Corporate Governance of Banks & the Financial Crisis

The story about excessive risk-taking and sky-high remuneration

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Abstract

This paper elaborates on the corporate governance of banks and its role in the recent financial crisis. While banks’ corporate governance nowadays is largely focused on the interests of shareholders, this paper investigates whether banks’ corporate governance should not be more oriented to the interests of the several other stakeholders that banks have. It starts by elaborating on the differences between banks and non-financial companies. These differences might give rise to specific corporate governance problems, for example the moral hazard problem which is present in banks due to their structure and the high degree of possible governmental intervention. Then, the specific role of the corporate governance of banks (more specifically, the incentivizing remuneration schemes and the excessive risk-taking) in the recent financial crisis is elaborated upon. Thereafter, a critical review of certain post-crisis proposals (e.g. say-on-pay-regulations) is given. Finally, this paper proposes certain bank-specific changes for their corporate governance which implement the interests of all stakeholders and which try to reduce the level of risk-taking to a level which is socially optimal for all stakeholders.

Key words: corporate governance, banks, executive remuneration, risk-taking and financial crisis.
Preface

Writing a master thesis is a last step in the academic career of most students. Although it is an important and interesting step, it is never an easy one. This thesis has been a search through academic papers, national and international regulations, regulatory proposals, newspaper articles, etc.. Some of these documents were colored by the authors’ preferences, others were tinted with finance formulas. Understanding these documents and creating an objective picture of the corporate governance of banks was not an easy but obviously necessary task. During my research, I have perceived with great interest the influence of the psychology of incentives (and money) on the actions of executives and the subsequent actions of the regulators. It has been an interesting and instructive walk through finance, economics, corporate governance and most importantly law.

This work could obviously not be accomplished without the support of certain specific and important people. First of all, I would like to thank my promoter, Mrs. Jing Li. I am grateful to her for providing me with several ideas on how to elaborate on certain specific parts of my thesis. In addition, I also want to thank her for her very fast answers to mails and for reading every single chapter of my thesis and providing me with her considerations and ideas. Secondly, I would like to thank the whole IBL-team for a very challenging year. The practical and theoretical knowledge I have gained during this year will be very valuable for my later legal career. Thirdly, I would like to thank my fellow students and all other people with whom I had the opportunity to exchange views on the corporate governance of banks. I also would like to thank all people who have read my thesis and provided me with their ideas and considerations. Finally and most importantly, I would like to thank my parents and family for their financial and mental support. Without their help and support, this work would probably never have been established.

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I. Introduction

Since the recent financial crisis of 2008-2009, no firms have been studied more than the financial institutions have been. Every element that could have caused or influenced the financial crisis has been examined. The results were often mixed. Also the corporate governance of banks was an important subject of scrutiny. Obviously, this corporate governance has played a role in the recent crisis. The question however is, to what extent the corporate governance has played a role in the financial crisis. When I, personally, think of the role of corporate governance in the crisis, it reminds me of an important saying in rugby: “forwards decide whether you win or lose the game, backs decide by how much”. The similarity between this rugby-saying and the role of corporate governance in the crisis can be found in the following. It were the macro-economic elements (‘forwards’) that created the crisis but it was the corporate governance of banks (‘backs’) that decided on the amplitude of the crisis. Several corporate governance elements can be identified as having an aggravating effect on the financial sector during the crisis. This paper mainly focuses on the monetary incentives for executives that incentivized them to take excessive and irresponsible risks.

Excessive risk-taking has obviously played an important role in the recent crisis. It were the executives themselves that preferred excessive levels of risk. These levels were obviously higher than the bank could handle. This can best be underpinned by the famous quote of Chuck Prince¹ regarding the exposure of Citibank to subprime mortgages. He told the Financial Times in an interview in July 2007 the following: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing”.² The quote of Chuck Prince proves that Citibank was not backing away from high risk activities. This was probably also the case in many other banks.

The high leverage position of banks and the large governmental interventions severely aggravated the moral hazard problem within banks. Therefore the shareholders preferred an excessive high level of risk-taking. These shareholders then incentivized executives to implement this high level of risk. This level was certainly not a level which was optimal for all stakeholders and ultimately for society. Actually it was a level of risk-taking which was only optimal for shareholders. Since corporate governance was largely oriented to the interests of shareholders, this excessive risk-taking could just carry on. Therefore, this paper advocates a system of corporate governance which is more oriented

¹ Former CEO and chairman of Citibank
to the preferences of all stakeholders (creditors, depositors, debtors, government, taxpayers, shareholders, staff, etc.)

Each turmoil arouses the legislators to act. This was not different in this case. To justify the large expenditures of tax money for bailing out banks, regulators created new rules for banks. However, the question is whether these corporate governance changes are able to tackle the main problems which actually have created the crisis (the excessive risk-taking and over-incentivizing remuneration schemes). Most proposals try to align the interests of the executives with those of the shareholders. Since the shareholders themselves also prefer an excessive high level of risk-taking, these proposals are unlikely to significantly reduce the level of risk-taking and to implement the interests of other stakeholders than shareholders.

Because banks differ fundamentally from non-financial companies and because banks are confronted with some specific corporate governance problems, they actually require a different approach in terms of corporate governance. Banks are of huge systemic importance (especially big banks) and have far more stakeholders than other companies. When creating a corporate governance system for banks, the regulator should take all these elements into account. Therefore a specific corporate governance regulation for banks is necessary.

The rest of this paper is organized as follows. The next chapter starts with an introduction of corporate governance in general. Then, the main differences between banks and non-financial firms, and the consequences of these differences for the corporate governance of banks are elaborated. In the third chapter, this paper will investigate the specific role of the corporate governance of banks in the crisis. In the fourth chapter, this paper will give a critical review of certain post-crisis regulatory proposals. It will investigate whether these proposals are able to tackle the main corporate governance problems in banks. In a fifth chapter, this paper will propose certain measures who are able to tackle these main corporate governance problems in banks. Finally, in the last chapter, this paper will provide my concluding remarks.

II. Corporate governance

1. General

An important concern in the governance of a company is to create a structure which makes (hired) managers maximize the value of the firm and work in the best interest of the company. Nevertheless, managers often have other incentives than shareholders (e.g. job security, reputation, etc.).
Therefore they will not always be motivated to maximize the firm-value and rather pursue their own interest and work on a sub-optimal level. Hired, non-incentivized managers mostly have an aversion for taking risks because they will not be rewarded for possible good outcomes, while they will be punished for bad outcomes (reputation, job security, etc.). This problem is known as the principle-agent problem and was already addressed by JENSEN and MECKLING\(^3\) in 1979. If one wants to solve this problem, one should try to align the interests of the managers with those of the shareholders by incentivizing the managers to take risks. Various corporate governance mechanisms might help to solve these incentive problems by aligning the interests of the various interested parties.\(^4\)

However, as will appear from this text, it seems that we are now confronted with the opposite problem. Nowadays, managers might be over-incentivized which makes them take excessive risk. In this case as well, corporate governance might offer several solutions. In the case where managers are over-incentivized, the purpose of corporate governance might not be to create incentives but rather to control incentives. However, as the recent financial crisis has shown, corporate governance mechanisms might sometimes fail to control incentives and avoid excessive risk-taking. The failure and weaknesses of certain corporate governance mechanisms contributed to the recent financial since these mechanisms were unable to safeguard from excessive risk-taking.\(^5\)

An interesting and simple starting point to define corporate governance is the definition of the Cadbury Commission\(^6\): “Corporate governance is the system by which companies are directed and controlled”. Later literature defined corporate governance as “a complex set of constraints that shape the ex post bargaining over the quasi rents generated by the firm”\(^7\) or “every device, institution or mechanism that exercises power over decision-making within a firm”\(^8\). These straight-forward definitions cover corporate governance in an objective and unbiased way. Every more specific definition would implement own ideas and views on corporate governance.

A more specific definition can be found in the OECD principles. Here, corporate governance is defined as follows: “Corporate governance involves a set of relationships between a company, its


management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring”. It should be clear that this definition is more biased and that the OECD implements its own views on corporate governance. With this definition, the OECD implements a new approach to corporate governance, namely the ‘stakeholder-oriented’ approach. This means that the OECD not only takes the interests of the shareholders into account, but the interests of the other stakeholders (creditors, debtors, depositors, government, taxpayer, etc.) as well. More specifically within banking corporate governance, the Basel committee and the European Union favour the more stakeholder-oriented approach as well. This approach is different from the shareholder-oriented approach. In the latter approach, governance should not serve the interests of all stakeholders (depositors, creditors, shareholders, state,...) but only the interests of the shareholders. When one observes the post-crisis proposals for better corporate governance of banks, one can perceive two groups. One group advocates the shareholder-oriented approach (Walker Report) while another group advocates the more stakeholder-oriented approach (European Union, the Basel Committee and OECD). It should be clear that when someone defines corporate governance in a particular way, it immediately shows his preferred approach to corporate governance.

2. Banks, the odd ones out

a. Odd?

So far this paper has mainly focussed on corporate governance in general. Now, it will turn to the specific corporate governance particularities and problems of banks. But before elaborating banks’ corporate governance, the main differences between banks and non-financial companies will be

explained. As it will become clear when corporate governance of banks will be elaborated, the differences between banks and non-financial firms will lead to specific problems in the governance of banks. Therefore, this paper argues that due to large differences between banks and non-financial companies, banks might require a different approach to corporate governance.

The first major difference between banks and non-financial firms is the high degree of specific banking regulation. Banks are subject to special regulation and supervision by national banking supervisors. Most regulators also restrict certain practices, such as the concentration of ownership or the ability for outsiders to purchase a substantial part of the banks' shares. Moreover, the appointment of management is in certain jurisdictions also subject to restrictions (e.g. 'the fit and proper-test'). Therefore there is a lower threat for managers to lose their job. The lower deterrent effect leads to the necessity for more incentives to ensure better performance by managers. This results in frequently outrageous incentivizing remuneration schemes. Because of these restrictions, also the market for corporate control is clearly disturbed.\(^\text{14}\) Related to the high degree of specific banking regulation, one could also point to the huge degree of governmental intervention. During the crisis a lot of banks were bailed out by the government. But also the deposit guarantee schemes are a sort of governmental intervention. Both of these governmental interventions, i.e. bailing out of banks by the governments and deposit guarantee schemes, will clearly impede the incentives of bank managers. These misaligned incentives may lead to a severe moral hazard problem in banks. This moral hazard problem will be elaborated upon later.\(^\text{15}\)

The second element where banks deviate from non-financial firms is the high level of leverage. Banks consist of more than 90% debt while non-financial firms normally consist of only 40% debt.\(^\text{16}\) This huge difference exists because leverage has a different function in banking than it has in non-financial firms. In non financial firms debt has a financing function while in banks debt is a factor of production (cf. Liquidity production function). In a normal system, debt is almost equally expensive as equity. However, in the banking sector this balance is clearly disturbed by the deposit guarantee schemes. Because depositors have access to these schemes they do not have the same risk as creditors of non-financial firms. Therefore debt will usually be much cheaper than equity for banks. An additional consequence of these deposit guarantee schemes is the seriously decreased incentive

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\(^{15}\) See part II b.

for depositors to monitor. Because their interests are already clearly protected by the deposit guarantee schemes, they will not benefit from the extra monitoring. The high percentage of leverage also means that the creditors (of whom the most important are the depositors) are a considerable stakeholder of the bank. Therefore their interests should also be taken into account.¹⁷

The third element where banks differentiate is their liquidity producing function. This function is based on the voluntarily acceptance of a maturity mismatch between assets and liabilities. The main liabilities of banks are deposits. These are available on simple demand by the depositor. Meanwhile, the assets of the company consist mainly of loans, which obviously have a longer maturity date. This maturity mismatch makes banks especially vulnerable to liquidity shocks which may eventually cause a collective-action problem. Namely, depositors can never ask repayment at the same time because the bank will simply not have sufficient funds to repay all the depositors at the same time. This collective action problem will especially occur in case of a bank-run. If depositors hear or think that there could occur problems within the bank, they will all ask repayment by the bank. Although (rational) depositors know that it is better to collectively refrain from withdrawing their money, they will choose the safe solution and ask for the repayment. That is mainly because a single depositor has no certainty concerning the actions of other depositors. This is a classic example of the prisoner’s dilemma. These bank-runs especially occur in times of financial crisis. This maturity mismatch also creates the likelihood that failures can even occur in the case of a solvent bank. This was what happened in the case of the French-Belgian bank Dexia, which had to be bailed out during the crisis. Although Dexia had a high solvency ratio, it got into trouble. These troubles were mainly owed to the serious uncontrolled maturity mismatch which created a large funding gap. Because of the dried up liquidity sources during the financial crisis, Dexia was also unable to refinance itself. This event proves that even solvent banks can get into trouble. Other examples are Northern Rock, Lehman Brothers and Merrill Lynch. Where the first one was an example of a bank-run of small depositors, the latter two were the result of a bank-run by other banks in the inter-bank market. In case of a bank-run by small depositors, deposit guarantee schemes might put a break on the withdrawing by depositors. These schemes might bring certainty for depositors (for their deposits under 100,000

EUR\textsuperscript{18}. However, as we have seen in the recent developments in Europe (cf. Cyprus), the deposits under 100,000 EUR might not be as safe as one thought.\textsuperscript{19}

The fourth specificity of banks is the opaqueness and complexity of their activities and balance sheets. Bank assets differ greatly from assets of non-financial companies. Non-financial companies mostly have physical assets (e.g. buildings, etc.). While bank assets consist of bank loans and other peculiar assets (e.g. credit default swaps, collateralized debt obligations, asset-backed securities, etc.). It is clear that the bank assets are much more opaque than the assets of non-financial firms assets. Certain academics have proven that bank assets are remarkably more opaque than assets of non financial firms. For example, MORGAN (2002)\textsuperscript{20} shows that rating agencies substantially disagree more about the rating of bonds issued by banks then about bonds issued by non-financial firms. IANOTTA (2004)\textsuperscript{21} comes to the same conclusion as well. This opaqueness has some direct consequences for the corporate governance. Due to the opaqueness, the monitoring function of the board of directors becomes much more difficult. To clearly understand and monitor the inner working of the bank, directors, and especially independent directors, need a good understanding of the financial market.\textsuperscript{22}

The fifth specific element where banks seriously differ from non-financial companies are the large portfolios of securities and derivatives that banks hold which are subject to the curves of the financial market. Together with the opaqueness of banks’ balance sheets, these large portfolios of sensitive assets make that the banks’ exposure to risk can increase dramatically in the short term.

\begin{thebibliography}{99}
\end{thebibliography}
But it also means that banks’ management can easily alter their risk profile whenever they want. Securitization leaves the possibility to the management to change long-term debt into tradable assets. The proceeds from these assets can be used to make more risky investments. This technique might be profitable for management, whose remuneration is based on the (short-term) performance of the bank but might pose a serious risk for other stakeholders of the bank. Again, it will be the quality of the board and their understanding of the financial markets that will play a key-role in the monitoring function of the boards.23

The sixth specific element of banks is the ‘interconnectedness’ of banks. Banks do a considerable part of their transactions with other banks. The consequence of this is that problems at one bank will spread much faster to other banks (e.g. Lehman Brothers) than in the non-financial industry. This interconnectedness creates a huge systemic risk within banking.24

The seventh element which has to be pointed out is the systemic importance of banks. This element is clearly explained by MEHRAN et al (2012)25 who describes banks as follows: “Banks are strange beasts. Much like electrical utilities or railroads, they are private-sector firms whose healthy functioning is in the public interest”. Banks cannot only be value-maximizing entities but they also have to serve the public interest. Therefore a good balance between the ‘safety and soundness of banks’ and the ‘innovation and improvement in the financial system’ has to be found.26

A last and maybe the most important element is the huge number of stakeholders within banks. Banks have far more stakeholders (shareholders, creditors, depositors, holders of subordinated debt, government, taxpayers, etc.) than non-financial firms. These stakeholders are also larger then in non-financial firms (e.g. debt holders: 90% of the banks’ balance sheet is debt). This element is important to choose whether one would choose for a shareholder-oriented or more stakeholder-oriented corporate governance approach. This decision is of great importance since all of these stakeholders

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have separate interests, which might have to be taken into account. For example, while creditors are better served with less risk-taking, we see that shareholders sometimes have no incentive to reduce risk-taking and therefore prefer high-risk investments. It is the role of corporate governance to choose whose interests has to be represented by the board and to what extent this interest has to be taken into account.

b. Corporate governance of banks

Banks are confronted with some specific corporate governance problems due to the above mentioned differences. It is not surprising that the agency problems within banks are more severe than in non-financial companies. Namely, because some incentives in the governance of banks are seriously misaligned. In this chapter, I will elaborate on several corporate governance problems which clearly indicate that there is need for a separate development of the corporate governance of banks.

A first specific corporate governance problem exists due to the high leverage of banks. JENSEN AND MECKLING already showed that agency costs are associated with the height of the debt within the firm. They stated that the higher the debt issued by the firm, the higher the incentives for managers to act opportunistically and engage in risky behaviour. This moral hazard situation is also clearly present in banks since these institutions have a remarkable higher debt level than other companies. Therefore bank managers have higher incentives to behave opportunistically. The following example clarifies this:

**Example 1a:** Consider a bank which is financed with € 10 of capital and € 90 of deposits. Shareholders can choose between two transactions, A and B. Transaction A has a 90% chance of a gain of € 2 and a 10% chance of a loss of € 10. Transaction B has a 90% chance of a gain of € 3 and a 10% chance of a loss of € 50. While transaction A has a clear positive expected value, will shareholders probably choose for transaction B because in both cases they will lose the same amount of money (there is only € 10 capital at stake for them) while the gains are higher if transaction B succeeds than if transaction A succeeds. The situation becomes even

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more clear when the € 10 capital is not totally equity but consists of € 8 real equity and € 2 other debt. In that case the shareholders have only € 8 at stake.\textsuperscript{30}

The latter example clearly proves the moral hazard situation in banks. However, this example does not clearly correspond to the reality as it will (almost) never be up to the shareholders to decide which transactions will be executed. It will be the banks’ management that will make these decisions. However, banks’ shareholders will try to align the interests of the management with their own interests. Therefore the remuneration of management will usually consist of a large amount of stock and stock options. By choosing for this composition of remuneration, management will have the same incentives as the shareholders.

Certain characteristics of the banking sector even strengthen this moral hazard problem. A first important aggravating element is the interference of the government by deposit guarantee schemes and government bailouts of banks. These two elements take away every incentive for depositors to monitor. They do not have to be concerned anymore because they are protected by the government against possible failure. The government bailouts will also provide the management with extra incentives to engage in excessive risk-taking as they will know that costs of failure will in most cases be borne by society and not by the bank itself. This means that the excessive profits of higher risk-taking will go entirely to the shareholders and management while the possible extra costs of excessive risk-taking will go to the society (e.g. taxpayers).\textsuperscript{31}

A second aggravating factor is the presence of bank holding companies. This extra layer in the bank structures minimizes the risks for managers severely. The following examples clarify this:

\textbf{Example 1b}: If we take the same asset structure as in example 1a (€ 8 equity, € 2 debt and € 90 deposits). The only difference is that now all the shares of the bank (€ 8) are totally owned by a bank holding company. This bank holding company is financed with € 2 of debt and € 6 of equity. Now, the compensation of the managers consist of stock and/or stock options in the bank holding company. In this case the possible losses for the managers and shareholders


are even smaller because they have only €6 at stake. This will increase the risk-taking
behaviour of bank management even more.\textsuperscript{32}

A third aggravating factor of the moral hazard situation is the grant of stock options. If the
management gets stock options instead of ordinary stock, they will pursue even higher risk-taking
activities as stock options will protect the management even more from the possible downside of
certain risky transactions. The options will capture the possible gains but they will not fully bear the
losses.\textsuperscript{33} This situation will be further elaborated later in this paper.\textsuperscript{34}

A second corporate governance problem occurs due to the specific regulation. Most jurisdictions
implement restrictions (transparency, ‘fit-and-proper-tests’,...) on holders of large blocks of equity of
the bank. For some possible shareholders, these restrictions may have been a deterrence for
becoming a block holder. Since large shareholders have higher incentives to monitor companies
more closely, this will lead to a decreased monitoring by shareholders.\textsuperscript{35}

As can be observed from the foregoing, banks have some unique features. Therefore they also
require a unique treatment. All the aforementioned differences and specific problems clearly show
that certain corporate governance mechanisms (the monitoring of the board, market for corporate
control, etc.) are clearly disturbed within banks. Banks are an interplay of several specific actors –
depositors, shareholders, creditors, directors, regulators, deposit guarantee schemes, taxpayers,
staff, etc.- and all these actors have their own specific interests. Therefore, the interests of all these
actors should be taken into account when making important decisions and not only the interests of
the shareholders. Several mechanisms should come into place to align all these interests in a proper
way. Certain other obstacles should be removed as well to align all these interests. For example, it is
in some cases even illegal for boards to take into account the interests of other stakeholders than
shareholders when making decisions.\textsuperscript{36}

It should be clear that the stakeholder-oriented approach to corporate governance is more
preferable for banks. In the next chapter this paper will first elaborate on the role of corporate
governance during the crisis and especially point out the major flaws within corporate governance. In

\textsuperscript{34} Chapter III, 3.
the fourth chapter, this paper will elaborate on several post-crisis regulatory proposals. And in the fifth chapter, this paper will propose certain bank-specific changes which are able to tackle the major short comings of corporate governance within banks.

III. Corporate governance of banks during the financial crisis: The perfect storm

1. The crisis and corporate governance

The recent financial crisis was an interplay of several circumstances and was certainly not totally and exclusively caused by corporate governance weaknesses. Most people agree that the major cause of the financial crisis was the combination of a credit boom and a housing bubble. From 2002 until 2007 house prices grew at high rate. Banks provided a lot of mortgages to families. Unfortunately, they also started to provide mortgages to people who were unable to pay them back. Therefore these mortgages had a high probability of default and were very risky. Banks started to bundle these risky mortgages through the technique of ‘securitization’. This provided the banks with a good way to take these risky mortgages of the balance sheet and to create profits and liquidity in the short term. These short term profits tend to be highly beneficial for managers whose remuneration is based on the short term performance of the bank. Notwithstanding the high risk, these securitized mortgages obtained triple A ratings. This was largely due to modeling failures and conflicts of interest within the rating agencies and also because these agencies were more interested in the fees they obtained from banks than in financial stability. Even worse was that banks were often provided with the models (on how to structure the securitization) by the rating agencies. When the housing bubble bursts, the underlying securitized mortgages also brought the whole financial market down. An accessory and aggravating element was that the securitization vehicles were not used for which they were made, namely to spread the risks of the subprime mortgages. In this specific case they were only used to circumvent capital requirement regulation by removing these mortgages off the balance sheet.37

However the question remains why the recent financial crisis created so much damage and had the known tremendous consequences. If we observe the crisis as a sort of legal ‘litmus test’ for good corporate governance of banks, one could obviously point a finger to the shortcomings within the corporate governance arrangements of banks. Corporate governance was not serving the purpose which it had to serve, namely as safeguard against excessive risk. Therefore, it seems that a lack of

sound corporate governance played a major role in the crisis. Banks were roughly underestimating
the risks they were taking. In some cases the information about the exposure to certain risks did not
even reach the senior management (and certainly not the board of directors), while risk
management was often separated by activity rather than enterprise-based. The deficiencies in
corporate governance arrangements provided executives with large incentives and possibilities to
take excessive risk.

A lot of empirical research has been done to find out which role corporate governance has played in
the financial crisis. The field of research has been broad, some research has been aimed at specific
countries or specific corporate governance elements (remuneration, risk management, board
structure, shareholder structure, etc.), other research has been aimed at the corporate governance
in general. While a lot of empirical research provides evidence to state that several weaknesses in
corporate governance can be appointed as having a detrimental effect on the financial sector during
the financial crisis, this paper will only concentrate on two closely linked specific elements, namely ‘remuneration and risk-taking’ and ‘risk management’. Before elaborating on these main
elements of this paper, this paper will touch upon some general elements of corporate governance
and their role in the crisis. This might strengthen the concluding remarks of this paper.

One important paper that has to be mentioned and provides a lot of important results is the one of
Beltratti and Stulz (2009 & 2011). They do not find any evidence that banks with better corporate
governance (measured with the corporate governance quotient) performed better during the crisis.

39 For example for Belgium: C. Van der Elst, “Belgian Bank Governance before and after the Financial crisis” ,
40 Example: R. Fahlenbrach and R. M. Stulz, “Bank CEO Incentives and the Credit Crisis”, 2010, Journal of
Financial Economics (JFE), Forthcoming; Charles A Dice Center Working Paper No. 2009-13; Fisher College of
43 Chapter III, 2.
44 Chapter III, 3.
45 A. Beltratti and R. M. Stulz, “Why did some banks perform better during crisis? A cross-country study of the
What they actually do find is that banks with lower leverage ratios had less negative stock returns during crisis. This gives some evidence for the support of the ‘moral hazard problem’ within banks.46 What they also find is that banks with more shareholder-friendly boards performed worse during the crisis. They also find that the banks with the highest returns before the crisis had the worst returns during the crisis. This can be explained by the ‘Tsunami-explanation’. Banks that took huge (and likely excessive) risks before the crisis to create shareholder wealth (e.g. more investing in high rated tranches of subprime securitizations) were exposed to a high risk position during the crisis. When crisis hit, these high risk positions led them to perform significantly worse than other banks. This research provides some evidence that a shareholder-oriented corporate governance might expose the banks to (too) high risks which might become uncontrollable in times of crisis. Evidence for this can also be found in LAEVEN and LEVINE (2008).47 They state that banks with large controlling shareholders (who obviously have more power) are generally exposed to higher risks than banks with diversified shareholders. Also ERKENS, HUNG and MATOS (2012)48 find that banks with greater institutional ownership experienced worse stock returns during the crisis. A possible explanation is that strong shareholders encouraged and incentivized managers severely to take excessive risks. Due to the aforementioned moral hazard problem, shareholders may find it optimal to increase the level of risk-taking to socially irresponsible levels.

This very limited overview of general research leads me to the preliminary conclusion that the corporate governance of banks and the incentives of executives should not be totally aligned with the interests of shareholders but should be more closely aligned with the interests of a broader range of stakeholders. This statement is also suggested by other research.49 This allows me to state preliminary that corporate governance of banks should aim to implement the interests of all banks’ stakeholders.

2. Remuneration and risk-taking

“Multiple surveys find that over 80 percent of market participants believe that compensation practices played a role in promoting the accumulation of risks that led to the current crisis” 50

46 Capter II, 2, b.
a. General

A lot of critics blame the ‘Wall street bonuses culture’ as major cause of the crisis. Even the Obama administration has already blamed this culture for the crisis. Therefore an important and frequently investigated topic is whether compensation practices effectively favored high risk-taking by banks and whether these compensation practices effectively played a role in the crisis. A fortiori this is of importance since several regulators have made proposals that intervene in the composition of executive pay (say on pay rules, claw backs, the restriction of bonuses). Some of these proposals will be elaborated later. However, if a regulator wants to restrict certain compensation practices, he should also know with a significant amount of certainty that these practices were effectively on the basis of the behavior which he wanted to avoid. The regulator should also assess whether the proposed regulation is able to tackle that specific misbehavior. More specifically in compensation practices, if regulatory proposals try to insert proper incentives in executives’ compensation contracts to lower excessive risk-taking by management, he should first of all know whether misaligned incentives where at the basis of excessive risk-taking. Secondly he should know whether inserting proper incentives will be able to lower this excessive risk-taking. In the following parts, this paper will first elaborate on this incentive problem in a more theoretical way. Afterwards, this paper will elaborate this problem in a more practical way by providing the results of several empirical research papers on the role of remuneration within the crisis.

b. Moral hazard within banks

Banking is characterized by a severe moral hazard problem (as shown earlier in this paper). Therefore, it can (theoretically) be stated that due to the structure of modern banking and the structure of executive remuneration, excessive risk-taking was in the rational self-interest of the executives themselves and that this excessive risk-taking laid the basis for the crisis. Executive remuneration is usually composed to incentivize executives to maximize shareholders’ value. Therefore a severe amount of the remuneration of executives consists out of stock and stock options. This aligns the incentives of executives with those of shareholders. Therefore executives will also be vulnerable to the moral hazard problem in banking.

The moral hazard problem especially occurs due to the high leverage position of banks. Banks finance their assets (e.g. loans) with a high amount of debt (e.g. deposits). Because of this high leverage, the shareholders will be better protected against possible losses. This is mainly because a high amount of

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52 Chapter IV.

53 Chapter II, 2, b.
losses will be absorbed by the creditors and eventually by the taxpayer. This will create a tendency for the banks’ executives (whose interests are closely aligned with those of the shareholders) to make bets on the bank’s assets. They do this by choosing transactions which have a probability to produce a very high profit but also have a high chance on an overly high loss. These transactions mostly have an overall negative value. However, since a high part of the negative consequences would be absorbed by other stakeholders, this transaction may be profitable for the individual shareholder and executives if it is successful while being socially detrimental for the society if it fails. The suffering stakeholders can be the creditors. But also the taxpayers and government can be affected. The small depositors are often not affected because they are mainly protected by deposit guarantee schemes (funded by all banks in the scheme). Since a lot of banks were bailed out by the government, it was the government (or other healthy banks) that had to come up with the necessary means. Because of this, depositors and debt holders also had no incentive to investigate or to monitor the banks’ strategy. Even in cases where there would be no deposit guarantee schemes, depositors would not have any incentive to monitor the banks because they are too small. Therefore creditors cannot be relied on to monitor executives’ pay.\(^4\)

This tendency to choose for overall negative and socially irresponsible transactions is even more aggravated by the banks’ structure and by the remunerations’ structure. As shown earlier, the structure with bank holding companies reduces the ‘skin in the game’ of shareholders (and consequently executives) even more and increases the part of possible losses that will be absorbed by other stakeholders. These structures (with a bank holding company) actually insulate the shareholders even more from the effect of possible declines in the value of bank assets.

The grant of stock options to executives has a similar ‘insulating’ effect. The wealth of executives consist of a large part of stock of the bank or bank holding company. This might actually lead them to a lower level of risk-taking than other shareholders would prefer. This seems logical given the fact that they have a large part of their wealth at stake and a possible failure of the bank would have worse consequences for them than it would have for other shareholders with a more diversified portfolio. The portfolio of the executives will probably not be as diversified as the portfolio of other shareholders. Because of this, executives will become risk averse since an undue part of their remuneration consists of common stock. Stock options might pose a solution. A stock option is a right for the holder to acquire a share in the future (after a vesting period) at a specific price (the strike price). The grant of a stock option increases the incentive for the executives to take risk. An option protects the holder of the option even more against possible declines of assets of the bank or

the bank holding company. The option is only of certain value if the stock price is above the strike price. Therefore it does not matter whether the stock price is only a little bit under the strike price or far below the strike price. This creates an incentive for the executives to choose for high-risk transactions where there is a high probability of big profits but also a high probability of big losses. This is mainly because the holder of the option does not have to bare these losses himself. It is clear that this aggravates the moral hazard situation even more. MEHRAN and ROSENBERG (2007)\(^{55}\) provided evidence for the fact that risk-taking of the bank will increase if the CEOs’ stock option holdings increase. Also CHEN, STEINER and WHYTE (2006)\(^{56}\) provide (pre-crisis) evidence that option based compensation induces risk-taking in the banking industry. This means that the grant of options increases the CEOs’ incentives to take risks. The combination of the grant of options and a crisis situation (e.g. the financial crisis) can also have a significant effect on the banks’ risk-taking. Due to the crisis there will usually be a decline of the value of common shares. Therefore the strike price is usually high above the current stock price (out-of-the-money-options). This makes these options worthless. This will theoretically lead executives to excessive risk-taking because executives have at that certain moment almost no ‘skin in the game’ anymore. It does not matter whether the stock price goes even lower because their stock options are already useless. The only possibility to make them valuable again is by performing risky transactions. Executives will therefore conduct very risky activities with an overall negative value but with a certain probability on huge profits (but of course also with a high probability on huge losses).\(^{57}\)

This mainly theoretical elaboration on the moral hazard problem provides the necessary (theoretical) evidence that executives are incentivized to take excessive risks in the interest of the shareholders. In case of a crisis, executives are even more incentivized to take excessive risks. Whether remuneration schemes with high amounts of stock and stock options have indeed incentivized executives to take excessive risks may or may not be proven by the broad empirical research that has been done. For the pre-crisis situation, MEHRAN and ROSENBERG (2007)\(^{58}\) already provided some evidence that stock options incentivize executives to take more excessive risks. Empirical research will also show that excessive risk-taking indeed led to worse performance during the crisis.


c. The empirical link between the crisis, remuneration, risk-taking and performance

A lot of empirical research has been done in this area but the results are rather mixed. First of all, Fahlenbach and Stulz (2010) did not find any correlation between remuneration structures of non-CEO executives and performance of the bank during the crisis. They also did not find an adverse impact of a higher fraction of the executive remuneration in option pay or bonus on bank performance during the crisis. However, what they did find is that banks whose CEOs’ incentives were better aligned with those of the shareholders performed remarkably worse than other banks during the crisis. They also find that the banks whose CEOs’ incentives were better aligned with the interest of the shareholder and thus performed worse during the crisis, performed remarkably better than others before the outbreak of the crisis. Fahlenbach and Stulz (2010) provide the following explanation for all their findings. They state that CEOs with better incentives to maximize shareholder wealth took more risks than other CEOs. These risks looked profitable before the crisis. During the crisis, however, these risks had unexpected poor results. Fahlenbach and Stulz (2010) state that a lack of alignment of bank CEO incentives with shareholder interests cannot be blamed for poor performance or the crisis because a lot of bank CEOs themselves had remarkable equity stakes in the bank and lost a remarkable part of their wealth during the crisis. However, this statement also has to be put in perspective, since the case study of Bebchuk, Cohen and Spaman (2009) namely shows that executives at Bear Stearns and Lehman Brothers were able to cash out a remarkable part of their performance-based remuneration. The findings of Fahlenbach and Stulz (2010) are certainly not totally inconsistent with the previously indentified severe moral hazard problem of banks. The opposite is true, the finding that better alignment of CEOs’ interests with those of the shareholders led to worse performance because of high risk-taking actually proves the moral hazard situation. CEOs took big risks which, ex ante, looked profitable and rational in the shareholders’ interest. And they even were profitable before the crisis. The possible losses, that occurred later, were only one of the possible outcomes. During the crisis, however, this last possible


outcome occurred and therefore banks that were led by CEOs whose interests were better aligned with those of shareholders, and thus took higher risks, performed remarkably worse.\(^{62}\)

Other empirical research provides some more and clearer evidence for the links between executive remuneration, risk-taking and worse performance during crisis. To start with, DeYoung, Peng and Yan (2009)\(^{63}\) and Suntheim (2011)\(^{64}\) (DeYoung et al for US banks and Suntheim for a more international sample of banks) find that the compensation and incentive structures of CEOs do have an impact on their risk-taking behavior. DeYoung et al (2009) also found more riskier policies during the crisis for banks with a more risk inducing compensation structure. Suntheim (2011) also found that the grant of remuneration that incentivized higher risk-taking (e.g. options) led to worse performance of the banks during the crisis. Chesney, Stromberg and Wagner (2012)\(^{65}\) provide some very important evidence which could also be of importance to explain the high risk-taking during the crisis. They state that not only stock options, but also stock holdings induces risk-taking substantially. Seen the remarkable amount of stock that CEOs hold, this could be a good explanation for the high risk-taking during the crisis.

It should be clear that major incentives to align the interests of the management with the interests of shareholders played a role in the excessive risk-taking of management during the crisis. However, certain critics also point to additional elements that could have played a role during the crisis. They appoint specific elements such as competition among large egos, the race to be in first position or a tendency for conformity and herding behavior.\(^{66}\)

\textbf{d. Managing the remuneration}

Given the importance of the incentives within remuneration, it is important that these incentivizing remuneration schemes are properly designed. A remuneration committee should be installed to


construct these incentives in a proper way. This committee should consist of independent and qualified people. It has to set out incentive schemes in accordance with the risk profile of the firm.\textsuperscript{67}

This independent committee will also help to carry out negotiations and decisions on an arm’s length basis. In the past, it has been found that managers had too much influence on their own remuneration schemes. While the OECD principles clearly state that the responsibility for setting the executive remuneration is with the board of directors, executives themselves seemed to have a strong bargaining positions. For example, in some cases the executives themselves hired remuneration consultants. If this consultant comes from a consultancy firm where the management also works together for other issues, serious conflicts of interests might arise. These conflicts might have had a serious influence on the setting of executive remuneration schemes.\textsuperscript{68} Therefore it is important that a board committee of independent directors is responsible for the remuneration. The effectiveness of the remuneration committee will totally depend on the independence and the competence of the independent directors that reside in the committee.

Another important issue is the transparency of the remuneration schemes. The past shows that this is an important but often very difficult issue. Remuneration reports are not always easy to create or to follow. Often not all forms (e.g. pension schemes) of remuneration are included. Although difficult to implement, one should try to create a good transparency policy. Therefore an independent remuneration committee and a clear transparency about their practices are of great importance for a good alignment of incentives.\textsuperscript{69}

Because of several weaknesses of the remuneration management (conflicts of interest, deficient transparency, etc.), remuneration schemes were not always created in a way which favored socially responsible risk-taking. This resulted in seriously misaligned incentives which created excessive risk-taking of the executives. During the crisis this excessive risk-taking resulted in bank failures.


\textsuperscript{68} Corporate governance and the financial crisis, conclusions and emerging good practices to enhance implementation of the principles”, 2010, available at oecd.org: http://www.oecd.org/daf/ca/corporategovernanceprinciples/corporategovernanceandthefinancialcrisis.htm, 8-12.

3. Risk management

“Information about exposures in a number of cases did not reach the board and even senior levels of management, while risk management was often activity rather than enterprise based”\(^{70}\)

The aforementioned quote of Mr. Grant Kirkpatrick clearly goes to the heart of an often heard criticism which, according to a lot of critics, played a major role in the crisis. Risk-taking and the management of this risk-taking are elements that flow through all elements of corporate governance (e.g. board structure, ownership- and shareholder structure, remuneration,...) and are therefore very important. Certain banks especially went down because they neglected the basic rules of risk management.\(^{71}\) Therefore a clean risk management which leads to an acceptable level of risk-taking is an important issue. Since the main topic of this paper is remuneration and the fact that remuneration is responsible for excessive risk-taking, it is important to elaborate on the risk management. Namely, remuneration practices which favored excessive risk-taking would never have entered into force if a thorough risk management would have been present.

The recent financial crisis has uncovered some severe problems of risk management. Risk management, according to the OECD\(^{72}\), is a duty of the board of directors. The board is responsible for creating and controlling a risk management structure which manages the risk of the whole bank and makes sure that all this is compatible with the strategy and the risk appetite of the financial firm (risk appetite means “the threshold of absolute risk that banks were a priori open to take”\(^{73}\)).

However, as the crisis has shown, the boards have often failed in their function. Directors took risks that were higher than the risk appetite of the firm. Or even worse, boards were unable to set an appropriate standard of risk appetite for their bank. In a lot of cases the directors were also unable to understand the complex financial products, therefore they were obviously unable to control and manage the exposure to certain risks embedded in these products. What also often happened was that risk managers were just not informed by the traders and/or operational staff. This was possible because there were often no standardized procedures which clearly set out the role of managers in


the creation of new business lines or new financial products. This made it possible for new products to be created by the operational staff without any knowledge by the risk management concerning the risk of these new products. Also the low prestige and low status of risk management possibly played a role in this. Besides, risk managers not only lacked prestige and status but in some cases they also lacked authority and above all independence.⁷⁴

Risk management was also often separated along product and organizational lines instead of focused on the whole bank. This ‘silo’ approach to risk management, where the different forms of risk (e.g. credit risk, market risk, operation risk,...) are separated over different institutions, can pose several problems at the level of the general risk management of the firm. Especially if the transmission of the information does not happen in an effective way.⁷⁵

ELLUL and YERRAMILLI (2010)⁷⁶ prove that risk management does really matter and also influences the performance of the banks. They created a risk management index (RMI). They provide evidence that banks that had a higher RMI before the crisis (and thus had a better risk management), have lower risk exposure, lower non-performing loans and above all better operating and stock return performance during the financial crisis. They conclude that risk management has played its role in the crisis.

Of course good risk management cannot and should not absolutely eliminate risk-taking. Risk-taking is an indispensable element of business and entrepreneurship. However, these risks should be clearly managed and controlled. Especially in firms with a systemic importance. Therefore risk management is mainly focused on controlling the risk-taking of the firm by assuring that the bank does not take on more risk than up to a certain level that is appropriate for that specific bank (‘the banks’ risk appetite’).

4. Preliminary conclusion

It should be clear that a lot of important corporate governance mechanisms have shown serious flaws during the crisis. More specifically, remuneration policies and risk-taking have had an important role in the financial crisis. In this chapter, this paper provided the reader with theoretical and


empirical evidence that showed that high incentivizing remuneration schemes led to excessive and irresponsible risk-taking by the management of banks. This is mainly because the corporate governance is largely focused on the interests of shareholders. We can observe that the interests of management are closely aligned with the interests of shareholders. They are incentivized with the grant of stock options, stock, etc. to maximize the shareholder value. This often leads to socially unacceptable levels of risk-taking by bank management. This excessive risk-taking has led to significant harm for the whole society. Stakeholders (e.g. government, taxpayer, depositor,...) have suffered the damage, while the shareholders enjoyed the profits of the risk-taking. Another major problem was that there was no proper risk management in place. Excessive risk-taking could just go ahead.

IV. Corporate governance after the crisis: Following the wrong track?

1. General

Governments have made huge expenditures to bail out certain banks. To justify these costs to the taxpayers, a lot of proposals have been issued that change certain corporate governance structures which might have led to the crisis. A lot of these proposals focus especially on remuneration. Although huge efforts have been made to work out these specific post-crisis measures, the key question is whether these proposals address the right problem in the right way. As shown earlier, managers have high incentives to work in the interest of the shareholders and therefore took excessive risk in the interest of the shareholders. This risk-taking played a huge role in the collapse of the financial system. Because of this collapse, governments had to make huge expenditures to bail out banks. It are actually these specific elements (the high incentives for excessive risk-taking) that need to be addressed by new regulation.

As the past has shown, it is not always easy to regulate remuneration without creating unintended consequences. A good example of regulation which had serious unintended consequences was the change of the US tax code in 1993. This change was intended to limit the disparity in pay between the CEO and the average worker. The US legislator implemented a maximum tax deductable remuneration for executives of one million dollar. If the remuneration was higher than one million

78 Chapter III, 2.
dollar, the company could not deduct the amount as a cost. An important exception in the initiative was that the remuneration above one million dollar was deductible if it was related to performance. Because of this exception it was not difficult to circumvent this regulation. All companies started to create complicated remuneration schemes with performance based remuneration (bonuses, etc.). As a result, the disparity in pay between the CEO and average worker did not decrease as it was expected, but instead it increased largely.\(^79\)

This chapter aims to provide a critical analysis of certain post-crisis recommendations or post-crisis regulatory proposals of all over the world which were intended to create a proper corporate governance of banks (without aiming to give a complete overview of all possible measures that have been proposed or taken). As will become apparent from the following, regulators have not always been able to appoint the right problem and to create the right legislation Often, they start from a wrong starting point which immediately makes it rather difficult to create a good legislation.

2. Say-on-pay

One of the most important post-crisis proposals was the introduction in several countries (e.g. in the US\(^80\) the say-on-pay regulation was a part of the Dodd-Frank Act\(^81\) of an advisory vote of shareholders on the remuneration packages for top executives of listed companies. These proposals actually introduced the so-called ‘say-on-pay’ policy. They were motivated by the urge to align the interests of executives with the interests of the shareholders. Important is that say-on-pay have in most cases only have an advisory function. This means that the votes are not binding in most cases (exception: the recent regulation in Switzerland implemented binding). Binding votes would pose other severe problems for continuation of the company.

Several post-crisis recommendations and proposals have expressed their preferences for say-on-pay regulations as one of the answers to the crisis. First of all, the post-crisis regulation of the US, the Dodd-Frank Act, has implemented such a regulation. But also in Europe voices have gone up for a say-on-pay regulation. For example, the CEBS (Committee for European Banking supervisors) notes in its ‘guidelines for remuneration policies and practices’ that the approval of an institution’s remuneration policy may be assigned to the shareholders meeting.\(^82\) They state that the vote can be


consultative or binding. But also the European Commissions’ Green Paper\textsuperscript{83} and the Walker Review\textsuperscript{84}, led by Sir David Walker, have recommended say-on-pay policies. The latter even goes one step further and recommends to implement a system where the chairman of the remuneration committee would be obligated to stand up for re-election, if not more than 75 per cent of the (attended) shareholders votes in favor of the remuneration policy. In Europe, more concrete plans of the European Union now seem to introduce a say-on-pay policy. On the 12\textsuperscript{th} of December 2012, Europe announced its plans to introduce a say-on-pay regulation.\textsuperscript{85} Although there is no draft regulation yet, some media already states that the European system would give shareholders a mandatory say on remuneration.\textsuperscript{86} In the meantime, several European countries are busy with creating their own national say-on pay regulations (e.g. Switzerland, Spain, Germany).

Regarding the foregoing, it seems that a lot of regulators see the shareholders as the ultimate means to circumvent excessive risk-taking and want to entrust them with a sort of gatekeeper role. So, the regulator mainly focuses on the internal corporate governance and the internal principle-agent problems between executives and shareholders. They give the shareholders a vote on the remuneration schemes of executives to align the interests of the shareholders with the interests of the executives. These votes might draw the attention of the directors on the shareholders preferences concerning remuneration when creating the remuneration schemes. Therefore it will deter directors to set pay arrangements that are totally unreasonable in the eyes of the shareholders. The say-on-pay proposals might also be helpful in cases where remuneration rewards short term gains at the expense of the long term shareholder value. The latter will however only be the case if the shareholders themselves have a long-term interest (which is not always the case anymore\textsuperscript{87}).\textsuperscript{88}

However, these new proposals will not be able to tackle an important problem which actually lays at the basis of the crisis, namely the excessive risk-taking of bank executives. As shown in the previous


\textsuperscript{86} J. O’DONELL and S. CRUISE, “European officials, emboldened by a victory over banker bonuses, will propose legislation this year giving shareholders voting rights to challenge executive pay at public companies”, 06/03/2012, Reuters, http://www.reuters.com/article/2013/03/06/us-eu-pay-idUSBRE9250WM20130306.


chapter, banks differ largely from non-financial companies. In non-financial companies the main concern is the internal corporate governance. Therefore, aligning the interests of shareholders with the interests of directors might be helpful in non-financial firms. However, in banking, the shareholders themselves prefer a significantly high level of risk-taking which is actually socially unacceptable. Therefore shareholders will have the urge to vote for remuneration structures that bring executives to a higher (and socially unacceptable) level of risk-taking. Due to these (shareholder-preferred) remuneration structures, executives will take excessive risks which exposes them to the benefits and profits that excessive risk-taking produces for the common shareholders, while the downside of this behavior will be largely absorbed by the depositors, bondholders, taxpayer and other stakeholders. So, the say-on-pay regulations will probably not be able to attack the excessive risk-taking in the banking sector since shareholders will probably not take into account the interests of depositors, taxpayers, bondholders or other stakeholders. Neither will they take into account the systemic risk resulting from their excessive risk-taking.

So aligning the interests of executives with the interests of shareholders, by providing the shareholders with a vote on the remuneration will not lower excessive risk-taking in the banking sector. This will also not make the executives take into account the interests of depositors, taxpayers or bondholders.

3. Structure of Remuneration

A lot of proposals and recommendations have been issued that are mainly focusing on altering the structure of executive compensation. These proposals are motivated by an urge to link compensation more closely with performance and risk-taking. They also try to focus more on the long term instead of the short term. A lot of proposal or recommendations specifically wanted to address the fact that remuneration policies encouraged much short-termism to the detriment of the long term. Also the new European proposal for the amendment on the Capital Requirements Directive (CRD IV)

92 EUROPEAN COMMISSION, Proposal for a directive of the European parliament and of the council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary
states that “the measurement of performance used to calculate the variable elements of remuneration should include an adjustment for all types of current and future risks” (article 90). To concentrate more on the long term, several substantive proposals have been done, for example the introduction of a claw-back (or malus) of bonuses, the implementation of deferred compensation, the implementation of the ‘European cap of bonuses’, etc.. While it cannot be ignored that short-termism was a severe problem and that these proposals might solve these specific problems, some of these proposals will however fail to address certain other problems. For example, none of these proposals will explicitly take into account the interests of all stakeholders and create a more stakeholder-oriented corporate governance.

More specifically, a lot of proposals and recommendations have advocated the introduction of a mandatory amount of restricted stock. For example in the US, the incentive compensation of top officers of US banks that received TARPs93 funds (troubled asset relief program) should exclusively consist out of long-term restricted stock.94 The proposal for the CRD IV includes the implementation of mandatory restricted stock as well.95 Obviously the compensation in restricted stock will address the problem of short-termism. But restricted stock will however not be able to address the aforementioned moral hazard problem inherently on banking. And although short-termism is also responsible for excessive risk-taking, this excessive risk-taking is also mainly caused by the moral hazard problem. The compensation remains mainly linked to the shareholders’ preferences which makes that the executives will still have the same incentives as common shareholders. Due to the high leverage position of banks, shareholders have incentives to take socially unacceptable excessive risks. Therefore restricted stock will not solve this specific problem.96

On the other hand, claw back (or malus) clauses of cash bonuses will be able to provide a better answer to the excessive risk-taking (due to the moral hazard problem) by executives. These claw back

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93 System which provided funds to financial institutions if these institutions comply with certain limits on executive compensation.


clauses are (*inter alia*) proposed by the CEBS\textsuperscript{97}. This ex-post risk adjustment should be performance based (and not only based on the share price). Because of these risk adjustments, the executives that are subject to certain claw back clauses will have incentives to take into account these elements if they choose a transaction with a certain risk profile. These clauses decrease the moral hazard problem and will make the executive choose for less excessive risks. Besides, these claw back clauses are also optimal to tackle the short-termism.

Although that some structural changes in the compensation setting may have the indirect effect that less risk will be taken, these changes do not have as ultimate purpose and effect to create a remuneration structure that provides incentives to take a socially acceptable level of risk. These changes also do not take the interest of other stakeholder than shareholders enough into account.

4. Governance of the remuneration

Due to the fact that remuneration systems influence the level of risk taking and the banks’ performance, a lot of regulators have proposed changes within the remuneration governance systems. These changes were mostly addressed towards the tasks of directors within this governance and the properties that the remuneration governance systems should have. These proposals have to attain that the remuneration schemes are negotiated at arm’s length. They also have to reduce the strong bargaining position which the executives nowadays often have. Moreover, they have to solve several conflicts of interest in the setting of the executive remuneration schemes.

According to the Basel Committee\textsuperscript{98} and the OECD\textsuperscript{99} it is the board of directors that is responsible for the design and operation of the compensation system of the bank. The board has to monitor and review the compensation system to ensure that it works as intended. Systemic (in terms of their size, internal organization and the nature, scope and complexity of their activities) banks have to establish a remuneration committee. The board members who are responsible for the design and oversight of the remuneration policy have to be non-executives and independent\textsuperscript{100}. Furthermore, most proposal  

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\textsuperscript{100} BASEL COMMITTEE ON BANKING SUPERVISION, “Principles for enhancing corporate governance”, October 2010, available on bis.org: http://www.bis.org/publ/bcbs176.htm, 25; P. O MÜLBERT and R. D. CITLAU, “The uncertain
are focusing on a close cooperation between the remuneration committee (or the board-members who are in charge of deciding upon the remuneration in non-systemic banks) and the banks’ risk management to make sure that both are perfectly matched and that remuneration does not incentivizes management to take excessive risks.¹⁰¹

Most post-crisis proposals concerning the governance of remuneration primarily focus on the independence of the members of the remuneration committee (or the board-members who are busy with the remuneration in non-systemic banks) and the close cooperation with the risk management. These changes obviously will have positive effects in terms of solving the conflicts of interest, creating a better bargaining position for boards in setting the executive remuneration schemes, etc.. Nevertheless, these changes will not succeed in solving the initial problem, because they will not bring the level of risk-taking to a level which is optimal for all stakeholders (socially optimal level of risk-taking). This is mainly because these changes do not take into account the interests of other stakeholders other than shareholders. Even in the most perfect system independent directors are elected by the shareholders. Consequently, these directors will also work in the main interests of the shareholders. Because shareholders prefer a level of risk-taking which is not optimal for all other stakeholders, the level of risk-taking will remain excessive or will at least not be socially optimal.¹⁰²

5. Transparency

A lot of proposals and recommendations were also aimed at improving and increasing the transparency of remuneration policies and packages. For example the Basel Committee recommends in its post-crisis ‘compensation principles’ that “firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders”¹⁰³. The Financial Stability Board also advocates an ‘annual report on compensation’.¹⁰⁴

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In the CRD III\textsuperscript{105} we also find elements which points to the interests of the EU in disclosure of remuneration policies. The CRD III requires disclosure of “detailed information on their remuneration policies, practices and, for reasons of confidentiality, aggregated amounts for those members of staff whose professional activities have a material impact on the risk profile of the credit institution” (recital 21). CRD III also states that supervisory authorities should collect information on remuneration to benchmark remuneration trends (recital 18). It is clear that a lot of post-crisis regulations and recommendations have emphasized the importance of a clear and timely disclosure of remuneration packages and policies.\textsuperscript{106}

However, the disclosure of the remuneration policies only ‘informs’ the stakeholders. The question however is whether these stakeholders will engage in the company in cases where they do not agree with the remuneration policies. The answer to this question depends on several elements. First of all it is important that the specific stakeholders have incentives to engage. As shown earlier, because of the specific situation within banks, most stakeholders (depositors, creditors, etc.) have a lower incentive to engage. Depositors can rely on the deposit guarantee schemes and therefore have lower incentives to engage. The incentive of other creditors are also seriously lower because of the possible government bailouts. But also shareholders have lower incentives to engage in banks. And if they would engage, shareholders would try to bring the level of risk-taking to a level which is optimal for them. As shown earlier however, this level of risk-taking is higher than the socially optimal level of risk-taking. The second element is whether the stakeholders are able to engage in the bank. It is obviously clear that it is easier for certain groups of stakeholders to engage. It is also clear that certain groups of stakeholders simply will have a higher influence if they engage. Institutional investors, for example, will be better able to engage and will have a higher influence if they engage than other shareholders. Again, these institutional investors are shareholders and will prefer a higher level of risk-taking than is socially optimal. A third and last concern is that disclosed documents have to be understood by the stakeholders before they engage. Again it will be the more professional investors who will be able to understand these documents. If it is necessary, they can engage and bring the level of risk-taking to a level which is optimal for them. However, this level of risk-taking is mostly not optimal for all other stakeholders. In the light of all this, it remains the question whether disclosure of remuneration policies will be able to implement the interests of other stakeholders than shareholders and whether this can bring the level of risk-taking of a bank to a level which is


socially optimal. Probably not. In the best case, an efficient market will bring the remuneration package (and the attached level of risk-taking) to a level which is optimal for shareholders, but certainly not for all stakeholders.

6. Preliminary conclusion

A lot of proposals and recommendations have been issued with the intent to solve the problems that were at the basis of the crisis. Although these proposals and recommendations seem to tackle some problems (for example the short termism), they do not tackle all problems. Namely, they fail to sufficiently implement a level of risk-taking which is optimal for all stakeholders. It is also notable that these proposals or recommendations do not succeed to adequately implement the interests of other stakeholders than shareholders. Most of them are mainly focused on the internal principle-agent problem between management (or directors) and shareholders. Therefore they primarily focus on the internal corporate governance and mainly try to implement the interest of shareholders more. However, since shareholders often have a higher risk appetite than other stakeholders, they allow banks to work at a level of risk-taking which is socially unacceptable. Therefore more proposals have to be done where the interests of other stakeholders are clearly taken into account. In the next chapter, this paper elaborates on some systems which can be used to implement the interests of other stakeholders than shareholders.

V. Proposals for a better regulation: How to get back on track?

1. General

Obviously, it has to be stated that the aforementioned changes also have certain positive effects. They strongly encourage executives and investors to think in the long term and they try to abandon the ‘short-termism’. Unfortunately, they fail to implement the interests of other stakeholders than shareholders in a sufficient way. In addition, they will probably also fail to reduce risk-taking to a level which is socially optimal. These post-crisis proposals focus mainly on the implementation of the interests of the shareholders while the shareholders themselves often prefer a level of risk-taking which is often socially unacceptable. Therefore these changes will not succeed to reduce risk-taking to a socially acceptable level.

In this chapter, this paper will present some bank-specific proposals which would considerably change the bank corporate governance. These proposals aim to decrease the level of risk-taking to a level which is optimal for the whole society and to implement the interests of other stakeholders, next to those of shareholders. At the same time, these proposals are aimed to create a structure
which strengthens the capital of banks in order to make sure that governments, and subsequently taxpayers, do not have to intervene. Although these changes will lower risk-taking in the banking sector, it is obviously not my goal to mute risk-taking totally in the banking sector. This paper tries to balance all interests and decrease the excessive risk-taking. But next to these elements, it is also one of the main goals of these proposals to maintain innovation, profitability and efficiency in the banking sector.

These proposals are specifically tailor made for banks. Banks need a specific treatment in terms of corporate governance for several reasons. First of all, they differ severely from non-financial companies (e.g. the high leverage position). Secondly, several incentive structures are also seriously misaligned due to governmental interference. Thirdly, banks do have far more stakeholders than other companies and it is important that the interests of these stakeholders are taken into account. Because of all these reasons banks need a specific corporate governance treatment.

The changes this paper proposes can be divided into two groups. Two of the proposals (‘the fiduciary duty’ and ‘the contingent capital) will focus more on the level of the general corporate governance while the last proposal will concentrate specifically on remuneration issues and the composition of the remuneration of executives.

### 2. Fiduciary duty

The first change this paper proposes would be the extension of the fiduciary duties of the boards of directors beyond the usual shareholder-maximization and to make the boards take into account the interests of all stakeholders or to take into account the safety and soundness of the bank. The first traces of such a fiduciary duty can actually already be found in the OECD principles of 2004. Principle VI.C states that ‘the board should apply high ethical standards and it should take into account the interests of stakeholders’. But also the green paper of the European Commission concerning the ‘Corporate governance in banks and remuneration policies’ mentions such a fiduciary duty of the board of directors to all stakeholders. Although these recommendations have

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mentioned such a fiduciary duty, none of them have already succeeded to effectively implement such a duty into a legal system. Some authors\textsuperscript{112} state that, so far, it is even illegal for the board of directors to take into account the interests of other stakeholders than shareholders when making decisions.

This proposed change is based upon a logic reasoning. Shareholders have incentives to choose for excessive levels of risk-taking. Therefore the fiduciary duties of the board of directors should not only be oriented to these shareholders but should be oriented to other stakeholders (depositors and creditors) as well to effectively reduce risk-taking. However, one could truly point to the problem that depositors and creditors prefer a level of risk-taking which is very low and might even be lower than the optimal level of risk-taking for all stakeholders (including shareholders). Therefore I choose not to implement a fiduciary duty only to the depositors and/or bondholders but to extend the fiduciary duty of the board of directors to make them take into account ‘all stakeholders’ and oblige them to take into account the ‘financial stability’ and the ‘safety and soundness of the bank’. By doing this, the board will have to take into account the interests of the depositors and bondholders, but also those of the shareholders. By adding an obligation to take into account the ‘safety and soundness of the bank’ and the ‘financial stability’, the decisions of the board of directors will have to be taken in a more balanced way, respectively, at the level of the individual bank and at the level of the banking sector as a whole. Although these standards might sound rather vague in comparison with a single fiduciary duty to the shareholders. The ratio behind this is to create an optimal and safe level of risk-taking without killing innovation, profitability and the efficiency of the banking sector. Another important reason for a rather vague standard is that it will give the necessary consideration space for judges.

If boards fail to respect this fiduciary duty or to take adequately into account the financial stability and the safety and soundness of the bank, they should be held directly liable. This direct liability creates the necessary dissuasive effect. It will also create incentives for the directors to make sure that they know and, more importantly, understand what is happening within the bank. However, this proposal has one weak point, which is that it will be very difficult for judges to determine \textit{ex post} whether the directors have breached their duties and whether they have failed to take into account the ‘financial stability’ and the ‘safety and soundness of the bank’. Especially since these standards are rather vague. Capital ratios might be able to play a role but they might certainly not be the sole basis for these standards. Especially since the recent crisis has shown that directors might sometimes

take false comfort of such ratios or might even roughly try to circumvent these ratios. To solve this problem MÜLBERT and CITLAU suggest a sort of self-regulatory system where the financial industry itself (in cooperation with and under the supervision of the national supervisor) creates some criteria to decide whether directors have breached their duties or not and whether they have to be held liable or not. Possible directions on how the extension of the fiduciary duties of the board should look like could possibly be found in the following: if directors have to approve transactions, they should take into account whether the transaction will 1) affect the ability of the bank to repay its debt when it becomes due 2) materially increase the riskiness of the bank or 3) materially reduce the bank’s capital position.

To optimize the effectiveness of this duty, one should aim to create a good enforcement system. All stakeholders should have to be able to sue the directors and to claim the damages which are attributable to the breach of the duties. This actually means that also the deposit guarantee scheme will have at least a derivative action. Especially since it will they will bear the damages of depositors.

It is obvious that these duties go further than the usual shareholder-maximization objective. The objective of this new proposed duty of the board of directors is to implement the interests of all stakeholders (including shareholders) in a balanced way. This should reduce risk-taking to a level which is optimal for all stakeholders. By aiming to achieve this optimal level, this paper tries to create more certainty while at the same time not shutting down innovation and profitability in the banking sector.

3. Contingent Convertible Capital

In this part, this paper searches how liability structures could be altered in order to make sure that neither the taxpayer nor the government bares the costs of a bank failure but the banks themselves (shareholders, bondholders, depositors, etc.) bear these costs. At this time, Europe is preparing rules to solve this problem. Europe is creating rules for winding down struggling banks in a proper way, in

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order to avoid expensive (taxpayer-funded) government bailouts. While the first mentioned proposal (‘the extension of the fiduciary duties’) is roughly intended to avoid excessive risk-taking, is this proposal intended to strengthen the capital structure in order to make sure that the right party bears the costs of possible excessive risk-taking?

Shareholders are obviously good candidates to bear the costs of bank failure. They already form a buffer against bankruptcy of the bank. They are a first cushion against possible losses for the depositors and possible costs for the deposit insurance funds. A step further would be to alter the liability structure and make shareholders liable for more than their investment or make them even unlimitedly liable. This would be an optimal solution. It would decrease the moral hazard problem in a significant way and therefore would lower the level of risk-taking within banks severely. However, this solution is not feasible for two main reasons. First of all, this system would depend on the wealth of the unlimitedly liable partners. If they are also insolvent, the system will not work. Secondly, this system would increase the cost of capital to a level which would make the system unsustainable and the economy collapse. Therefore the creation of unlimited liability of banks’ shareholders is not a possible solution.

A more pragmatic solution is the implementation of a mandatory amount of contingent convertible capital as a fixed portion of the banks’ capital. Contingent convertible capital is defined as the conversion or write down of a banks’ debt securities into equity securities upon the occurrence of a predefined trigger event. In the aftermath of the financial crisis, many national and international regulators and policy makers have recognized the important role that contingent convertible capital can play in the financing of banks. For example the recent proposal for the CRD IV regulation permits contingent capital securities as an ‘additional Tier 1 instrument’.

121 Switzerland and Germany
123 EUROPEAN COMMISSION, “Proposal for a Regulation of the European Parliament and of the council on prudential requirements for credit institutions and investment firms, COM(2011) 452, article 49(l)(n). (the proposed regulation defines one form of “Additional Tier 1 instruments “as a capital instrument in which “the
This proposal goes further than the CRD IV proposal and implements a mandatory fixed amount of contingent convertible capital next to the already existing tier 1 capital. This contingent convertible capital is a debt security which will be converted into an equity security if a trigger event takes place. These events indicate financial distress within the bank (e.g. a possible bankruptcy) and can take several forms (stock price, index value, CDS spread, capital ratio, etc.\textsuperscript{124}). The implementation of contingent convertible capital has several advantages\textsuperscript{125}. First of all, it will create an extra buffer against bankruptcy of the bank. This is mainly because the contingent convertible capital will strengthen the capital structure of the bank when necessary. It also has the accompanying advantage that governments will have fewer costs for bailing out banks because bank insiders themselves (e.g. holders of contingent convertible securities) will carry a higher amount of these costs. Therefore these securities will also decrease the moral hazard problem. Secondly and even more important, the contingent convertible capital will create incentives for the common shareholders and for the holders of the contingent convertible securities to decrease the level of (excessive) risk-taking. The system actually creates an extra group of stakeholders which have a lower risk appetite than shareholders. The holders of the contingent convertible securities have a higher incentive to oversee the banks’ actions because they do not want their debt claims to be converted in equity claims. They will try to avoid the trigger event and the subsequent conversion at all costs because the substitution in equity claims means less certainty for them. But also the existing common equity holders will try to avoid the conversion of the contingent convertible capital because if the conversion takes place, their own equity claims will be diluted.\textsuperscript{126} Therefore I think that the implementation of a mandatory fixed amount of contingent convertible capital will incentivize banks’ stakeholders (including the common shareholders) to tend to a level of risk-taking which is socially optimal. The implementation of contingent convertible capital therefore actually substitutes partially for certain corporate governance mechanisms.

4. Composition of executive remuneration

As shown earlier, pay arrangements for executives are able to create incentives for excessive risk-taking. Therefore, this third proposal mainly focuses on altering the composition of pay arrangements in a way that they provide less incentives for excessive risk-taking. Pay arrangements


should be composed in a way that they provide proper incentives for executives to pursue a socially acceptable level of risk-taking. Therefore, regulating and monitoring pay arrangements should be a main task of the national supervisor. There should be a high level of transparency on the composition of the executives’ remuneration. If the incentives for excessive risk-taking are too high, the supervisor should intervene. This is mainly because the shareholders will not intervene since they have incentives to pursue excessive risk-taking themselves.127

To avoid excessive risk-taking by the executives, one should aim to alter the composition of their remuneration in a way that it is not mainly linked to the equity of the bank because if one compensates executives of a high levered firm with equity this will lead to risk shifting (moral hazard). To avoid risk shifting it is much better to align the executive compensation with debt instruments.128 BOLTON, MEHRAN and SHAPIRO (2011)129 even go one step further and suggest a structure where the CEOs’ compensation is partly tied to the ‘credit default swap spread’ (or CDS spread) of the bank. The CDS spread is a proxy for the banks’ credit quality. If banks are doing well and their credit quality is strong (low CDS spread) this will result in an increase of the part of the remuneration which is tied to the CDS spread. However, if the credit quality weakens (increasing CDS spread), the part of the remuneration which is tied to the CDS spread will decrease. This remuneration structure creates incentives to strengthen the credit quality and therefore to take into account the interests of the creditors. More importantly BOLTON ET AL provide evidence that increased CEO exposure to underlying bank risk will reduce the risk-taking of the bank. The system creates incentives for CEOs to avoid excessive risk-taking. BOLTON ET AL also show that shareholders themselves will not choose to implement a remuneration system like this. Therefore the regulator should intervene to introduce a system like this.130

VI. Conclusion

This paper started by pointing to the main differences between banks and non-financial companies. These differences give rise to specific corporate governance problems within banks. An important

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problem consists of the extensive moral hazard problem which is created due to the high leverage position of banks and the high degree of possible governmental intervention (in case of ‘Too big to fail’). Therefore shareholders prefer an excessive high level of risk-taking. They are i.e. only exposed to the high profits of this behavior, while the downside of this behavior will largely be absorbed by the other stakeholders (depositors, creditors, government, taxpayer, etc.). Since corporate governance is largely focused on the shareholders’ preferences, executives will be largely incentivized (remuneration schemes) to follow the shareholders’ preferences. Therefore executives will also prefer a level of risk-taking which is only optimal for the shareholders but certainly not optimal for all other stakeholders (depositors, debt holders, government, taxpayers, etc.). The recent financial crisis actually revealed these misalignments in the corporate governance of banks and acted as a wake-up call for regulators all over the world. Banks whose boards were more aligned with the interests of shareholders preferred a higher level of risk-taking which resulted in worse performance during the crisis. So, banks with shareholder-friendly boards essentially performed worse during the crisis because of their high level of risk-taking.

During the crisis, governments have made large expenditures to bail out banks. To justify these expenditures, governments have proposed several regulatory changes within the corporate governance of banks. However, it seems that the regulators have followed the wrong track in their urge to improve banks’ corporate governance. A lot of proposals for new regulation were especially aimed at implementing the interests of shareholders and avoiding short termism. Obviously, these regulatory changes might have had positive effects. However, these changes will probably not be able to implement the interests of all stakeholders, nor will they be able to reduce the level of risk-taking to a socially optimal level.

Due to the big differences between banks and non-financial companies, and the specific corporate governance problems, banks might need a different approach to corporate governance. This approach has to be more oriented to the preferences of all stakeholders. Therefore, I propose three bank-specific corporate governance changes which are aimed at implementing the interests of all stakeholders and reducing the level of risk-taking to a level which is socially acceptable for all stakeholders. A first proposal consists of an extension of the fiduciary duties of the board of directors beyond the usual shareholder-maximization and make them take into account the interests of ‘all stakeholders’ and oblige them to take into account the ‘financial stability’ and the ‘safety and soundness of the bank’. This change will oblige the directors to take into account the interests of all stakeholders, under the threat of possible personal liability. A second proposal consists of the implementation of a mandatory fixed amount of contingent convertible capital next to the already
existing amount of tier 1 capital. This change will strengthen the capital structure of the bank in order to avoid expensive government bailouts. It will also create the necessary incentives for the holders of these contingent convertible securities to monitor the bank in order to avoid the trigger event. But also the common shareholders will monitor the bank better in order to avoid the trigger event, as the conversion of these contingent convertible securities might result in a dilution of their own securities. A third change proposes to tie the CEOs remuneration partly to the CDS spread. The CDS spread is a good proxy for the credit quality. If the credit quality weakens the remuneration of the CEO decreases. By partly aligning the remuneration of the CEO to the credit quality, he will have to take this credit quality into account when making decisions. Therefore, also the interests of the creditors will have to be taken into account.
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