Corporate Governance in Banking System.

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Abstract

Banks have a central role in any economy. They mobilize funds, allocate capital and play a decisive role in the corporate gove rnance of other firms. All this means that, when banks are efficient, they stimulate productivity growth and the prosperity of the whole economy. On the other hand, banking crises are able to destabilize the economic and political situation of nations. These strong externalities on the economy make the corporate governance of banks a fundamental issue. Well-governed banks will be more efficient in their functions than those governed poorly (Levine, 2003). And as a result of its relevance, in the case of banks, corporate governance is not merely a private, but also a public affair manifest through the existence of bank regulation and supervision. Furthermore, not only the good governance of banks is important, but the question arises as to whether it is different from other firms. As this paper will show, banks appear to pose new questions to the corporate governance problem due to their intrinsic characteristics and their regulated condition. In the current European situation, where the deregulation process has dramatically changed the competitive scenario of the banking industry in the recent years, understanding the corporate governance of banks becomes an exciting challenge. Given that the failure of the boards of directors and management is acknowledged to be one of the major causes of the collapse of many banks (Office of the Comptroller of the Currency, 1988), we believe that a better knowledge of the particular way banking firms are and should be governed will be very helpful in preventing important not only private, but also social costs derived from bank failures or simply poor bank performance. From the banks' perspective, the fine development of a governance system should be a main matter of concern and could constitute an essential strategic strength for banks willing to be competitive in the new EU scenario.In this paper we review the academic literature trying to understand the special characteristics of the corporate governance of banks and its role for the good performance of the banking firm. Our findings can be briefly summarized around three main questions:

1.Why are banks different?Existing research points at diverse features, such as,regulation,supervision, capital structure,risk, fiduciary relationships, ownership, and deposit insurance, that would make banks special and thereby influence their corporate governance.

2.What is different about the corporate governance of banks?According to past studies, boards of directors and takeovers, both friendly and hostile, play a weaker disciplinary role in banks; even though boards are larger, more independent, have a superior number of committees and meet more often. Top executives compensation is higher in banking, but pay-performance sensitivity is lower. Finally, while banks present more dispersed ownership structures, high government participation is common all over the world.

3. What works for banks? Within the governance system, the elements that seem to lead banks to increased performance,as suggested by the empirical evidence on the issue, are ownership concentration, certain levels of managerial shareholdings and larger boards. All this make us think that the whole understanding of the corporate governance problem may vary considerably with the industry and, perhaps, this could be one of the reasons behind the lack of more significant results in the corporate governance literature. In this sense, on top of banks, other sectors of the economy might benefit from this industry-specific study too by considering the potential uses of regulation to enhance their competitiveness.Nonetheless, it might also be important to keep in mind that the number of studies that focus specifically in the banking sector is not so large at the present moment and they have primarily been based on US banks. Therefore, it remains yet to be seen whether further research will confirm the current findings on the specific governance mechanisms conducing to the improved financial performance of banks. It is necessary to make clear some delimitations to our study. The corporate governance role played by banks in other firms has been broadly touched upon in the academic literature, but it does not constitute the object of our research in this paper, where we are concerned with the way banks themselves are being governed. Finally, the surveyed literature focuses mainly on commercial banks or universal banks that undertake the full range of traditional banking services.

1.Introduction

What is corporate governance?

There is a very wide literature on corporate governance. Research has been done both in theory and empirical issues. But, why has it become such a hot topic in the last years so as to attract all this unprecedented interest? According to Becht et al. (2002), we can find the explanation to this on a set of phenomena, such as: (1) the privatization wave that spread all over the world during the past two decades, (2) the pension fund reform and

the growth of private savings that meant increased investor activism, (3) the takeover wave of the 1980s in the U.S. and the 1990s in Europe, (4) the deregulation and integration of financial markets, and finally, (5) the recent scandals and failures that took place in some of the largest U.S. firms in the last years.
Now that we now what brought it into the picture, we may start wondering what is in fact all this corporate governance issue about. From a broad perspective, we could say that "Corporate governance is concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders. If we narrow the approach and take a straightforward agency perspective, focusing on the separation between ownership and control, then: "Corporate governance deals with the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment."(Shleifer and Vishny, 1997). These studies constitute today two of the most comprehensive reviews of the theoretical and empirical research on corporate governance. Finance without governance, legal protection of shareholder rights, large shareholders and takeovers, debt finance, and state ownership and cooperatives are the possible solutions mentioned by Shleifer and Vishny (1997) to the governance problem.
Similarly, Becht et al. (2002) point at five mechanisms to solve the collective action problem: large shareholders, hostile takeovers and proxy voting contests, the board of directors, executive contracts linking compensation and company performance, and finally, well-defined CEOs fiduciary duties combined with class-action suits. They reach the conclusion that the major problem now is balancing the tradeoff between regulation of large-shareholder supervisory power in order to protect the dispersed investors and the need to monitor managers to prevent them from self-dealing and abuse shareholders In their survey, Shleifer and Vishny (1997) account for different governance models across countries. The US and the UK have a governance system characterized by a strong legal protection of investors and the lack of large investors, except when ownership is concentrated temporarily during the takeover process. In Continental Europe (particularly, Germany) and Japan, corporate governance relies more in large investors and banks to monitor managers; legal protection for investors is weaker and hostile takeovers very uncommon. What we see in the rest of the world is heavily concentrated ownership in families, some outside investors and banks; and an extremely limited protection of investors. Legal protection of investors and concentration of ownership are considered complementary approaches to corporate governance. All successful governance models (Anglo-Saxon, German or Japanese) are characterized by protecting efficiently at least some kind of investors.

2. Incentive pay

Changing now to the use of incentive pay as a governance mechanism, Murphy (1999) makes a comprehensive review of the empirical and theoretical research on executive compensation. His findings suggest that pay-performance sensitivity is positive and small, but with a tendency to increase over time. Nonetheless, the causality is debatable; since, on the one hand, managers may be more likely to accept performance related pays when they expect good performance (it is not uncommon that managers influence their own pay), and on the other, there is typically more room for extra compensation packages, including performance related pay, when the company is doing
well. Even if it is true that there has been a stronger alignment between executives and shareholders during the last decades as a result of the increased reliance on equity-based forms of compensation, especially on stock options plans, Daily et al. (2003a) and Daily et al. (2003b), when reviewing the research on governance through ownership and regarding the relationship between CEO comp
ensation (shareholdings versus salary) and firm performance, find little agreement on any strong relationship. Even when such relationship has been consistently demonstrated, the causality is not clear. Likewise, there is no firm evidence on the efficacy of the recent trend consisting on compensating members of the board of directors with stock (Daily et al., 2003b).
Within the field of research that aims to find an explanation to these differences in the corporate governance models prevalent around the world, two main streams of literature stand out: the political approach and the legal perspective.

3.Corporate governance as a determinant of performance.

There are numerous studies that provide us with both theory and empirical evidence to link the governance of the corporation to its performance. We will briefly highlight here the main findings from the literature that focuses on the board of directors, ownership structure, incentive compensation and the legal protection of investors.

3.1 Board of directors

The board of directors is known as one of the most important instruments to solve the corporate governance problem (Jensen, 1993), since it is the organ primarily used by other stakeholders to monitor management. Despite this fact, the theoretical studies on the board of directors have been quite scarce.Hermalin and Weisbach

(1998) construct a model that examines the determinants of board composition as a bargaining process between the existing directors and the CEO over the incorporation of new members on the board. Depending on the CEO's perceived ability compared to potential successors, the power of the CEO in the negotiations will determine whether he dominates the board or, instead, he will be subject to active monitoring. The model predicts a number of empirical regularities: poorly performing CEOs are more likely to be replaced than well performing ones; the sensitivity of CEO turnover increases with the independence of the board; after poor firm performance, additions of independent directors to the board are more probable; the board will become less independent over the course of a CEO career; and last, management turnover is better explained by earnings that by stock returns. The model also suggests some other predictions not yet empirically tested. First,there will be long-term persistence in corporate governance practices. Second, when a manager is fired on the basis of private information, it should be followed by a fall in the stock price. Conversely, if the reason of the firing is public, the stock price would rise.

And third, their last prediction is concerned with the sensitivity of the CEO salary to past performance, which should increase with the level of performance achieved.

In another interesting study, Bennedsen (2002) finds two motives behind the establishment of boards when this is not imposed by law. In his model, besides the governance motive (boards exist because they create firm value by monitoring the management and governing the firm), there is a second reason (distributive motive): boards help solving conflicts between controlling and non-controlling owners. The strong presence of this distributive motive leads him to argue that increased investor protection could reduce its relative importance, permitting boards to be more focused on governance,
thus boosting the value of the firm.

3.2 Ownership structure

Moving on to our second governance mechanism, we find that the effect of the ownership structure on firm value has often been studied in relation to the level of product market competition.

In a very interesting paper, Nickell et al. (1997) also look for an interaction between competition, ownership and performance. They use a productivity growth model on a panel of 580 UK manufacturing companies from 1982 to 1994 to show us, confirming previous studies, that product market competition, financial market pressure and shareholder control are all associated with some degree of productivity growth. Furthermore, they find some significant evidence that financial market pressure and shareholder control can substitute for competition as a disciplinatory mechanism of
Management.However, later findings by Demsetz and Lehn conflict with this thesis (Demsetz and Lehn, 1985). After examining the impact of ownership structure on firm value in a single regression model, they claim that the lost of control by the owners could be offset by a lower cost of capital or other benefits of diffuse ownership causing the optimal degree of ownership concentration to vary across firms according to differences in firm size, the instability of the environment, the presence of regulation in the industry or the amenity potential of the firm's product for the owners.

4. Legal aspects.

As we have seen, whereas legal protection of minority shareholders has been shown to boost the valuation of banks (Caprio et al., 2003), in agreement with findings for other sectors of the economy (La Porta et al., 2000), bank specific regulations and supervisory practices seem to have little impact, if any, on them (Caprio et al, 2003), Supporting Caprio et al. (2003) with new evidence on the little evidence of bank regulations on performance, Barth et al. (2003) address key issues in banking supervision: its structure (single versus multiple supervisors, central bank as a supervisor), scope
(whether the banks' supervisor should supervise as well other financial services industries), and independence (the degree to which supervisors are influenced by the political and economic power), trying to find out if there are related to bank profitability. Their results show a weak impact of the structure of supervision on bank performance (particularly, the single-supervisor system might, but only might, enhance bank profitability). No strong significant relationship is found. This suggests that the selection of the right supervisory structure may be oriented to improve other aspects of the banking system: individual bank safety and soundness and the stability and development of the
banking system.

5. Improvement of corporate governance at Albanian banks and CG in Raiffesisen Bank (international bank).

Effective practices of corporate governance are essential for achieving and maintaining public trust and confidence in the banking system, both very crucial for the proper functioning of the banking sector and economy as a whole. Poor corporate governance leads to bankruptcy of the bank, which may cause public costs and consequences considering the impact on the deposit system, and the consequences may spread on a wider macroeconomic scope, as may be the risk and impact to the payment systems. In addition, weak corporate governance can lead markets to lose confidence in the bank's ability to manage it's assets and liquidity, including deposits, which may in turn lead the bank toward a liquidity crisis. The recent changes to the law" On banks in the Republic of Albania" stipulate some of the principles of good corporate governance, one of them being the composition of the board of directors. Stipulating in the banking Law the principles of "loyalty" and the "conflict of interest", not only with regards to managers and directors but also to members of the management or directors board and shareholders, is the concrete expression of the principle of the reliability obligation of the above mentioned persons to perform their duties, set out in the law and the charter, trustworthily and in the best interests of the society as a whole. Board members must have the right qualification for their positions, a clear understanding of their role in the governance of the bank, and be able to provide a sound judgment about its matters, and this does not apply only to financial institutions. Shortcomings in the composition and authority given to Boards have been evident and widely disputed. The remuneration of board members and senior managers also remains a very controversial issues that emerged in the OECD report regarding the lessons learned from the 2008 financial crisis, where the banking sector was hit most. The crises in the financial institutions in 2008 have been described as the most serious financial crisis, since the Great Depression. By mid 2008 it was clear that the crisis in the USA along with the lack of liquidity had a major impact on financial institutions and banks in many countries.

The Albanian banking sector is composed of 16 banks. The presence of the foreign capital is dominant in all banks (Bank of Albania, 2011, p. 77) (subsidiaries of larger groups and branches of foreign banks), such as in Intesa San-Paolo Bank, Raiffeisen Zentrale Bank, Societe Generale, and Credit Agricole. The high degree of foreign ownership has brought the best experiences and banking practices in the financial system, along with modernisation and innovation through high-tech products. More importantly, they have contributed to developing high-standard organizational and corporate governance practices.

The Albanian banks' origin of capital includes countries like Austria, Italy, Greece, and France. According to the Bank of Albania (2011, p. 77), the total assets of the banking sector mount to EuR 7 billion, representing nearly 80% of the GDP in 2010. Sixty four per cent of the total bank assets belong to the largest four banks.

CG in Raiffesien Bank.

The term corporate governance implies the responsible management and control of a company aimed at achieving long-term growth in value.

Trusting and efficient cooperation of the various corporate bodies, protection of shareholder interests, and open and transparent communication are the central guidelines for Raiffeisen Bank International in implementing modern corporate governance. As a company listed on the stock exchange, Raiffeisen Bank International is committed to the principles of good and responsible corporate governance as set forth in the Austrian Corporate Governance Code and agrees to comply with them. These remarks on compliance with the Code refer to the new version of the Austrian Corporate Governance Code of January 2012.

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- Directors' dealings
- Articles of Association of Raiffeisen Bank International.
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6. Summary and conclusions

In the new deregulated EU banking scenario, where an extra pressure is set on banks' profitability, the design of the right corporate governance system is a must for banks that want to be successful in the new competitive environment. But if banks are unlike other firms, as it has been long postulated by the economic literature, we may also wonder whether this singularity affects their corporate governance, and thus, makes necessary specific research that investigates the governance mechanisms in the particular case of the banking industry. This paper reviewed the academic literature that studied the corporate governance problem in the specific case of banks, analyzing its different features and the argued reasons behind them, as well as the role of the governance system for good bank performance.

In summary, this paper tried to make clear the important role of good governance for the success of the corporation, in particular if this corporation is a bank; as well as it investigated the different governance issues and practices when it comes to banking firms. Can we then conclude, based on existing research, that the corporate governance of banks is fundamentally different than in other industries? Overall, it seems that both the presence of regulation and the nature of their business affect the corporate governance problem in banks and this is reflected in the different governance structures observed. But the question is still open as to what extent the functioning of these corporate governance mechanisms and their relation to performance is different in banking compared to non-financial firms, as well as what would be the specific causes behind the different behaviors.

However, the literature leaves unsolved some of the most publicly debated issues, such as the true value of enhancing the independence of the board, the impact of having a dual CEO/chairman of the board, the actual role played by political directors, the influence of the governance system, or the question of whom should ideally be the object of the bank directors' fiduciary duties.

This last discussion stems from the banks' highly leveraged condition and entails two important implications for the design of an efficient corporate governance system from the regulators' point of view. First, it can be argued that debtholders interests should receive greater protection, meaning that directors should owe fiduciary duties to them as well as to shareholders, and bank managers should always take solvency risk into consideration when making decisions. Second, some authors have proposed the regulation of management incentives as a more efficient tool than capital requirements to monitor risk-taking by the bank.

Finally, most of the work reviewed here deals with US and, sometimes, Japanese banks. Given the existence of different governance systems and the particular impact that institutions have in the banking sector, only further research on the corporate governance of banks across countries will allow us to tell whether these observed specific features are confirmed internationally; or, if this was not the case, the different governance solutions respond to the existence of diverse national institutions or even individual firm-specific needs.

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