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Corporate Governance in Banks and its Impact on Risk and Performance: Review of Literature on the Selected Governance Mechanisms

Abstract: Corporate governance is viewed as an important, essential, and most significant factor for well-functioning of firms. Recent academic work and policy analyses have given insight into the governance problems in banks exposed to the financial crisis and suggest possible solutions. This paper begins by explaining the importance of corporate governance and its impact on risk taking and bank performance based on the theoretical background relevant to the corporate governance of banks. I combine the literature that looks at three areas of governance: ownership structure; board structure; and risk management, with the literature on risk-taking and performance effects in order to better assess the weight of the impact that these governance mechanisms have on both performance and risk. The paper concludes by highlighting the areas where further research is needed.

Keywords: banks; boards; owners, corporate governance; risk taking; performance.

JEL: G3

Introduction

This review of the selected corporate governance mechanisms treats them as practical traits from multi-theory lenses, focusing on the agency theory and the stakeholder theory and how they fit in the institutional setting from the perspec-

tive of institutional theory. This paper contends the importance of interrelatedness between the three theories, specifically how they relate to corporate governance in banks as complex firms. The purpose of bringing the three strands of theory together is to bring a more contextual perspective on corporate governance. Corporate governance of banks is relevant and important topic due to banks' role in economic development and growth. Corporate governance of banks is an instrumental determinant for economic growth (Levine 1997, 2005; Claessens, 2006). While substantial empirical evidence exists in relation to corporate governance of non-financial firms, less is known about how special features of banks could affect corporate governance of banks.

This paper provides an overview of some important studies on corporate governance, focusing on selected governance mechanisms, specifically ownership and board structures, as well as risk management practices. The studies on the ownership structure and board of directors are the central focus of this paper as they are typically central to corporate governance and the framework for their actions is dependent upon legal, regulatory, institutional and ethical environment of the community in which they operate.

The paper proceeds as follows. The first part starts with theoretical background, followed by definitions of corporate governance and problems in enterprises nowadays, while the mechanisms of corporate governance emerged are discussed in the second part. Remaining at a general level, we link the discussion to the interaction between governance and various institutional environments in the third part. Further on, we proceed to explain the characteristics of banks and the corporate governance issues faced by these types of firms today. This part highlights the importance of banks for the whole economy, and the focus of the governance mechanisms not only on performance of banks but also on bank risks (in relation to various bank stakeholders), specifically the mechanisms that prevent excessive risk taking in case of banks more than in the case of other firms. The fourth part overviews the existing literature of banks' behavior towards risks and performance, referring to the theoretical framework from the first part. Due to the specific role of shareholders in banks (i.e. they only hold limited equity and are motivated to transfer risk to creditors), this study reviews the literature on specific types of owners in banks. Finally, based on the theory and the existing literature, we attempt to derive what is missing in the literature at the moment and recommend suggestions for future research.

1. Corporate Governance through Selected Theory Lenses

Since the early work of Berle & Means (1932), the importance of corporate governance for good performance of corporations, as well as for firms' access to financing and, consequently, for economic growth, continues to be debated amongst scholars, policymakers and private sector. This groundbreaking work, which came after the Wall Street crisis in 1929, and subsequent Jensen & Meckling (1976) and Fama & Jensen (1983) work on the agency costs influenced greatly further development on corporate governance issues related to shareholders rights and control (Shleifer & Vishny 1986, La Porta et al., 1998), as well as, transparency and accountability (McNutt, 2010). Bohren & Odegaard (2005) argue that corporate governance is a young academic field characterised by partial theories, limited access to high quality data, inconsistent empirics, and unresolved methodological problems.

Theoretically, corporate governance research has been and continues to be dominated by the Agency theory. The Agency theory views a firm as a *relationship* of contracts between the principal (providers of the capital) and the agent (manager of the capital). This view dates back to Jensen & Meckling (1976) and their definition of firms as simply legal fictions which serve as a nexus for a set of contracting relationships among individuals. In this relationship, it is the principal that hires the agent to manage its capital on the principal's behalf and in their best interest as well. However, the agency theory relies on an assumption of self-interested agents who seek to maximize personal economic wealth (Bruce, Buck & Main, 2005). In this relationship, the agency theory addresses the problem of differences between the goals and the risk attitudes of the principal and the agent. Therefore, the conflicting interests between the principal and the agent in terms of goals and desires, as well as, risk appetites would result in agency cost. Agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests, plus the residual loss incurred because the cost of full enforcement of contracts exceeds the benefits (Jensen & Meckling, 1976). Ideally, the principal-agent relationship should reflect efficient flow of information and risk bearing cost. In reality, however, this is not always the case and so a certain system of rules is used to regulate the contracting process between the principals and the agents. In general terms, this system of rules, practices and processes under which a firm is managed and controlled is basically what the corporate governance is about. Despite the strong dominance of the agency theory in corporate governance studies, particularly in the economics and finance literature, the use of complementary and alternative theories is necessary in order to interpret and explain global governance practices.

In contrast to the agency theory views, which deal with the relationship and alignment of interest between the *agent* and the *principal*, the stakeholder theory views go beyond just a single shareholder to include a wider group of stakeholders, other than just shareholders. The agency theory views a firm as the shareholders' property (Alchian & Demsetz 1972, Fama 1980, Jensen & Meckling 1976), whereas stakeholder theorists argue the primacy of shareholders and bring attention to a balanced power of all stakeholders who contribute to the firms achievements (Cyert & March 1963, Mintzberg 1983, Freeman 1984). Furthermore, Freeman (1994) argues that the purpose of the firm is defined by the overall value creation for stakeholders and that it should be managed in the interest of all its stakeholders. These interests include not only those of the shareholders but also a range of other direct and indirect interests. Freeman's work provided grounded basis to categorize the structural and relationship framework between managers and various stakeholders into three pillars, the normative, the instrumental and the descriptive pillar (Donaldson & Preston, 1995). This is particularly important when we are dealing with banks as they are multi-constituency firms due to their special groups of stakeholders, which are depositors, bondholders, regulators, and other stakeholders.

The stakeholder theory has brought significant attention and support since its early formulation as it attempts to develop alternatives for corporate governance which include and balance a multitude of interests. The stakeholder theory is highly regarded for bringing ethics and addressing morals and values while managing a firm. Finally, to address the issue of a firm's performance and efficiency, theories of corporate governance usually (not exclusively) adopt either an agency/ shareholder approach (Jensen, 2000) or a stakeholder approach (Fligstein, 2001). Consequently, the two most dominant models of the corporate governance, the Anglo-American and Continental models of corporate governance have their base in the agency and stakeholder's theories.

The focus of the Anglo-American model (common law) of corporate governance is the shareholder, their protection and their wealth growth, whereas Continental Europe extends its focus to the stakeholders as well, which for banks are quite a few. While the Anglo-American model of corporate governance is based on profit maximization and shareholders' interests protections, the Continental European model considers that firms are run in the interests of stakeholders i.e. shareholders, employees, management, creditors, public and society in general.

Both agency and stakeholder theories are limited in recognising the institutional context relevant to firms' operations and their corporate governance. Institutional context is extremely important in order to identify the restrictions that could be

imposed on firm stakeholders in different societies. Development of legal rules that strengthen the shareholders' voice and, on the other hand, ensure the managers' accountability towards firm owners reflects the recognition of importance of the overall institutional environment for the proper functioning of the corporate governance systems. In their study "Law and Finance", La Porta et al (1998) sparked an extensive research on the relationship between the legal institutions, corporate governance and financial development. The authors show that differences in the strength of the investors' rights – as provided by the legal systems – are the key determinant of the patterns of corporate finance and governance across the countries, i.e. the breadth and depth of capital markets, the pace of new securities, issues, corporate ownership structures, dividend policies, efficiency of investment allocation, etc.

Institutional economists recognize that political, cultural, and legal factors are independent variables that affect the organization of firms (Demirguc-Kunt & Maksimovic 1998; La Porta et al 1997a,b). They argue that corporate governance issues are solved differently in different societies because of opportunities and constraints of the existing political and legal systems. Stronger linkage on how political, cultural, and legal systems interact with firms and how they impact the efficiency and economic growth have been extensively documented (Bebchuk & Roe 1999; Fligstein 1990, 2001; Hall and Soskice 2001; Roe 2003). A more expansive view of the types of the institutions that could affect the market outcomes can be found in North (1990), La Porta et al., (1998), La Porta, Lopez-de-Salines, & Shleifer (1999b), and Carlin & Mayer (2003). Consequently, changes in corporate governance of banks and how these changes are affected by the institutional context in countries and regions where they operate remains an important topic of further research.

2. What is Corporate Governance and Why did Mechanisms of Corporate Governance Emerge?

Corporate Governance is not new and it has been practiced for a long time. Generally, it deals with a large number of economic and legal phenomena. Because of the very fact of its broad scope, its definition also differs depending on one's focus of the issue at hand. A narrow view of corporate governance focusing strictly on shareholders is defined by Shleifer & Vishney (1997) as process that "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." Remaining at the narrow level, Hart (1995) describes corporate governance as the relationships between the firm's capital

providers and top management, as mediated by its board of directors. Within this narrowed approach, Cadbury report (1992) UK, and The Sarbanes–Oxley Act (2002) US defines corporate governance narrowly as the system by which firms are directed and controlled with a focus on the shareholder. This approach is typical of the Anglo-Saxon model of governance. A broader view of corporate governance involves balancing interests of stakeholders and it includes shareholders, management, customers, suppliers, financiers, government and the community.

Blair (1995) defines corporate governance in this broader context and argues that corporate governance should be regarded as the set of institutional arrangements for governing the relationships among all of the stakeholders who have contributed firm-specific assets. This view echoes the stakeholder approach beyond the simple relationship between the firm and its capital providers. Furthermore, the Principles of Corporate Governance of Organization for Economic Cooperation and Development (OECD, 2004) reflect how various constituencies that define the entity they serve, and are served, by the corporation. Within this framework, corporate governance is defined as a set of relationships between a firm's management, its board, its shareholders, and other stakeholders, which echoes the Continental European model of governance.

Given the broad number of stakeholders, as well as the broad scope of activities that it encompasses, corporate governance framework is designed to align different interests for attaining a firm's objectives. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources, and the aim is to align as nearly as possible the interests of individuals, corporations and society (Cadbury, 2000). Consequently, the central issue in corporate governance is to understand what the outcomes of the process within this framework are likely to be, and how they deviate in practice from the efficient processes standards.

The prominence of corporate governance, both in academia and policy makers' agenda, seems to increase around global events, usually associated with crises. Different waves of crisis, such as the Asian crisis 1998, followed by the failure of Enron and WorldCom, and the global financial crisis of 2007, has focused lot of attention to corporate governance. The breakdowns in the application of all parties in corporate governance resulted in failures to achieve entity goals and objectives. Often the board of directors steps aside to allow management to make decisions and carry out strategies without oversight or accountability to the stakeholders. Desire to maximize profits at the expense of following prudential limitations resulted in a far-reaching crisis situation. Poor corporate governance has been indicated as one of the causes of the recent 2008 credit crisis. At their

summit in Pittsburgh in 2009, leaders of the G20 consequently called for stricter rules for risk-taking, improved corporate governance mechanisms that align compensation with long-term performance, and greater transparency in corporate governance (Kostyuk, Mizuno & Pizzo, 2012). In this regard, the recent focus is specifically on the weaknesses in the existing governance systems of banks. The crises, however, are just manifestations of a number of structural reasons why corporate governance has become more important for economic development and a significant policy issues (Bobirca & Miclaus, 2007).

It has become very evident that what is a necessary component of success and sustainable economic growth is good corporate governance. Following the systemic failures of the recent past, boards of directors, as well as regulators and other stakeholders, saw where lapses had occurred and weakness in corporate practices had been tolerated. As a result, all stakeholders mandated the return to sound guidance and management of entities – a return, as it were, to Good Corporate Governance practices.

Becht, Bolton & Roell (2002) argues that not all development incurred in corporate governance should be attributed to crisis related events and identifies identified five reasons (including crisis) why corporate governance became so prominent in the past two decades: 1) the world-wide privatization wave, 2) pension fund reform and growth of private savings, 3) the takeover wave of the 1980s, 4) deregulation and integration of capital markets, and 5) crises. It is very evident that all these reasons have influenced a greater shareholder activism, a growing importance for the corporate governance issues, and with it, greater development of legal institutions and recommendations on how corporate governance should be designed. It can clearly be argued, that good corporate governance is now considered as one of the key elements for the growth and development of the whole economy of a country (Clarke, 2004).

3. Corporate Governance of the Banks

Building on the well-known question “What’s different about banks?” (Fama, 1985) as a starting point, particularities of bank corporate governance became a subject of empirical and theoretical studies more recently, in the wake of the recent financial crisis. The credit crisis of 2008 has reconfirmed the importance of good governance for sound performance of banks, raising the need to understand the agency problems in banks and the efficiency of various corporate governance mechanisms in mitigating these problems. Therefore, it is easy to see that external shocks to an industry provide researchers intriguing opportunities

to investigate the performance and adaptation of corporate governance systems (Kole & Lehn, 1997). Banks have a number of specific characteristics that “alter” the agency problems and require a different view of corporate governance. For example, banks are organized in a variety of ways, from stand-alone corporate entities and single bank holding companies to multiple bank holding companies and diversified holding companies (Macey & O’Hara, 2003). Banks’ assets are more opaque, which makes it harder for the owners to monitor their bank’s activities. Banks also have the ability to take on risks very quickly, in a way that is not immediately visible to directors or outside investors (Becht, Bolton & Roell, 2012). Moreover, banks are subject to stricter regulation by regulators and deposit insurance, which has important implications for the risk-taking incentives of bank managers and moral hazard problem in banks. The existence of regulators and deposit insurance ensures that the core source of funding which comes from the depositors is protected since this group of stakeholders (depositors) pay less attention to the bank’s risk profile. Rapid developments in technology and increased financial sophistication have challenged the ability of traditional regulation and supervision to foster a safe and sound banking system (Furfine, 2001). Deposit insurance is a two-edged sword that provides the safety net to one class of stakeholders (depositors) in the event that governance bodies fail to properly identify and manage risk taking in a bank’s activities, while at the same time, as stated, it can create the “moral hazard” of motivating bankers to take on higher risk.

Another reason for banks to be treated differently is the influence/role of their special groups of stakeholders, which are depositors, bondholders and regulators, i.e. banks are multi-constituency organizations (Becht, Bolton & Roell, 2012). In other words, bank corporate governance is different from the governance of other firms since its scope goes beyond the shareholders (equity governance) to include debt-holders (debt governance) (Hopt, 2012), as well as the regulators who have a “stake”, which is their responsibility to promote/ensure a safe, sound and stable financial system that supports economic growth with minimal disruption. On a final note, banks need to be treated differently because they usually operate on much lower capital ratios than non-financial firms. So outside stakeholders are funding a much higher proportion of the business.

In conclusion, the literature highlights three key differences that distinguish the governance of banks from other firms; (i) The broader range of stakeholder, including depositors and creditors; (ii) The opacity and complexity of banks business, (Macey & O’Hara 2003, Devriese et al. 2004, Levine 2004, Graham, Harvey & Rajgopal, 2005); and, (iii) The unique system of oversight in the form of bank supervisors, deposit insurers and a comprehensive body of banking laws and reg-

ulations (Kern 2004, Heremans 2007, Ungureanu 2008, Hopt 2012). The literature does acknowledge all the characteristics that make the banks unique from the governance perspective (Prowse, 1997; Ciancanelli & Reyes, 2001; Macey & O'Hara, 2003; Levine, 2004).

The increasing focus on bank governance is evidenced also by the increasing number of empirical studies in the field (Kose & Qian, 2003; Adams & Mehran, 2003; Sponge & Sullivan, 2007; Tandelilin et al, 2007; Laeven & Levine, 2008; Alonso & Gonzales, 2008), as well as theoretical works (Prowse, 1997; Ciancanelli & Gonzalez, 2000; Macey & O'Hara, 2003; Levine, 2004; Mullineux, 2006; Kern 2006; Polo, 2007). These papers try to understand how the structural schemes of the banks such as board structure, decision-making, management information system, remuneration schemes of bank managers, and so on influence bank risk-attitude and performance. These stated papers are, however, based on Western Economies (USA, Europe) and often involve banks with dispersed ownership and control.

4. Corporate Governance and Banks Behaviour

The connection between corporate governance and firm performance has been the subject of important and on-going debates in the corporate finance literature. While empirical evidence is not always in agreement in terms of the functioning of specific governance mechanisms (i.e. there is no "one-size-fits-all"), there is a widespread belief that the quality of corporate governance and investor protection significantly impacts firm behaviour and performance (Bebchuk & Hamdani, 2009). Better governance enables firms to access capital markets on better terms, which is valuable for firms intending to raise funds (Doidge, 2004). Better governed firms also trade at higher market value and generated superior shareholder returns (Gompers, Ishii & Metrick, 2003). In similar vein, academic studies mostly based on non-financial institutions in developed economies show that better governed firms are relatively more profitable.

Economies of countries in transition have paid limited attention to the corporate governance issues. The setting of countries in transition is somehow unique due to the dominance of foreign owned banks. Until the 2008-09 financial crisis, foreign ownership was viewed as a key ingredient of financial development and a driver of economic growth (EBRD, 2006). However, this view changed since foreign banks were the main conduits in transmitting the crisis from western into transition countries (Bakker & Gulde, 2010; Bakker & Klingen, 2012; Popov & Udell, 2012). Consequently, analysing corporate governance of banks in rela-

tion to their (foreign) ownership and its implications for bank behaviour during the recent financial crisis is a current and relevant question. The same applies to the board structures of these banks, as well as risk management frameworks and practices. This is mostly relevant and important for the emerging countries, where the dominance of foreign owned banks is so pronounced. How independent are the supervisory boards and management of such institutions? How relevant are their policies to local conditions, and how responsive are they to local needs? Are the shareholders and board committed to support the local institution in a crisis or will they shut down credit and limit their exposures because of problems originating in their parent bank abroad? Are they collecting local funds for transfer to foreign operations? Are they willing to sacrifice the liquidity and solvency of the small local institution to the needs of the parent? The track record of the latter is not so good, I think, and this is where the third “stakeholder”, the regulator, should have an influence.

4.1. Ownership Structure and Banks' Attitude towards Risk and Performance

Corporate governance within banks facilitates the balancing of powers between the shareholders and managers. Maintaining the balance of power and control between the two has been the key challenge of corporate governance, specifically when it comes to risk taking. This approach goes in line with the agency theory. In addition, the balance of power stems from the differences within the governance mechanisms related to investor protection in different countries. In many emerging economies, the development of financial markets and investor protection is not yet fully developed. The frameworks for accounting, transparency, and disclosure are generally weak, as is the capability of the regulators to serve as the counterbalancing influence.

In relation to the institutional environment, the legal framework shaping the governance of banks varies substantially, from banks operating under common law, continental law or in some cases, a combination of both. Common law provides stronger protection for the shareholders (La Porta et al, 2000). In civil law countries, the role of corporate governance has traditionally been more to ensure a balance of the interests of a variety of key groups such as employees, managers, creditors, suppliers, customers and the wider community (Solomon & Solomon, 2004). Specifically, the market for corporate control lies at the heart of the Anglo-American system of corporate governance, while the salutary role of non-shareholder constituencies, particularly banks and workers, is central to the Franco-German governance model (Macey & O'Hara, 2003).

The ownership forms also differ between the two systems. The Anglo-American system is known for rather dispersed ownership. When ownership is diffuse, as is typical in the U.S. and the U.K., agency problems originate from the conflicts of interests between outside shareholders and managers who own little equity in the firm (Jensen & Meckling, 1976). The Continental European system tends to be more concentrated in terms of ownership structure and a large divergence of cash flow rights from control rights. Concentration of ownership is measured by the size of the largest shareholders (Becht & Roell 1999). Normally, one way of mitigating the control effect between managers and shareholders (agency problem) would be to concentrate the ownership. Banks are generally known to concentrate their ownership structure, therefore balancing the incentives of shareholders and managers. La Porta et al, (2000) argued that a better investor protection framework will reduce the need for the emergence of large shareholders to control management. The largest shareholder is defined as the largest direct or indirect stake of an individual shareholder or a group of shareholders (Köhler, 2012). Normally, large shareholders should mitigate the self-interested managerial behaviour. While concentrations of shareholders can bring financial and managerial strength to an institution, they can also bring self-serving and abusive behaviour to the detriment of interests of small shareholders, depositors, and the public.

Market efficiency is another way to increase the power and the protection of shareholder (Manne, 1965). Unfortunately, this is often absent in emerging economies whose financial markets are still under-developed. And, how functional is market efficiency as a governance factor? In the developed financial markets, the level of disclosure, transparency and market efficiency had been heralded. In actuality, it all failed.

The theoretical framework provided by Hansmann (1996) provides a grounded basis on how the ownership structure affects the internal design of the organizational structures including the internal governance mechanisms. Ownership form of the bank can imply differences in its respective organizational diseconomies; costs of delegated monitoring; and therefore, the likelihood that specialization in transactional or relational lending could be different across ownership forms of a given size (Delgado, Salas & Saurian, 2007). Ownership form of the bank and the attitude toward risk should be seen purely from the behaviour perspective and how it matters for economic performance. The relationship between the ownership structure of the banking system and the risk attitude towards better performance has been intensively discussed, both theoretically and through empirical literature, mostly focusing on ownership concentration (Berle & Means, 1932; Jensen & Meckling, 1976; Fama, 1985), and the nature of owners (Alchian,

1965; Shleifer & Vishny, 1997). Empirical research in terms of the effect of ownership concentration on risk taking finds a significant relationship between the two (Saunders, Strock & Stavlos, 1990; Gorton and Rosen, 1995; Houston and James, 1995; and Demsetz, Saidenberg & Strahan, 1997).

Additional literature, which has built on agency theory about the direct effect of ownership concentration on bank risk, assumes that stakeholders prefer more risk to less, (Saunders, Strock & Stavlos, 1990; Demsetz, Saidenberg & Strahan, 1997; Iannotta, Nocera & Sironi, 2007). However, it is not the preference for more risk, but the preference for higher returns on their investment by stakeholders (most often shareholders) which results in higher risk. In order to obtain higher returns, managers must resort to higher risk-taking in their banking activities. And this occurs as much in instances of high ownership concentration as it does in diverse ownership. Market prices on listed shares are very much influenced by the return on equity investment. Self-serving controlling owners seek dividends (and other forms of compensation such as preferential loans or high deposit rates), which must be funded somehow, usually by higher risk taking.

Governance mechanisms work differently depending on the type of ownership structure. Iannotta, Nocera & Sironi (2007), in their hypotheses on the ownership–governance interaction on the large European banks, compare government owned banks (GOB); privately owned banks (POB); and, mutual banks (MB) on their profitability, cost efficiency and risk. They find that when accounting for bank characteristics, country and time effects, mutual banks and government-owned banks exhibit a lower profitability than privately owned banks, in spite of their lower costs. Several other researchers found that GOBs are less efficient than POBs (La Porta, Lopez-de Salis & Shleifer, 2002; Beck, Demirgüç-Kunt & Maksimovic, 2004; Berger et al., 2005; Micco, Panizza & Yanez, 2007; Iannotta, Nocera & Sironi, 2007). Iannotta, Nocera & Sironi (2007) focused on large European banks, which, regardless of country and whether they are privately or mutually owned, are subject to the EC Directives and supervisory regime. Mutuals (of which there probably are not too many large ones, so the sample size may result in unreliable conclusions), focus on serving the needs and preserving the funds of the owners, who usually are individuals and not corporate, and consequently would focus on less risky, lower return activities. Government-owned institutions tend to provide lower cost loans and investment products in order to stimulate economic development in areas/sectors that are government priorities. So both these types would be expected to have lower returns because of the reason for, and the way, they price their products. In most emerging economies, the results of the second group of studies would be the expected norm because the GOBs in these countries generally serve as employment agencies for govern-

ment and “connected” persons and tend to loan to the interests of persons of influence in their governments, who sometimes feel no obligation to repay. Micco et al. (2007) found that whether a bank is privately owned or state owned does affect its performance. According to their results, state owned banks operating in developing countries tend to have lower profitability, lower margins, and higher overhead costs than comparable privately owned banks. In industrialized countries, however, this relationship has been found to be much weaker. Iannotta, Nocera & Sironi (2007) point out that government owned banks exhibit a lower profitability than privately owned banks.

There are also a number of both single and cross-country studies which investigate the impact of ownership on banking in Central and Eastern Europe and these analyses vary in terms, countries and period under analysis. Bonin, Hasan & Wachtel (2005b) found that government-owned banks are least efficient. Grigorian & Manole (2002) observed that private banks established after the start of the transition are no more cost efficient than old banks. Drakos (2002) conclude that foreign entry may improve the overall performance of the banking system. To an extent, Bonin, Hasan & Wachtel (2005b) reflect the general perception regarding GOB, whereas Grigorian & Manole (2002) could reflect on the initial period during which one of the imposed conditions for a foreign bank to purchase an existing bank was that it would not create wholesale unemployment. In some instances, the transition from the one-tier banking system to the privatized two-tier banking system was prolonged. The old banks became “private” banks overnight but still were overstaffed and their portfolios were poor because the object was not for profit but to fulfil the “plan”. The firms these banks loaned to also were not efficient or profitable. It took a prolonged period during which both the private sector firms and the “privatized” banks were restructured.

In similar vein, Crespi, Garcia-Cestona & Salas (2004) analysed three forms of ownership, Independent Commercial banks, Dependent banks and Savings banks and found a negative relationship between performance and governance intervention (changes in the board, removal of the Chairman, CEO dismissal and mergers/acquisitions) for banks, but the results change for each form of ownership and each type of intervention in the Spanish banking industry. This confirms the statement that “one size does not fit all”. Results will depend upon the nature of the problem that caused the intervention and whether the intervention was an appropriate one in the circumstances. The different forms of ownership may have limited the types of interventions that could have been taken.

In terms of the *nature* of shareholders, it is a common belief that both block holders and institutional owners are capable of changing corporate behaviour

towards risk. Specifically in the banking industry, institutional ownership has largely outperformed individual and family ownership over time. In many instances, holding firms are listed on major exchanges and have diverse ownership, but the influence of the diverse ownership, being indirect, tend to be subjugated to the interests of the immediate institutional owner. Barry, Lepetit & Tarazi (2011) argue that institutional investors can shape the nature of corporate risk taking. Hartzell & Stark (2003) find that institutional ownership concentration is positively related to the pay-for-performance sensitivity of executive compensation, whereas Cheng, Hong & Scheinkman (2010) argue that institutional investors are more sophisticated and provide a monitoring service. Both conclusions are valid and are not mutually exclusive, nor does either guarantee good governance or risk management.

The studies focusing on the *origin* of the owner (foreign vs. domestic) find foreign banks to be more profitable in general but specificities of the country of their operation do have an impact on their performance. Demirguc-Kunt & Huizinga (1999) find that foreign banks have higher margins and profits compared to domestic banks in developing countries, while the opposite holds in developed countries. In investigating the determinants of bank efficiency and performance, Grigorian & Manole (2002) and Bonin, Hasan & Wachtel (2005a) find that foreign-owned banks are significantly more cost efficient than domestic banks. In terms of the age of a bank, Kraft & Tirtiroglu (1998) document that newly established banks are less efficient but offer better profit performance than either privatized or state-owned banks, whereas Jemric & Vujcic (2002) find that new banks are more efficient.

Numerous empirical studies investigating this issue have been published. Some of them provide evidence on cross-country level and some on the banking system of individual countries. Most of them provide evidence relating to UK and US firms or Fortune 500 firms, or related to a single country. Less of these cross-country studies have been conducted to investigate the impact of ownership on banking in transition countries. Though there are many studies on banking in transition nations, this literature focuses mostly on countries in Central and Eastern Europe, such as Croatia (Kraft & Tirtiroglu, 1998; Jemric & Vujcic, 2002), the Czech Republic (Matousek & Taci, 2002; Weill, 2003), Hungary (Hasan & Marton, 2003), and Poland (Nikiel & Opiela, 2002; Weill, 2003).

The results of these studies, which primarily examine the association between bank ownership and performance, and that between ownership and efficiency, are rather mixed. Hasan & Marton (2003), Jemric & Vujcic (2002), and Weill (2003) find that bank efficiency is positively related to foreign as opposed to state

ownership, while Nikiel & Opiela (2002) observe that foreign banks are less profit efficient than domestic private banks. Finally, looking at a more detailed breakdown of bank ownership, Fries & Taci (2005) find that private banks are more efficient than state-owned banks, and that privatized banks with majority foreign (domestic) ownership are the most (least) efficient. Share ownership by managers (inside directors) is another governance mechanism that aligns the interest of managerial/board interests with those of shareholders. Brickley & James (1987), Allen & Cebenoyan (1991), and Carter & Stover (1991) find that share ownership by managers and directors is beneficial to shareholders of banks.

Countries worldwide differ considerably in the extent of foreign ownership in their banking systems. A characteristic of transition countries is the transformation of their economies from a centrally planned to market oriented. Each transition country's banking system varies in terms of foreign ownership but the research to date indicate that foreign ownership and private ownership can generate better performance than state ownership. This level of the impact has to be considered not only from the view of corporate governance mechanisms at bank level, but in relation with the corporate governance mechanism at country level (external governance mechanisms). A potential area for future research would be to focus on a wider set of governance mechanisms and investigate their interaction with the institutional environment as to what extent are they influenced by the institutional setting in which banks and their owners operate.

4.2. Board of Directors

Boards of Directors are at the heart of the governance structure of any corporation for its well-functioning and long term performance. Boards should act as the ultimate body of oversight as their role usually encompasses the setting of the development strategy, mobilizing the necessary resources (human and financial) to implement it, and overseeing performance against the strategy set out. Boards can be an important internal governance mechanism for protecting shareholders' interests (Fama, 1980; Fama & Jensen, 1983). Boards are at the centre of the corporate governance system of a bank, as they are the link between the three levels of parties of interest; the shareholders, the managers, and the stakeholders by ensuring proper disclosure and transparency.

In its consultative document titled "Enhancing Corporate Governance in the Banking Industry", the Basel Committee on Banking Supervision (BCBS, 2006) as the primary global standard-setter for the prudential regulation of banks identifies the board as an essential part of a bank's regulatory reforms. Board struc-

ture and their effectiveness has started to receive intensive attention of the regulators, policy creators and researchers after the 2007/2008 financial crisis, since board ineffectiveness was viewed as the major cause of the financial crisis. The OECD Steering Group on Corporate Governance argued that board failures in financial firms are a major cause of the financial crisis (Kirkpatrick, 2009). In response to this, the OECD Steering Group on Corporate Governance launched an action plan to improve the shortcomings of corporate governance. Soon after the crisis, board structures, particularly those in banks, started to catch the attention of not only the regulators and supervisors of banks but of many scholars as well.

Corporate governance literature identifies three determinants of the effectiveness in the board composition: independence (number of independent members against inside members), size (large number of board members vs. small boards), and experience (past financial expertise). Equity ownership by inside directors or managers, and lately the gender determinant (male vs. female), have been the subject of some research as well. The question remaining to be answered is how the composition of the boards of directors influences the risk taking and performance of banks.

As indicated above, limited research was devoted to board composition and its effectiveness of the banks prior to the crisis. In addition, the focus of the literature was mostly on non-financial firms. Most studies of board effectiveness exclude financial firms from their samples and as a result, we know very little about the effectiveness of banking firm governance (Adams & Mehran, 2012).

Since there is limited theory as to the most important board characteristics, an ad hoc selection of variables is made based on those emphasized most in the literature as a proxy of a 'strong bank board': board size, independent directors, and less restrictive shareholders rights (such as non-staggered boards) (Pathan, 2009). In terms of the roles and responsibilities of the board, theoretical governance literature on boards suggests that choosing appropriate board composition and size would balance the monitoring and advising the management (Raheja, 2005; Adams & Ferreira, 2007; Harris & Raviv, 2008). In the same vein empirical evidence follows the same view (Boone et al. 2007; Coles, Daniel, & Naveen, 2008; Lehn, Patro & Zhao, 2008; Linck, Netter & Yang, 2008).

Most of the pre-crisis literature focused on responsibilities of the board and their *role* to run the institutions (Mace, 1971; Shleifer & Vishny (1986), as well as, the composition and their effectiveness in exercising their roles (Brickley & James, 1987; Morck, Shleifer & Vishny, 1988; Yermack, 1996, 31. Brewer, Jackson & Jagtiani, 2000; Byrd et al. 2001). In terms of the board size and composition,

Brewer, Jackson & Jagtiani (2000) studied the effect of governance characteristics on merger premiums in banking during the 1990s and found that bid premiums increase with the independence of the target board and that they are not affected by the target board size. Byrd et al., (2001) investigated the effect of the board composition (independent directors) of the thrift industry during the 1980s crisis and found that thrifts that survived the crisis had a larger number of dependent directors. So the question that arises is what would be the optimal board size? Would it depend from the capital structure, organizational form or any other organizational characteristics? Raheja (2005) indicates that the optimal board size and composition are functions of directors' and firm's characteristics.

Empirical literature studying the impact of the board characteristics worldwide such as structure, composition, size, gender, and the like, gives rather inconclusive results. Pathan (2009) uses a sample of 212 large US bank holding companies from 1997 to 2004 and he finds that bank risk decreases with board size, board independence, CEO power, and CEO equity ownership. Adams & Mehran (2012) use a sample of 35 publicly traded Bank Holding Companies in the U.S. over the 1986–1999 period and examine the relationship between board governance and performance. They find that board size is positively correlated with performance. In a sample of 69 boards of large commercial banks from Canada, France, the UK, Italy, Spain, and the U.S. from 1995 to 2005, Andres & Vallelado (2008) found that bank performance has a significantly positive relation with an inverted U-shaped relation with board size and the proportion of outside directors. Expanding further to the board variables, using a sample of 41 banks, Rowe, Shi & Wang (2011) examine the impacts of different board variables on the Chinese bank performance and find that the percentage of executive directors in the boards has a significantly negative impact while the percentage of shares owned by the board has a significantly positive impact on bank performance. Some other aspects of corporate governance in banks, such as board characteristics and CEO pay and ownership, have been addressed in a few recent academic studies (e.g. Beltratti & Stulz, 2009; Erkens, Hung & Matos, 2010; Minton, Taillard & Williamson, 2011).

The size of the board has some influence, especially if the composition is reasonably balanced with independent directors who would represent minority interests and the interests of the community which the bank serves. But a more important and the key factor in the composition is whether the board members individually and collectively are able to provide independent and competent oversight of management's risk taking activities. In small banks with traditional banking activities – lending and deposit-taking – this is usually achievable, but in larger banks with complex activities, finding a mix of competent persons is difficult. In emerging and restructuring economies, usually smaller economies, the avail-

able pool of persons who would be both independent and competent generally is thin. In larger, more developed markets, where risk taking activities involve a more complex array of products, competence of the board members is highly questionable – as was seen in the crisis and in other instances where controls (a governance mechanism) broke down. Banks in these markets are now both too big to fail and too big not to fail. The size, volume and complexity of large bank activities are beyond the ken of most board members, auditors, and regulators. Competence to identify and monitor risks is shrinking, while the risks are increasing. This raises an important question of whether the traditional structures of supervisory board and management are still sufficient.

Beltratti & Stulz (2009) argue that banks that were pushed by their boards to maximize shareholder wealth before the crisis took risks that were understood to create shareholder wealth, but were costly post crisis because of outcomes that were not expected when the risks were taken. Erkens, Hung & Matos (2010) investigate the relation between corporate governance and performance of financial firms during the 2007/2008 credit crisis using an international sample of 296 financial firms from 30 countries and they found that firms with more independent boards raised more equity capital during the crisis. In contrast, Beltratti & Stulz (2009) and Fahlenbrach & Stulz (2011) find that better corporate governance, i.e. a more independent board to be positively related to the banks' crisis performance.

4.2.1 Board Size

The most recent empirical studies on board size find that a large board influences the corporate performance in a negative way due to difficulties with communication, reaching the consensus and agency problems. Jensen (1993) argues that large corporate boards are less effective due to the problems of coordination, control, and flexibility in decision-making and give excessive control to CEOs. Yermack (1996) and Eisenberg, Sundgren, & Wells (1998) provide support by showing that firms with small boards had superior financial performance. Pathan (2009) finds that small and less restrictive boards positively affect bank risk-taking. However, in contrast to this, other studies argue that larger boards may improve firm performances by facilitating manager supervision and bringing more human capital to advise managers. Coles, Daniel, & Naveen (2008) find that large boards positively impact firm performance, particularly for firms requiring more advising, such as complex firms that operate in multiple segments. Cheng (2008) also argues that because of the coordination problems that can arise in larger boards, the decisions of larger boards might be less extreme, resulting in lower levels of

risk. Andres & Vallelado (2008) also found a non-linear effect of board size on bank performance.

The varying conclusions within these studies indicate that size does not matter. However, with a large Board, the possibilities exist to establish committees with specific, delegated responsibilities that are peopled by appointees with more directly relevant skills and experience that relates to the responsibility of the committee. This solves the coordination and communication problems noted in some of the studies, provides a better focus and ability to monitor risks for which the committee is responsible.

4.2.2 Board Independence

The independence of directors on the boards is considered the most important measure when it comes to board effectiveness. Cotter, Shivdasani & Zenner (1997) define a board as independent when independent directors are more than fifty percent of the board membership. The literature is inconclusive in terms of the impact that large independent board might or might not have on effectiveness. Adam & Ferreira (2009b) show that banks with more independent board members performed worse during the crisis because they received more money from the Troubled Assets Relief Program (TARP). The findings related to the receipt of the TARP funds for the banks which had more independent board members, is also consistent with Beltratti & Stulz (2009). The question still remains about the equitable distribution of TARP money since many of those “independent” board members were politically tight with influential US politicians and the Federal Reserve leadership. Erkens, Hung & Matos (2010) argue that firms with more independent boards and higher institutional ownership experienced worse stock returns during the crisis. Agrawal & Knoeber (1996) find that a higher percentage of independent boards decreases a firm's value. In contrast, Rosenstein and Wyatt (1990) show that stock prices react positively to the nomination of independent directors to the board. Usually this occurs after a crisis or internal debacle that has become public knowledge and the appointments are seen by the Board (and regulator) as a means of counteracting adverse public reaction. In the normal course, public reaction to changes in the board is low. Similarly, Klein (2002) argues that earnings quality increases with the proportion of independent directors. Hermalin & Weisbach (2003) and Coles, Daniel, & Naveen (2008) find no statistically significant impact of a firm's number and/or percentage of outside directors on firm performance.

A growing body of literature examines the percentage of directors with experience (present or past). The importance of the *financial expertise* (competence) of independent boards became an important subject soon after the crisis. Fernandes & Fitch (2009) found that banks with more financial experts serving as outside directors limit their risk exposure before the crisis and exhibit better stock return performance during the crisis. Minton, Taillard & Williamson (2011), finds that financial expertise among independent directors of commercial banks is negatively related to changes in both firm value and cumulative stock returns but is positively associated with risk-taking levels in the run-up to the crisis using both balance-sheet and market-based measures of risk. Garicano & Cuñat (2009) find evidence for Spanish *cajas* demonstrating that *cajas* that had chairmen without previous banking experience (or without postgraduate education) performed worse. Similarly, Hau & Thum (2009) find evidence that lack of financial experience of board members in German banks was strongly positively related to losses by the banks. Finally, a board should have an appropriate mix of experience and capabilities to serve its purpose of monitoring and evaluating both management and its corporate strategies.

4.2.3 Structure of the board

The structure of the board can be organized as dual or sole board system also known as one-tier and two-tier board structure. Most countries have adopted only one of the two following board structures: the first is the unitary board of directors used in common law countries, and the second, the two-tier board structure, is used in several code law countries (Reyes & Zhao, 2010). A typical two-tier system adopted by some countries refers to the supervisory board and management board which is comprised of the main executives. The motivation behind adopting a two-tier system vs. one-tier is to have strong separation between the management and control functions. Also due to the complex and opaque bank structure it is considered to be highly important to have an independent risk committee or independent Chief Risk Officer (CRO). Adams & Ferrera (2007) analyse the consequences of the board's dual role as advisor as well as monitor of management and they find that it may be optimal to separate the advisory and monitoring roles of the board; that is, to have a dual board system as in many countries in Europe, as long as this optimum is reached by having a management friendly board due to the willingness (unwillingness) of the CEO to withhold or share information with the supervisory board. The information sharing factor by the boards to gain knowledge about firms' projections and strategies and facilitate the decision making process has been a subject of other studies as well (Raheja, 2005; Harris & Raviv, 2008; Fenghu & Thakor, 2007).

A growing body of research is also considering the gender diversity of the boards (e.g. Erhardt, Werbel & Shrader, 2003; Carter, Simkins & Simpson, 2003; Adams & Ferreira, 2009a; Farrell & Hersch, 2005), and the evidence is inconclusive. Most of this research focused on non-financial firms, and studies that have banks in terms of gender diversity in their sample, are still rare. Therefore, theoretical connection between gender diversity and firm performance as with other governance mechanisms relies on studies of non-financial firms due to the absence of such theoretical research for banks.

Bear, Rahman & Post (2010) indicate that a way to ensure that more perspectives and issues are considered in the decision-making process, resulting in the board's better decisions, diversifying boards by increasing the number of female directors would be a proactive approach. Mateos, Gimeno, & Nieto (2012) find that firms under competitive market conditions have a greater presence of female directors. Based on a sample of 212 large US BHCs over the period 1997–2011, Pathan & Faff (2013) find that gender diversity in the boardroom improves bank performance in the pre-SOX period (1997–2002), and that the positive effect of gender weakens in the post-SOX (2003–2006) and crisis periods (2007–2011). Adams & Ferreira (2009a) find that the proportion of women on boards increases the CEO performance-turnover sensitivity. Women are perceived to be less risk prone. Mateos, Gimeno & Nieto (2012) using a large sample of 612 European banks from 20 European countries found that women accounted for just 7% of the board members of European banks in 2006, and that the proportion of women is higher on the boards of banks with lower risk and less leverage.

5. Risk Management

Enhancing risk management framework has been the most recommended policy action especially after the 2007/2008 financial crisis. The second pillar (supervisory review process) of Basel II identifies the role of the board as an integral aspect of risk management, therefore aligning the internal governance structure in the light of comprehensive risk management approach seemed like an immediate need. Two of the most important internal governance mechanisms which support the comprehensive risk management framework are the establishment of an Independent Chief Risk Officer (CRO) and/or Risk Management Committee (RMC) that will have an oversight responsibility for all risks undertaken by the bank. The need for these two risk governance mechanism to be established and strengthened has become a necessity in the post-crisis period. A vast majority of banks did not have CROs in their teams prior to the crisis nor was its independence clearly defined either.

The academic literature in this area is limited as well. The most prominent study investigating the strength and independence of the risk management was done by Ellul & Yerramilli (2013) during the credit crisis in a sample of large US bank holding companies. Their Risk Management Index (RMI) which is based on five variables related to the strength of a bank's risk management, including a dummy variable whether the bank's CRO is a member of the executive board and other proxy measures for the CRO's power within the bank's management board. They found that banks with a high RMI value prior to the crisis (2006) had lower exposure to private-label mortgage-backed securities, a smaller fraction of non-performing loans, lower downside risk, and a higher Sharpe Ratio¹ during the crisis years 2007/2008. Using a sample of 573 North American banks, Aebi, Sabato & Schmid (2012) find that banks in which the CRO directly reports to the board of directors and not to the CEO (or other corporate entities), exhibit significantly higher (i.e. less negative) stock returns and ROE during the crisis. In contrast, standard corporate governance variables are insignificantly or even negatively related to the banks' performance during the crisis. Keys et al. (2009) find that larger relative power for the CRO (measured by CRO compensation divided by the amount of compensation given to the top five paid executives) implies lower default rates on loans (mortgages and home equity loans). To summarize, the above findings in the empirical literature suggest that banks need to significantly improve the framework and quality of their risk management function since the crisis has highlighted the importance of the risk governance in the banks.

6. Conclusions

The 2007/2008 financial crisis has highlighted that corporate governance requires major improvements both in developed and developing economies. International organizations have been working at arm's length with the regulators and policy-makers in order to improve corporate governance practices both in non-financial and financial institutions such as banks. Moreover given that most of the existing evidence is based on the performance of banks in developed countries, it is important to extend the existing evidence to other developing countries and to include additional bank-specific characteristics that have not been extensively analysed so far, such as the ownership structure, board structure and risk management. Additional research needs to be done in a banking sector where less is known about governance structures, which requires a separate analysis of their

¹ The Sharpe ratio is calculated by subtracting the risk-free rate - such as that of the 10-year U.S. Treasury bond from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns.

corporate governance within a greater timeframe to truly analyse the banks' behaviour. An ideal timeframe would be to analyse banks' behaviour before, during and after the recent crisis, therefore looking at overtime trends. This analysis and its findings would represent areas of opportunity for banks searching to improve their corporate governance framework and practices and for policymakers looking for policy measures that can contribute to achieving it. Further research will be needed to make headway on such issues.

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