns on their investments, but they also need to have in mind the other stakeholders interests, such as the depositors, they have to come up with good strategies that will strengthen the people's trust in banks and avoid any major negative effect that banks might cause to the society.

Since the banking business is opaque and complex, the composition of the boards of directors needs to be carefully designed with professionals and people that not only have knowledge and interest in business, but also in banking, otherwise the advisory and oversight role of the board of directors might be compromised.

As mentioned before, the ways of mitigating the agency costs also include the role of the directors. Having high equity ownership by insiders can help in addressing principle-agent problems, and by insiders are also members of the board of directors. If not using the mechanism for reducing agency costs, a highly independent board is asked and this also suggests that high importance needs to be given to the members of the board of directors.

How important board of directors are for the functions of the banks

Globalization, evolution and the appearance of the universal bank determined mutations in the banking sector. Therefore the banks haven't only used its old financial instruments, but there have appeared also new ones, or the old ones suffered mutations. The concept of universal bank has been studied by Jean-Pierre Danthine[45] who divided the banking activity into 3 categories: Retail banking with its Private banking, Investment banking with mergers and acquisitions and Asset management which includes the bonds and pension funds. To these division and financial instruments new actions have been added, such as insurance services. Yet, no matter if banks are seen through modern or traditional glasses they retain its specificity which derives from its basic functions of managing people's savings and to grant loans.

In order to understand banks specificity one must focus on a banks functions[46]. Not all the functions are connected are affected by the boards of directors, but still a big number are.

- Monitoring

It is believed that the banks existence is of a great importance for monitoring the persons that have received loans. If the entity that offers the loan it is not a specialized institution it is most possible that it would be created a big information asymmetry gap between the lender and the borrower regarding the borrower's capacity to repay back the debt because only he knows what the economic results of his activity are going to be. Hence the loan giver needs to be able to obtain this type of data (repay possibilities of the loan taker) in order to reduce the information asymmetry. Monitoring is an expensive activity, but due to the high volume of transactions and of its monitoring system that is adapted to the client's needs banks are able to conduct these operations at a lower unitary cost[47]. Board of directors monitors the monitors, so although there is no direct function, they ensure that the monitoring is done properly by the management.

- Counseling

Boyd and Prescott in their article *Financial intermediary coalitions*[48] found counseling to be an additional role for the financial institutions. Therefore banks provide information regarding the investing opportunities to the economic agents.

[45] Danthine Jean-Pierre, Giacazzi Francesco, Vives Xavier, Ernest-Ludwig von Thadden, *The Future of European Banking*, Centre for Economic Policy Research, London, Monitoring European Integration no. 9, 2000
[46] Gorton G, Winton A., *Financial Intermediation*, NBER Working Paper no. w8928, 2002, Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=311424
[47] Diamond D., *Financial intermediation and delegation monitoring*, Review of economic studies, no 51, 394-414, 1984, found at: http://www1.fee.uva.nl/fm/courses/Arping%20PhD%20Course/diamond_1984.pdf
[48] Boyd J, Prescott F, *Financial intermediary coalitions,* Journal of Economic Theory, no. 38, pp. 211-232, 1993

- Consumption rationalization

It is believed that banks incentivize savings detrimental to spending and hence it rationalizes the people's consumption by introducing the long term deposits[49]. The board of directors play a significant role because banks influences on consumption rationalization depends on the strategies the bank follows and the strategies are decided by the board of directors.

- Providing liquidity

The credit institutions, according to Freeman[50] provide the most important provisions of liquidity to both private and public sectors. Again the boards of directors' strategies are important on this matter because they decide what type of loans they will grant.

- Accountability

Because of the specific risks that the banking industry has the managers of the financial institutions are stimulated to conduct the activities in a responsible way, showing a prudent behavior[51]. There is a need for special knowledge and preparation on behalf of the monitors. For this reason board of directors are important since they are the ones to monitor the actions of the management.

- Prudent regulation

Because of the domino effect that a bank failure has and the threat that such an event might reduce the trust people have in banks it is necessarily to have a strong and prudent regulation. A prudent regulation must also focus on managerial best practices and corporate governance best practices. A prudent supervision includes provisions about issues specific to the banking sector such as reserve requirements, interest rate and mergers and acquisitions. Yet studies[52] have showed that a too heavy regulation of the financial system might have as an effect the stimulation of the directors to enter into risky actions because they have to recover the losses that

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[49] Diamond D, Dybvig P, *Bank runs, deposit insurance and liquidity*, Journal of Political Economics, no. 91, pp. 401-419, 1983

[50] Freeman S., *The payments system, liquidity and rediscounting*, American Economic Review, no. 86, pp. 1126-1238, 1996 found at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3729

[51] Flannery M, Sorescu S, *Evidence on bank market discipline in subordinated debenture yield*, Journal of Finance no 51, pp. 1347-1377, found at: http://www.jstor.org/stable/2329397

[52] Freixas X., Rochet J., *Microeconomics of banking*, 1997, found at: bib.convdocs.org/v34301/?download=1

a strict regulation have caused. Other studies[53] show that this effect will counterbalance the desire to strongly regulate the financial system and it will lead to a better balanced regulation.

One size does not fit all: different boards for different types of banks

Corporate governance not only differs from an industry to another, but also within an industry. Each firm has its specifics that call for a special corporate governance structure. By having information one can assess whether the communication channel between shareholders and board of directors is advisable and needed for all types of banks.

In his paper *Corporate Governance at Community Banks: One size does not fit all*, Robert DeYoung[54] explains why banks need different corporate governance systems. After he makes a study on banks in US, he notices that most of the banks are considered community banks and they are mostly small commercial banks with a local geographic focus and knowledge on business within the area that grant loans to the members of the community and to its local businesses. There are two categories of community banks: the closely held ones which are usually owner operated and the ones that are affiliated in publicly traded companies. Each has its own environment. In the closely held banks the owners are usually the same with the ones involved in the management of the firm and hence there cannot be too many conflicts between stakeholders and management. There is no need of a board of directors to monitor the management because the owners themselves can do it. The shareholders receive signals on how well the company is being run from the inside reports, but also from the changes in the dividends checks. In this situation the need for a very independent board of directors with a high number of outside directors is not needed.

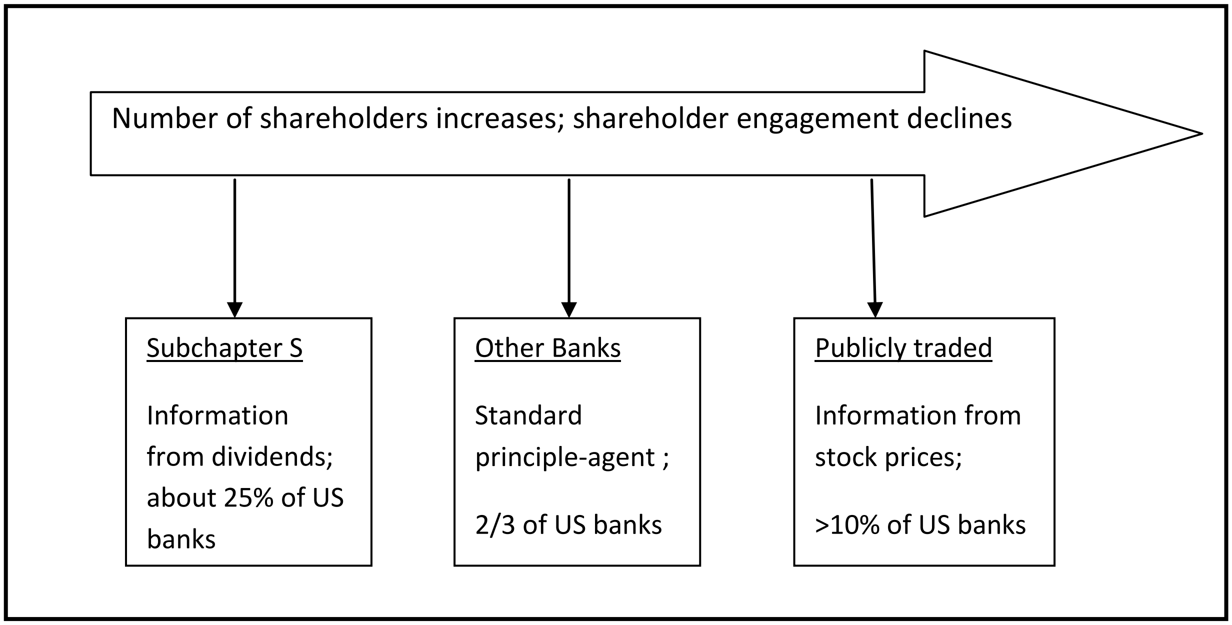
On the other hand, there are the public multi-bank holding companies which usually have widely dispersed ownership and the management is run by hired professionals, which do not own too much of the ownership stake, therefore there is a strong need of a board of directors to monitor, so they need to be properly designed. Not only do they have to meet all the requirements that good corporate governance practices or codes require, but also the stock markets requirements. Therefore the need for independence or gender diversity is bigger. Other than the information

[53] Gorton G., Winton A., *Financial intermediation*, NBER Working Paper, no. W8928

[54] DeYoung R., *Corporate Governance at community banks: one size does not fit all,* Corporate Governance in banking. A Global perspective by Beneton E. Gup, University of Alabama, 2009, pp. 62-75

received from the board, the shareholders use also other sources to see how well the firm is being run, such as variations in the price of the shares.

Source: Robert DeYoung, *Corporate Governance at community banks: One size does not fit all*



As one can follow in the image below, as the number of shareholders increases, the effect is that shareholder engagement decreases because of the lack of incentive of monitoring and being active when they could just be a free rider and benefit from other large shareholders monitoring. In US there are a category of banks which belong to Subchapter S corporations and are usually small firms with few shareholders. In this situation the owners who might own a large stake of the bank engage in the management, the incentives are aligned and there is no need of strong monitoring.

On the opposite pole are the publicly traded banks with many shareholders which mostly own only small stakes in the bank are show a general disinterest in monitoring and engaging.

Being on the extremes (publicly traded or subchapter S) has its advantage that they receive constant information about the performance of the bank either through the dividends or the value of the share and this enables the owners to take measures and reduce the agency costs. All the other banks that are in between have more problems mitigating the principle-agent costs. They receive less external signals of how well the firm is run, so they need a different corporate governance approach than the other two categories[55].

[55] DeYoung R., *Corporate Governance at Community banks: One size does not fit all*,

As a remark, maybe it is not necessarily for a subchapter S type of bank to have this mechanism, but would be definitely favorable for the other community bank types.

Relevant literature on Board of directors

Size

Having a right size of the boards of directors is a measure each company can take at low costs. If studies made on non-financial firms suggest that is should be kept a smaller size of the board in order to be much effective and bring greater value, then there is a need to assess if the same happens to banks.

In a study[56] conducted by Belkhmir Muhamend, he tries to determine whether there is a right size for the board of directors of a bank and if the size has an impact in bank performance. In order to find the answer he examines a number of American banks during 1995 and 2002. It was before believed that a limited number of members in the board of directors would increase the efficiency and effectiveness of the board and consequently the bank's performance. The main belief was based on a psychological characteristic of big groups, where usually communication, decision making and coordination of tasks in between more people are done with greater effort. If this is to be true, then Belkhmir argues that empirical investigations should show a negative correlation between the size of the board and banks performance. The study shows though that there were no such findings (that size would have an impact on performance) during the investigations. In addition, he focuses whether board size has been modified after a bank's poor performance. A poor performance doesn't necessarily have an impact on the number of the directors, it is just a new flow of directors because a number of them usually leave the board and new ones join the board.

Similar findings that challenge the common belief that small boards are more efficient and create more performance are the ones of Andres and Vallelado[57]. They advocate that a higher number of directors would benefit during the monitoring and advisory process and it would improve the

[56] Belkhir M., *Board of Directors' size and performance in banking industry*, October 2004. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=604505

[57] http://www.uam.es/personal_pdi/economicas/paalonso/Archivos/AndresVallealdo2008JBF.pdf

governance. Yet, this number gets to a certain threshold where the benefits of better monitoring and advising process are less than the costs brought by a higher number of directors. Coordination, control and decision-making become more difficult above 19 members in the board of directors.

Some other studies made in Nigeria also discovered that enlarging the board of directors until a certain threshold improves bank performance, but if the "efficient limit" is passed, than the performance is being destroyed[58].

Gender diversity

Board composition is an important issue for the proper functioning of a company because it leads to a cocktail of skills that are required to proper manage the companies, skills that cannot be found in just one person or one typology of persons. Directors' different education, experience, profession, gender and ethnic may influence the monitoring and counseling functions that directors have and consequently have an impact on shareholder value[59]. The multitude of skills that a bank's board requires asks for an analysis of the benefits and costs of diversity. A lot of studies and steps forward have been taken in the assessment of non-financial firms, but those findings cannot be generalized to the banking sector which covers different functions of great interest for the society as the other sectors.

Gulamhussen and Santos[60] have summarized what are the benefits and costs of gender diversity that need to be taken into consideration. The benefits are:

- "ability to tap into dissimilar networks and connections"(Granovetter[61] 1973)
- "out-of-the-group thinking on problems and solutions" (Watson, Kumar and Michaelson[62] 1993)

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[58] Kama U., Chuku C., *The Corporate Governance of Banks in Nigeria: how effective are the boards of directors*, 2009. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1350735

[59] Gulamhussen M., A., Santa S., F., *Women in bank boardrooms and their influence on performance and risk-taking,* Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615663

[60] Gulamhussen M.A., Santos S.M., *Women in Bank Boardrooms and their influence on Performance and Risk-taking,* Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615663

[61] Granovetter, M. *The strength of weak ties*, American Journal of Sociology 78 (6), 1973, pp.1360-1380

- "Availability to participate in various governance committees and regular attendance of meetings" (Adam and Ferreira[63], 2009)

On the other hand, the costs that must be taken into consideration are:

- "conflicts emerging from divergent perspectives" (Gratton, Voigt and Erickson[64], 2007)
- "lack of cooperation" (Slaiken and Hasson[65], 1998)
- "noise in communication" (Lau and Murnighan[66], 1998)

There is a phenomenon called *the reduced pool of woman candidate* that was placed into light by Cabo, Gimeno and Nieto[67]. In their paper about women discrimination for the board positions they highlight the reasons for the low representation of women in the European countries. First explanation would be that men and women are different and this leads to different professional profiles and the candidate profiles are usually matching better a male profile, hence just a few women will fit the profile and they will be excluded from the pool of potential candidates. Secondly, there appears a "taste-based discrimination" which implies that women will be disconsidered for a position in the board of directors because the other members might consider that there are different kind of costs (like psychic costs) for the male representatives to work with women, hence they decide to stick to the men formula, and in case of needed extra skills just to appeal to external services (Becker concept, 1957). Thirdly, there is a "statistical discrimination" when women are considered part of a group of biased characteristics and not individuals with personal characteristics[68].

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[62] Watson, W. E., Kumar, K., Michaelsen, L. K., *Cultural diversity's impact on interaction process and performance: Comparing homogenous and diverse task groups*, Academy of Management Journal 36 (3), 1993, pp. 590-602.
[63] Adams, R., Ferreira, D., *Women in the boardroom and their impact on governance and performance*, Journal of Financial Economics 94 (2), 2009. Pp. 291–309
[64] Gratton, L., Voigt, A., Erickson, T. J., *Bridging faultines in diverse teams*, MIT Sloan Management Review 48 (4),2009, pp.22-29.
[65] Slaikeu, K. A., Hasson, R. H., *Controlling the Costs of Conflict: How to Design a System for Your Organization*, San Francisco: Jossey-Bass, 1998.
[66] Lau, D. C. and Murnighan, I. K., *Demographic diversity and faultiness: The compositional dynamics of organizational groups*. 1998, Academy of Management Review 23 (2), 325-040.
[67] Cabo R.M., Gimeo R., Nieto M, *Gender Diversity on European Banks' Board of Directors: Traces of Discrimination*, Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362593
[68] *Idem*

In 2011 the European Union through its Commission proposed new regulation[69] regarding the way of improving gender balance among non-executive directors of listed companies. It has been noticed at European level that there is an under-utilization of the skills that qualified women posses and an attitude that is called the *glass ceiling* and it is described through the reluctance to appoint female representatives in board positions because of the male-dominated business culture and lack of transparency in board appointment process[70]. It is considered that a predominance of male representation creates the likelihood of a narrow group thinking, which means less diverse views, ideas and values that come together and therefore there will be less incentive to debate and face new challenges during the board meetings.

The purpose of European Directive is to rise the percentage of female representation up to 40% for the non-executive director positions in the companies that are listed on the stock market, which is also the case for some of the banks. Yet, this might not be the best solution for financial firms.

There have been made different researches that not always prove the same thing.

Gulamhussen and Santos[71] study on 461 large banks from the OECD countries found that the participation of female representatives has a positive effect on the return of equity, the return on assets and the operating income ratio and a negative influence on risk-taking.

Pathan and Faff[72] that did a study on 212 large US BHCs between 1997 and 2011 left from the perception that female directors are perceived to create firm value because of their personal skills of being hard-working and having better communication skills which helps in decision-making and problems solving. Yet, the research has shown that before the SOX Act gender diversity did have a positive impact on bank performance, but after it has started to decline and now, starting with the financial crisis it shows a more negative impact on bank performance.

A higher number of women representatives would also benefit in the proposed communication channel with the shareholders. They would be more willing to accept more tasks because they

[69] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0614:FIN:en:PDF
[70] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0614:FIN:en:PDF
[71] Gulamhussen M.A., Santos S.M., *Women in Bank Boardrooms and their influence on Performance and Risk-taking,* available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615663
[72] Pathan S., Faff R., *Does the Board Structure in Banks really affect their Performance?*, Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1979297

have shown to be hard working and in addition, they possess good communication skills. Women tend to like talking and usually have the needed patience for explanations.

The downside might be the biased perception of the shareholders that might not trust or might not want to communicate with females.

As a conclusion, used in a balanced formula gender diversity helps improving corporate governance, they should be preferred by the depositors and other stakeholders because of their not so risky behavior and would help in implementing the communication channel.

Remuneration

Remuneration is an important factor in mitigating agency costs and hence heading towards good corporate governance. The compensation amount must be properly design to attract and retain qualified professionals with proper knowledge to monitor and to advise the company. In addition, it has to motivate powerful enough the directors to act solely in the interest of the owners and stakeholders. The compensation has to be well design and high enough to cover not only the time spent on board, but also the risks that such a position might bring. It is important to keep in mind that the directors also bring in reputational risk[73].

This study[74] takes into consideration the agent-principal problems and observes that directors with just a fix salary will be less incentivized as a director to take risks and to better monitor the executives since he has a more or less fixed compensation. If a hired manager receives stake ownership or stock options the interests of the director and the shareholders will be more aligned. In addition, it is shown that if a manager or director has its wealth concentrated in the shares of a limited numbers of companies, he will be more incentivized to proper monitor and to take less risks rather than a director with dispersed wealth who might show risky behavior.

[73] Larcker D, Tayan B., *Corporate Governance Matters: A closer look at organizational choices and their consequences*, April 2011, p. 106

[74] Spong K, Sullivan R, *Corporate Governance and Bank Performance*, August 2007. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1011068

Therefore, having stock in the company where the individual plays the role of a director makes him more willing to take risks and get higher returns, but if all the wealth of that director is in the same company, the effect might be the opposite.

If a new role would have to be implemented for the board of directors or for at least one nominated spokesperson, it requires extra amount of time spent that would probably not allow the participation on other boards of directors or to some other positions.

Independence

Board independence is one of the requests for good corporate governance. It implies that the board's members show independence which means that they are free from conflicts of interest that may influence them to not act solely in the interest of the company; the directors have to be able to take positions in opposition to the management. Regulation, such as the Sarbanes-Oxley Act and requirements of the stock exchanges provide rules that require a majority of independent directors.

True independence is yet not necessarily what regulation provides. Psychological independence is hard to define, but it is important to keep in mind that even a non-related independent board member that have worked for several years with the management may become biased and he will not maintain his truly independence. In order to get a fully picture about an individual's independence one has to look at its background, education, experience, values and personal relation to the management[75].

It is widely believed that board independence is important because of the need of good monitors for the managers. But there is a problem in attracting independent directors into a board since

[75] Larcker D, Tayan B., *Corporate Governance Matters: A closer look at organizational choices and their consequences*, April 2011, p. 70

there is a great reputational risk and in the case of banks, the intense regulation and the high penalties can discourage qualified directors from wanting to join such a board[76].

One other aspect that should be taken into consideration when assessing how independent a bank's board should be is that there might be banks where there is a very high information asymmetry and where more inside directors that have the firm-specific information might be serving better the purposes of the board than an independent outside director[77].

A study that Kama and Chuku made brings into discussion that in order to raise performance, having an independent board in the sense of a high number of outside directors is not sufficient. It is more important that the members posses the proper knowledge, incentives and abilities, in other words they fit the job position, in order to monitor, discipline and give advice to the managers[78].

Yet, although there is no certain evidence that there is a positive relationship between concentration of outside directors and board performance most of the non-binding codes of good corporate governance practice suggests increasing the number of non-executive directors[79].

For the position of spokesperson an inside director would not be an obstacle.

Combined position of CEO and Chairman

It has been argued both for financial and non-financial firms if the position of CEO should be combined or split from the position of Chairman. This would make perfect sense since the role of the chairman is to monitor the CEO on the behalf of the shareholders; the first one runs the board of directors and the second one runs the company. But as in the overall situation, one size doesn't fit all and both models of combined or separated positions can be used successfully. It has been noticed that usually the banks that have problems have a too strong CEO and a board of

[76] Pathan Shams, Faff Robert, *Does the Board Structure in Banks really affect their Performance?*, Journal of Banking and Finance, Forthcoming, 2012. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1979297
[77] Fama E.F., Jensen M.S., *Separation of ownership and control*, Journal of Law and Economics no. 26, pp. 301-325
[78] Harris, M., & Raviv, A., *A Theory of Board Control and Size*, Review of Financial Studies, In press.
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directors that is too weak[80]. In this case the separation between positions would be advisable, but not indispensable.

Yet, splitting the two positions doesn't ensure good results, since there are banks that took this measure and failed to recover on their own and it is also argued that the separation might even be destructive especially if the relationship between the CEO and the Chairman is bad or adversial[81]. In addition, splitting the positions may cause to fade the responsibility lines.

Other studies have discovered that the time that such positions require is of such a great amount that it cannot be summed. A chairman of a financial firm is around a third of its total and a CEO covers the whole time a person might have[82].

One more situation that needs to be taken into account is that studies have shown that financial industry expertise of the chairman of the board is positively related to bank performance.

Board Committees

Not all the matters of the firm are discussed and deliberated by all the members of the board of directors, but some of them are delegated to committees. These committees can be standing or especially established for some matters, but some of them are of a huge important for good banking corporate governance.

One of the biggest threats of banking corporate governance is excessive risk taking. In accordance with agency theory shareholders and managers are incentivized to have different risk preferences: shareholders tend to be risk-neutral, while managers risk-averse. This may lead to situations where managers reject profitable, but risky projects that would satisfy shareholders appetite for risks and profits[83]. Shareholders prefer excessive risk taking due to the moral hazard problem of limited liability[84] and maybe also because of the safety feeling of too big to fall conception. On the other hand, some advocate that stakeholders are more important in banks

[80] Wllian I., *Split Chairman and CEO roles? It depends*, Available at: http://www.americanbanker.com/bankthink/split-chairman-and-ceo-roles-it-depends-1059136-1.html

[81] *Ibidem*

[82] Goodman A., *Should banks keep combined the role of CEO with Chirman?,* Available at: http://www.ft.com/intl/cms/s/0/fb849930-b251-11e2-8540-00144feabdc0.html#axzz2WV5ALPZG

[83] Hutchison M, Ngoc T.B., *Corporate Governance and Risk Management: The Role of Risk Management and Compensation Committees*, 2012, Financial Markets and Corporate Governance Conference. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1979895

[84] Jensen M.C., Meckling W.H., *Theory of the Firm: Managerial behavior, agency costs and ownership structure*, Journal of Financial Economics, 1976, pp.831-880;

than shareholders and that risky actions taken in one bank may produce cascading affects that would drawn much more other financial firms[85]. Consequently, a lot of importance must be given to monitoring excessive risk taking.

These responsibilities are given mostly to the risk management committee and the compensation committee.

It has been shown a positive association between risk and the structure of the risk management and compensation committee[86]. Risk committee has the role to monitor the level of risk the company faces and in the same time to think about the wish of the shareholders that want high profits. Compensation committee develops different practices that are intended to create efficient incentive in the form of compensation in order for the directors to take the risks that the shareholders would tolerate[87].

In order to have a high performance of the company there is a need of good corporate governance. For good corporate governance of banks there is a need of a well designed board of directors that has its own committees. Yet, there is the signaling theory[88] that puts into light the general belief that it is good to disclose good and expected corporate governance practices in order to create a good image for the company. Being known that fact, companies might want to disclose positive information and therefore to create the signals that the market needs, but this doesn't mean that these committees will achieve their purposes. Consequently, it is not enough to have those committees, but it is important how they are designed[89].

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[85] Gordon J, *Executive compensation and corporate governance in financial firms: the case for convertible equity-based pay*, Columbia Law and Economics Working Paper no. 373, 2010. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633906

[86] Hutchison M, Ngoc T.B., *Corporate Governance and Risk Management: The Role of Risk Management and Compensation Committees*, 2012, Financial Markets and Corporate Governance Conference. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1979895

[87] *Idem*

[88] Certo S.T., *Influencing initial public offering investors with prestige: signaling with board structures*, Academy of Management Review, 2003, pp. 432-446

[89] Menon K.,Williams D.J., *The use of audit committees for monitoring*, The Journal of Accounting and Public Policy no 13, 1994, pp. 121-139; Akhigbe A.,Martin A.D., *Valuation impact of Sarbanes-Oxley: Evidence from disclosure and governance within the financial services industry*, Journal of Banking and Finance no 30,2006, pp. 989-1006.

Since both risk management committee and compensation committee are covering the monitoring function, these committees should have the same characteristics as the audit committee for good governance[90]:

- The members should be independent from the management (outside directors)
- The members of these committees need to have business expertise so they will be able to properly take part in the monitoring process (they need good financial expertise, judgment and ability to raise questions and challenge the management)
- The members need to have sufficient time to spend on both the board matters and the committee matters
- The committees need to have an appropriate size with sufficient opinions

Number of directorships

Since bank's structure and activities are highly complex they necessitate serious amount of time invested on behalf of the directors for improving performance. In order to increase the efficiency of the board, different organizations or companies imposed or recommended a limited number of directorships. Such mandatory rules can be found at the *New York Stock Exchange* and recommendations in the *National Association of Corporate Governance*, *The British Code of Governance*.

Several studies have been done on the effect of interlocking directorates for non-financial companies, but their conclusions can be applied in our study as well. The complexity of structure and activities of the banking sector asks for even more attention and time from its directors.

A study made by Guerra and Santos[91] comes to few conclusions about the effect and consequences of busy boards. By busy boards one must understand boards where their members are involved in more than one boards of directors. They tend to show a much passive attitude towards board activities and less performance.

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[90] Xie B., Davidson W.N., DaDalt P.J., *earning management and corporate governance: the role of the board and audit committee*, Journal of Corporate Finance no. 9, 2003, pp. 295-316

[91] Guerra S., Santos R.L., *Busy Boards: How does the simultaneous participation of directors in multiple companies affect the Boards' activities?*, Corporate board: Role, duties and composition, Vol. 8 2012, pp. 69-79, Available at: http://bettergovernance.com.br/Uploads/Docs/AR24082012-68439.pdf

- Directors that occupy more director positions in different boards of directors are less engaged in hiring and firing the chief executive officer;
- Busy directors are not that willing to approve the hiring or dismissing of the executives which leads more power to the CEO, who might take those decisions alone;
- Busy directors are not so good evaluators and monitors of the company's executives;
- Busy directors are less willing to actively engage in guiding the succession of key executives;
- Busy directors do not get too involved in the elaboration or approval of the code of conduct;
- Show a passive attitude in important matters such as acquisitions, capital structuring or dividends payouts;
- They are less prone to observe the possible relationships between the executives and related parties;
- Are prone to skip observing the company's risk.

Critics and suggestions

The board of directors is designed in such a manner and with such attributions that it can happen that they won't devote themselves with the maximum diligence to their work.

The discussed literature has pointed out that sometimes the size of the board is not suitable for the specific bank, then a too high number of directors might create communication problems, but also it might dissolve the responsibility each director has. On the other hand, a reduced number of directors will also have a reduced number of opinions and their background and knowledge might be a bit more limited than in a large board of directors.

Author considers that a right number of directors can be assessed through internal investigations, where the size and characteristics of banks are taken into account, and also the creation of psychological and experience profiles that are needed for the candidates in the board of directors. This way there will be a possibility to limit the entrance of more directors than needed with the same knowledge and abilities, all the needs will be covered and the number of members won't be too high. In other words, more attention should be paid for the recruitment policies of the banks, which should be individually made for each firm.

After the recruitment of the directors, the non-executive and independent directors should participate in trainings where the structure of the organization is explained. There have been cases where the directors had not a proper financial expertise and education to understand the complexity of the banks and have failed to be able to proper monitor.

For a director to properly fulfill its advising and monitoring function, he needs first to be able to spot the mistakes that are being made or the risks that the bank faces. In order to observe them, he needs to be properly trained, either through trainings provided by the bank, or to have banking expertise, most advisable as a former manager. A good knowledge of the organization structure would also benefit for the speed of doing tasks.

The Board of directors should also have a good communication channel with the banks stakeholders. Since the banks activities are such complex and opaque, it is difficult for the outsiders to understand if there are any risks that the company is facing. People, especially individuals like some of the shareholders and depositors don't have the needed knowledge to understand or to trust disclosure statements that the banks give to the public. But it is in human nature to trust other people that are in the position to guard your interests. This is a why improvements in communication should be made and non-executive directors, among the management should participate in the reports given to the stakeholders.

If depositors, one category of stakeholders, would have the possibility to discuss the financial statements and risky environments of the bank with the board of directors, some individuals that they trust and are suppose to be acting in the interests of the shareholders, but also other stakeholders, especially in a bank oriented system, than the risk of a bank run would decrease. Depositors could have the right information and decide not based on rumors, but on actual facts if they should withdraw their deposits from the banks.

Other stakeholders that would benefit from a possible communication channel with the board of directors are the several authorities, such as supervisory or insurance authorities. A better communication would signal possible risks that might happen and the stakeholders need to know about in order to take measures.

By increasing the boards of directors responsibilities with the communication task, the independent directors will have to pay more often attention on the monitoring action on the management, so they can be well prepared with the information.

Gender diversity is also a lately very discussed problematic, which the author doesn't consider to be of such an importance as other aspects of the corporate governance. It is not contestable that a diversity of thoughts and opinions and communication skills would improve the decision-making environment, but as mentioned before, it is highly important for the directors to have financial expertise and knowledge. Usually the directors are chosen from individuals that have worked as executive managers before. The promotions in the management take time and it is often seen that women don't climb as high as men in the hierarchical scale, so just a few of them have good knowledge of all the banking activities and products. It is therefore understandable why not so many women join the boards of directors, especially in banks. Yet, the ones that have such a position might present manly traits, are very hard working and although they posses good communication skills, they are reversed professionals.

The independence of the board of directors must be taken into account together with the equity structures of the banks, the remuneration of the members and the need of banking knowledge. As mentioned in the last chapter, there are situations where there is a high level of information asymmetry and where an inside director might be better prepared to cover the responsibilities of the board of directors. Yet, independence is highly required for trusting the board's decisions. Therefore trainings should be made for the outside directors and private meeting with those before they took the positions and also with the inside directors to exchange information. This way the lack of extra-knowledge will be covered and more independent directors can be brought without diminishing the monitoring and advising functions of the board.

Conclusions

This paper provides some guidelines of good corporate governance, in particular about the board of directors. It shows that the specific characteristics of banks make them be seen from a different perspective than non-financial firms, which requires some differences in the corporate governance practices.

For most of the banks there aren't enough signals for the shareholders to tell them how the company is being run. There is a necessity of a mechanism, other than dividends and share prices to report to the shareholders the quality of the management. For this reason boards of directors are considered as being highly important. To overcome the downsides of the opaqueness and complexity of the banking industry, the shareholders must design and trust the board of directors.

This paper suggests that the guidelines for good corporate governance of banks should be divided for banks categories because one size doesn't fit all and just one model design of good corporate governance may create misunderstandings among all types of bank categories.

A need of equilibrium is required for the design of board of directors in a financial firm. There is no definitive rule for what size a board may have, what committees, how diverse or how independent is has to be and it depends on the size and type of bank.

Gender diversity brings both benefits and costs and we advocate the idea that each bank typology must assess in their case if the costs overcome the benefits or the other way around. Regardless of that assessment, women must be seen as particular individuals, not parts of a group with biased characteristics, and the focus should be more on their knowledge, expertise and personal soft skills. Lack of diversity on boards also arises from the strict profile that is being used when selecting members for the board of directors.

Author advises to keep a concentrated structure of ownership to incentivize monitoring and to make it easier to design good remuneration schemes for the directors which need to have stake ownership or stock options in order to their interests to be aligned with the shareholders', but their personal wealth must not be entirely connected to the shares, otherwise they will be more passive in risk taking.

Although independence is recommended by most of the codes of good corporate governance, the specifics of the banks, its complex nature, switches the focus from independence to knowledge and abilities. These features are also suggested when assessing the composition of the different committees that a board might have. In addition, author recommends the dual membership of risk management committee and compensation committee.

Number of directorships and also combination of functions of CEO and Chairman must be taken into consideration regarding the impossible physical number of hours that the individuals need to spend and that it comes to passivity in at least one of the boards/committees.

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