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FEATURE ARTICLE

The corporate governance of banks

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Abstract

Purpose – To consider the implications of the banks fiduciary duty to their depositors (as well as the shareholders) and the government's fiscal duty to taxpayers (in the presence of deposit insurance) for the corporate governance (CG) of banks.

Design/methodology/approach – Recent contributions to the literature are outlined and assessed in the context of the asymmetric information literature relating to banking.

Findings – The good CG of banks requires regulation to balance the interests of depositors and taxpayers with those of the shareholders.

Originality/value – Linking the bank regulation in literature based on information asymmetry to the CG literature.

Keywords Banks, Corporate governance, Regulation

Paper type Viewpoint

Introduction

Banks are special because their managers have a fiduciary duty to (more risk averse) depositors as well as (more risk prone) shareholders and thus a solution to the "principal-agent problem" aimed at maximising shareholder value is inappropriate. Further, banks are the most important source of external finance, especially for small and medium enterprises (SMEs), and thus play a key role in allocating capital and the corporate governance (CG) of non-financial firms. Further, they are at the core of payments systems and so systemic crises are very costly. Depositor protection helps reduce the risk of systemic crises, but at the cost of increasing moral hazard and adverse selection; requiring the government to protect taxpayers against abuse by banks taking excessive risk. Good regulation, aimed at curbing excessive risk taking, thus becomes a cornerstone of the good governance of banks. This argument can be extended to other financial firms given their fiduciary duty to retail savers as well as shareholders.

The contributions of Macey and O'Hara (2003) and Levine (2003) to the literature on the CG of banks are reviewed and their recommendations assessed and placed within the context of the literature on asymmetric information in banking. The implications for Basel II's "three pillars" in developed and developing countries and other related issues are then considered before policy conclusions are drawn.

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Why banks are special

Banks are the dominant financial institutions, in the sense that loans from banks are the main source of external finance for business in all economies. Banks are most dominant in countries with the least developed and capital markets, such as developing countries, and least dominant in the USA, which has the most developed financial markets. Further, firms and households primarily rely on banks for payments services. In the USA, since the Glass-Steagall Act was repealed in 1999, many commercial banks have developed investment banking capabilities to service the need for broking and underwriting services of their larger corporate clients in the manner of the continental European universal banking model.

Consequently, banks play a major role in the CG of non-financial firms. This is particularly true in countries such as Germany where the big banks commonly hold shares in non-financial firms and can exercise proxy voting rights and are thus effectively institutionalised investors. Big banks in Japan are also significant shareholders. In contrast, in the USA (and the UK), banks do not normally have significant shareholdings in non-financial firms.

Further, in all countries, banks are by far the most important source of external finance for SMEs, which are effectively dependent on banks for external finance, and the SME sector accounts for more than half of the output or employment in non-centrally planned economies. Typically, it is only high-tech growth firms that have access to venture and private equity funding and this is generally not highly developed in many countries.

It is well known that banks are prone to instability due to the combination of information asymmetry and the practice of holding reserves that are a fraction of (demand) deposit liabilities. Experience has also demonstrated that systemic banking crises are extremely costly to taxpayers (who must ultimately fund the restructuring and re-capitalisation of banks) and in terms of lost growth whilst the banks' ability to lend is impaired.

Banks and corporate governance

Well governed banks are more likely to allocate capital efficiently and less likely to fail. They are thus more likely to assure that other firms also allocate capital efficiently and to contribute to monetary and financial stability; which itself is likely to encourage investment and growth.

In lesser developed countries, government ownership of banks and direction of their lending to prioritised sectors of the economy, in the name of industrial and development policy or to politically favoured borrowers, for example, is widespread. This raises numerous conflicts of interest if the government's or politicians' objectives are not to maximise public economic welfare. CG is thus embedded in and conditioned by the wider governance system and can only be expected to be effective if the wider governance structure is supportive.

Similarly, the independence and effectiveness of financial regulators and supervisors is dependent on the quality of the wider governance system, including the judiciary.

A supportive (independent and trusted) legal system is thus a requirement for good CG. Bankruptcy laws are particularly important, because banks need to be able to

remove capital from poorly performing firms and to re-invest it in firms with greater potential, if they are to allocate capital efficiently on a dynamically continuous basis.

Why is the CG problem for banks different?

Viewed from the perspective of the principal-agent problem, the CG problem in the case of a non-banking firm can be viewed as one of finding a set of incentives that align the interests of agents (management) with that of the principals (owners and shareholders) of firms. Under Anglo-Saxon legal systems, firms have a fiduciary duty to their shareholders and the managers should thus run the firms in the shareholders' best interests.

In the case of deposit taking banking firms, however, the management has a fiduciary duty to depositors as well as shareholders. Macey and O'Hara (2003) explore the implications of this for bank regulators and also stress that the existence of state-backed deposit insurance creates a fiscal duty for the government to protect tax payers against excessive drawings on the deposit insurance fund.

In any particular bank, the interests of bank depositors, who are seeking a safe haven for their money, are not the same as those of bank shareholders, who have chosen to hold a more risky asset in pursuit of a higher return. If a bank is run in the interests of its shareholders, it may thus take more risk than its depositors would like.

Hence, governments have an incentive to protect both bank depositors and taxpayers (and thus voters) by regulating banks to discourage excessive risk taking and to protect the deposit insurance scheme from moral hazard abuse by bank management.

Good bank regulation and supervision thus becomes part of the CG system of banks. Historically, such considerations have also been used to justify quantitative controls on bank lending and other asset holdings by regulators and supervisors in development countries. Some still remain, but generally the trend over the past 20 years or so has been to remove such controls and replace them with risk related capital adequacy requirements.

To a considerable extent, the arguments for the specialness of the banks' CG problem carries over to other financial firms, which have a fiduciary duty to savers (household investors), especially where the state provides an investor protection fund. Further, the definition of a bank has become problematic as commercial banks have diversified into investment banking and insurance and vice versa.

Levine (2003), who seems to have in mind commercial, deposit taking and loan making banks, pinpoints two main sources of bank specialness. The first is their greater "opaqueness" than other (financial and non-financial) firms. The second is the fact that they are more heavily regulated than most other firms in most economies. Their regulation often includes direction of lending and government ownership, especially in developing and formerly centrally planned economies, as noted above.

As regards the second source of specialness, we should recall James Tobin's question: are banks different (special) because they are regulated differently and are they regulated differently because they are different (special)?

The importance of asymmetric information

Neither Levine (2003) nor Macey and O'Hara (2003) address the question of why banks have a high "opaqueness" and are relatively heavily regulated. The academic literature

on the implications of asymmetric information for banking and the wider financial system (which is nicely summarised in Mishkin (2003)) provides some answers. Essentially, banks exist (and hence are necessarily opaque) because the borrowers know more about their credit worthiness than the lenders (the banks). If this were not the case, all finance would be "direct" or non-intermediated, finance. We would only need money and capital markets and there would be no need for bank intermediation.

Depositors leave the costly job of collecting and processing information on the credit worthiness of firms (and other borrowers) to specialists (banks) and thus are at an information disadvantage relative to bank management as regards bank asset quality (Ackerlof, 1970). The combination of information asymmetry and fractional reserve banking makes un-insured depositors prone to panic and so individuals bank failures can be expected from time to time. Domino-effects, in which un-insured depositors at other banks also panic, can be expected; resulting ultimately in systemic banking or wider financial crises.

Deposit insurance can eliminate panics, but at the cost of increasing moral hazard by removing the incentive for depositors to choose the best banks. In the presence of interest rate competition, "flat-rate" deposit insurance (related simply to the aggregate of protected deposits in a bank) can generate adverse selection under which deposits are attracted to the most risky banks. These are generally ones that aim to grow fast by offering higher interest on deposits than competitor. To make a return they then need to earn a higher than average return on loans and thus to take on more risky loans than competitors. Costs generally cannot be cut quickly enough under a rapid growth strategy to generate the higher returns. The riskier loans are commonly those shunned by other, less aggressive, banks. This was a factor underlying the US Savings and Loan crisis and the Credit Lyonnais debacle. Risk-related deposit insurance premia, where the premia are related to the risk to which the depositors are exposed through the banks lending decisions are thus preferred.

Further, taxpayers (voters) need to be protected against abuse, by bank management, of state-backed deposit insurance schemes and against the risk of systemic crises and consequent costly bail-outs.

Information asymmetry thus explains why banks exist and are highly opaque, why they are commonly heavily regulated and also why SME's face credit rationing (Stiglitz and Weiss, 1981), herd behaviour amongst banks and much more.

The next question is how best to regulate and supervise banks in order to assure the effective CG of banks?

Basel II's three pillars

What is the appropriate balance between Basel II's "three pillars": bank regulation (risk-related capital adequacy requirements, etc.), supervision, and market discipline?

Macey and O'Hara (2003) argue for greater formal legal recognition of the fiduciary duty of banks to depositors and clarification of the relationship between that duty and the banks' fiduciary duty to bank shareholders (and others creditors, such as bank bondholders). Essentially, the boards of directors should be made responsible for the fulfilment of the fiduciary duty to depositors and adequate internal controls should be put in place. Supervisors and external auditors then primarily have an oversight role.

Levine (2003), tentatively comes down in favour of less regulation (formal rules backed by legislation) and better information and incentives for private agents

(through "market discipline" and institutional investors) to exert governance over banks. He concludes that the good CG of banks required building sound legal and bankruptcy systems, which he notes can be lengthy processes. He also finds that evidence tends to support the establishment of independent (of government) supervisory authorities with well defined objectives.

We may note, however, that independence itself is hard to guarantee unless the wider governance system is robust and the legal system is itself politically independent. In many developing countries, central banks are often more trusted than governments and "independent agencies" staffed by government appointees may be distrusted. Further, in many countries (e.g. Japan) former regulators frequently anticipate "descending from heaven" to take up directorships on boards of banks which they previously regulated, leading to conflicts of interest.

Levine (2003) is sceptical about proposals to require banks to issue a sufficient proportion of subordinated debt and debentures to ensure that informed creditors perform the bank monitoring role in place of uninformed depositors. This is because the legal rights of "bondholders" and especially non conventional debt holders (e.g. holders of Collateralised Debt Obligations, CDOs), are uncertain and are currently being contested. Also, large creditors may use their insider status at the expense of less informed, generally smaller, depositors. Nevertheless, there is evidence that the bond markets are increasingly playing a useful direct role in regulating banks (Ashcroft, 2006) at least in the USA, and thus also that credit rating agencies might also play an increasing role in the CG of banks.

Levine also observes that greater disclosure is required to increase market discipline. Hence, accounts and internal controls need to be reliably audited according to widely accepted international accounting standards. This concurs with developing practice, especially in light of the 2002 US Sarbanes Oxley Act and the work of the International Accounting Standards Board, but full global harmonisation remains a distant goal.

There is, however, a limit to how far disclosure can be increased without reducing the incentives for banks to undertake the cost of collecting and processing information (and thereby reducing information asymmetry and risk). This is because revealing proprietary information will allow other banks to copy without making a similar investment (the "free rider problem"). The business of banking is based on information not just money! Banks do, however, have incentives to share some information, e.g. on the credit risks of credit card applicants.

Further, market discipline is at its basis a reflection of the collective wills of shareholders, and may not be consistent with depositors' interests, especially during periods of "irrational exuberance".

Other related issues

Banking systems commonly have the structure of an oligopoly with a competitive fringe. The UK is archetypical and Germany an exception (Mullineux and Terberger, 2006). Oligopolies can be highly competitive, but there are often strong incentives for collusion, and other non-competitive behaviour, as appears to be the case in the operation of the UK payments systems.

The UK's Competition Commission and Office of Fair Trading have conducted and continue to conduct a number of investigations into the exploitation by big UK banks

of their oligopoly position in the payments system. High bank charges for various payments-related services have been identified and there seems to be a lot of cross-subsidisation, often of more wealthy by less wealthy customers. In the case of providing bank account services to SMEs, for example, the Competition Commission Report (2002) found the banks to be operating a "complex monopoly"[1] and imposed a rather odd pricing structure under which banks are required either to pay interest of at least the Bank of England base rate less 2.5 per cent on SME account credit balances or to make no charges for the main money transmission services (or to offer a choice between the two). The banks have generally chosen to credit interest (with Barclays on exception in offering a choice), leaving themselves free to set charges as they wish (Bank of England, 2003).

The UK's financial sector regulator, the Financial Services Authority (FSA), has also taken a substantial interest in related issues in light of the clear information advantage of the banks over the retail customers to whom they are selling increasingly complex financial products. There have been a number of incidences of mis-selling (pensions, endowment mortgages, etc.) and there is a clear need to raise the financial literacy of household clients. In order to re-establish public confidence in the financial system, the FSA has launched a treating customers fairly initiative (Llewellyn, 2005). It is hoped that as a result, voluntary agreed codes of practice and internal controls will evolve to reflect the responsibility of banks not to exploit customer's ignorance. However, the FSA has also begun to regulate products and has encouraged the development of basic mortgage, pensions and other products, and ruled out some complex products and the Banking Codes Standards Board experienced a surge in complaints about banks in 2006.

Oligopolistic structures also create a "too big to fail" problem (Morgan and Stiroh, 2005). The big banks know that the authorities cannot allow them to fail because of the disruption to commerce and consequent costs and thus may take more risks than would otherwise be the case. Historically, however, the oligopolotic structure was fostered in the UK by the club-like regulatory structure (Goodhart, 1985). There seemed to be a belief that less competition in banking was a price worth paying because it enhanced financial stability (Revell, 1975; Cruickshank, 2000). The *quid-pro-quo* was that the big banks, in return for their protection, performed certain public duties with regard to access to the payments system and finance. With the move away from self-regulation under the Bank of England as Club Chairman, to statutory regulation by the FSA, the situation has changed and banks have reneged on the contract and have increasingly competed and tried to exploit their "complex monopoly" powers (Cruickshank, 2005).

It should also be noted that the role of auditors in maintaining internal controls is contested. This is particularly so since they may regard themselves as too big to be effectively punished for sloppy practice and succumbing to temptations offered by conflicts of interest following the reduction of the number of major auditing firms to four after the post Enron demise of Arthur Anderson. There seems to be little confidence in solutions such as revolving auditors or audit partners and it is not clear how the number of major auditors can be increased. Should supervisors have responsibility for this instead and, if so, who should bear the cost of supervision? A similar problem relates to the reliance on three major international agencies to provide credit ratings on corporate debt as a fulcrum of market discipline.

Further, international CG standards have yet to be agreed. The OECD has compiled a list of best CG practices, but the EU has failed to agree on a common CG code. It has also failed to agree a common set takeover rules, which is becoming an increasingly important component of CG systems as capital markets develop and with them the market for corporate control.

Additionally, legal traditions and systems vary in type across countries (La Porta *et al.*, 2000), including members of the EU, and consequently bankruptcy laws afford different levels of protection to banks and their debtors and creditors in different countries. Few countries are totally happy with either their current bankruptcy laws, which have recently been amended in the UK and France, or indeed with their CG systems. The CG code seems to be under almost constant review in the UK and the 2002 Sarbanes-Oxley Act is under attack in the USA due to its supposedly high cost to benefit ratio and the growing fear that it is driving stock exchange business from New York to London.

Conclusions

The good CG of banks requires good (risk-related) prudential regulation and attention to conflicts of interest and competition issues, especially given the clear information advantage of banks over their retail customers. It will be facilitated by more disclosure of properly audited and internationally comparable accounts. The incentive to collect and process good quality information should not be diminished by free-rider problems, however.

Common principals of prudential regulation, CG and bankruptcy should form the basis of common codes ahead of agreement on more detailed common laws and rules, which will eventually be required in order to achieve a genuinely level global playing field.

Countries at different stages of development may, however, require different rules until a greater degree of convergence is achieved. It should also be noted, however, that as Basel II is progressively adopted by developing and emerging market economies, they will be induced to enhance their CG codes, internal controls, auditing procedures and bankruptcy laws in order to implement its risk-based approach.

Note

1. A "complex" monopoly situation, in relation to the supply of (banking) services in the UK, exists when at least one quarter of the services supplied (by a group of banks in this case) are supplied in such a way that prevents, restrains or distorts competition. Further details can be found in Section 7 (2) of the UK's Fair Trading Act.

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