Corporate Governance of Banks after the Financial Crisis - Theory, Evidence, Reforms

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Abstract

Poor corporate governance of banks has increasingly been acknowledged as an important cause of the recent financial crisis. Given the developments since the Asian financial crisis in 1997, this fact is not readily to be explained. Listed banks and even non-listed firms worldwide have publicly emphasized that good corporate governance is of vital concern for the company, and have adopted firm-specific corporate governance codices. Moreover, banking supervisors have taken up the issue. In particular, the Basel Committee on Banking Supervision has already published two editions of a guideline entitled “Enhancing corporate governance for banking organisations” which perfectly reflects the supervisors’ perception of and approach to the issue Still, only during the second year of the financial crisis, the issue of banks’ good corporate governance has again started to attract pronounced interest. Given the numerous reforms to improve banks’ corporate governance that have either been proposed or already implemented at the international level, national, and supranational, e.g. E.U., levels, the article takes stock of relevant theory and examines recent reforms in light of the empirical evidence. Taking the well-known question “What makes banks different?” (Fama) as a starting point, the theoretical part first analyses the particularities of banks’ corporate governance with respect to a bank’s financiers (shareholders, depositors, and bondholders) in a principal-agent framework and finds that banks’ corporate governance mostly differs from that of a generic firm because of deposit insurance and prudential regulation. While aimed at compensating for deficits in the monitoring and control of banks, both institutions serve to exacerbate the particular problems that are inherent in banks’ corporate governance. The theoretical part, then, presents the supervisors’ financial stability perspective as illustrated by the Basel Committee’s guidance, and concludes with a discussion of the functional relationship between corporate governance and banking regulation/supervision: Whereas banking regulation/supervision acts as a functional substitute for debt governance, equity governance benefits less from such regulation/intervention. Put succinctly, shareholder interests and supervisors’ interests do not run exactly parallel, not even from a long-term perspective. The following part provides an overview of the numerous reform initiatives in light of emerging empirical research on the corporate governance-failure hypothesis, and presents some more ideas for reforms. Of particular interest to this discussion are risk management, board composition, and executive remuneration. The article concludes with some tentative reflections on the lessons from banks’ corporate governance for corporate governance of generic firms, i.e., firms not subject to prudential regulation/supervision. Because of the particularities due to the existence of deposit insurance and prudential regulation/supervision, one may doubt whether banks’ corporate governance should map the way forward for corporate governance.

Keywords: banks, corporate governance, banking regulation, banking supervision, deposit insurance, financial crisis

JEL Classifications: G01, G21, G28, K23

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Corporate Governance of Banks after the Financial Crisis
– Theory, Evidence, Reforms

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1. Introduction

The economics and functions of banks differ from those of industrial firms. Because of these differences, banks are subject to stringent prudential regulation of their capital and risk. Moreover, these differences are reflected in corporate governance practices observed in the banking sector and in theoretical works on the "good corporate governance of banks." With respect to corporate governance practices, a particularly striking feature of mostly large commercial and investment banks has been the prevalence of remuneration schemes that provide high-powered incentives, not only for executive directors (officers), i.e., members of the management board in a two-tier system, but also for senior managers at lower levels, and even for more junior employees in some functions, in particular the trading and sales function. In turn, at least some theoretical works suggest that good corporate governance of banks requires a somewhat different framework from that for industrial firms. At an even more fundamental level, even the notion of "good corporate governance of banks" is somewhat ambiguous. Some participants in the debate, in particular banking supervisors, use this term in a way that reflects their particular supervisory concerns but deviates from the general understanding. Hence, quite a number of proposals and ideas for further improvements of corporate governance in the banking sector are bank-specific and, at a first glance, do not easily fit in with the general debate on good corporate governance. However, more recently, some elements, such as risk management and compliance, have started to become an important issue in the general corporate governance debate, as well. From this perspective, good corporate governance of banks shows the way forward for good corporate governance in general.[1]

Against this backdrop, the rest of this paper is organized as follows: The next section briefly explores the diverging usage of the term corporate governance in the context of banks (2). Section 3 identifies previous work on banks' corporate governance and describes the extent to which the recent turbulences on the financial markets have been attributed to deficient corporate governance practices (3). Section 4 outlines what is special about banks compared to a generic firm, explores the consequences flowing from these particularities in a principal-agent approach, and, in part as a contrast, describes the supervisors' ideas and concepts for a good corporate governance of banks. Against this backdrop, section 5 presents the results of empirical studies of the (un)importance of banks' corporate governance for the financial crisis and outlines the numerous reforms already implemented or, at least, under way as well as some ideas for even further reforms in this area. Finally, section 6 offers some concluding remarks.

[1] Cf. the position of the OECD Steering Group on Corporate Governance (infra nn. 29-30).

2. Concepts of corporate governance

A generally accepted definition of corporate governance has not yet evolved. Traditional concepts describe corporate governance as a complex set of constraints that shape the *ex post* bargaining over the quasi-rents generated by a firm[2] or as every device, institution, or mechanism that exercises power over decision-making within a firm.[3] Put differently, corporate governance deals with the decision-making at the level of the board of directors and top management (i.e., the management board in a two-tier system), and the different internal and external mechanisms that ensure that all decisions taken by the directors and top management are in line with the objective(s) of a company and its shareholders, respectively.

The OECD Principles of Corporate Governance, *inter alia* referred to in the EU Commission's Action Plan on Company Law and Corporate Governance,[4] take a slightly broader view: "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders, and should facilitate effective monitoring."[5] This definition goes beyond the definitions cited above mainly insofar as a company's objective(s) and the mechanism for setting the objective(s) are treated as a corporate governance issue, not as endogenously given. Put succinctly, corporate governance "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[6]

By contrast, a much broader definition describes corporate governance as encompassing the standards for decision-making within a company, the duties of board members and officers, the internal structure of the firm (enterprise) and the relationship between the corporation and its shareholders, and other stakeholders.[7] Such a concept of corporate governance goes beyond even the OECD's definition in two respects: first by implying that corporate governance also deals with substantive management issues and

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[2] Luigi Zingales, "Corporate Governance," in *The New Palgrave – Dictionary of Economics*, ed. Steven N. Durlauf and Lawrence E. Blume, 2nd ed. (Basingstoke: Macmillan, 2008), 250.
[3] Jonathan R. Macey, *Corporate Governance* (Princeton and London: Princeton University Press, 2008), 2.
[4] See Communication from the Commission to the Council and the European Parliament, "Modernising Company Law and Enhancing Corporate Governance in the EU," (COM(2003)284), 10 n. 10, http://ec.europa.eu/internal_market/company/modern/index_en.htm.
[5] OECD, *Principles of Corporate Governance* (Paris: OECD, 2004), 11. Also available online at www.oecd.org/daf/corporateaffairs/principles/text.
[6] Andrei Shleifer and Robert W. Vishny, "A survey of corporate governance," *Journal of Finance* 52 (1997): 737.
[7] See Stefan Grundmann and Peter O. Mülbert, "Corporate Governance: European Perspectives," *International and Comparative Corporate Law Journal* 2 (2000): 415-422.

the pertinent decision-making by the board and top management, for example by requiring them to set up an independent compliance function and a risk-management system, and second by dealing with the internal structure of the firm, i.e., with internal structures below the level of the company's board and officers (top management).

This much broader concept is very much in line with the banking supervisors' understanding of corporate governance as embodied in the Basel Committee on Banking Supervision's guidance entitled "Enhancing corporate governance for banking organisations" The guidance paper states that from "a banking industry perspective, corporate governance involves the manner in which the business and affairs of banks are governed by the board of directors and senior management which*, inter alia*, affects how they:

- set corporate objectives,
- operate the bank's business on a day-to-day basis;
- meet the obligation of accountability to their shareholders and take into account the interests of other recognized stakeholders [including, *inter alia*, supervisors, governments and depositors];
-aAlign corporate activities and behavior with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and
- protect the interests of depositors."[8]

3. The rising interest in banks' corporate governance

3.1. From the Asian crisis in 1997 to the financial crisis

The particularities of banks' corporate governance first became of some interest during and after the Asian crisis in 1997.[9] From then on, in line with a more general trend, listed banks and even non-listed institutions worldwide started to publicly emphasize that good corporate governance is of vital concern for the company, and even to adopt individualized corporate governance codices.

More specifically, the Basel Committee on Banking Supervision published the first edition of its aforementioned guideline "Enhancing corporate governance for banking

[8] Basel Committee on Banking Supervision, "Enhancing corporate governance for banking organisations," (Basel: BIS, February 2006), 4 n. 10, http://www.bis.org/publ/bcbs122.htm. See Peter O. Mülbert, "Bankenaufsicht und Corporate Governance – Neue Organisationsanforderungen im Finanzdienstleistungsbereich," *BKR* (Zeitschrift für Bank- und Kapitalmarktrecht) 6 (2006): 349-360; Jan-Velten Große and Karl-Heinz Boos, "2005 – ein Fortschritt bei den Corporate Governance-Regeln?," *WM* (Zeitschrift für Wirtschafts- und Bankrecht) 60 (2006): 1177-1183; Klaus J. Hopt, "Corporate Governance von Banken – Überlegungen zu den Grundsätzen des Basler Ausschusses für Bankenaufsicht vom Februar 2006," in *Entwicklungslinien im Bank- und Kapitalmarktrecht – Festschrift für Gerd Nobbe,* ed. Mathias Habersack et al. (Köln: RWS Verlag, 2009): 853-882.

[9] See, e.g., Simon Johnson et al., "Corporate Governance in the Asian Financial Crisis," *Journal of Financial Economics* 58 (2000): 141-186.

organisations" in 1999 and, building on the OECD's thoroughly reviewed Principles of Corporate Governance of 2004,[10] a revised version of its guideline in 2006.[11] Some national banking supervisors even published rules detailing the corporate governance structures and features required by banks, in particular the Swiss Financial Market Supervisory Authority (FINMA; formerly Swiss Banking Supervisory Authority)[12] and the Banca d'Italia.[13] At international level, the World Bank Group, as a direct consequence of the experiences during the Asian crisis, has taken up the issue of banks' corporate governance from several angles. The World Bank itself, taking the Basel Committee's guideline as a starting point, developed a corporate governance methodology in order to assess the legal and regulatory framework for banks' corporate governance on a country level. In contrast, the International Finance Corporation (IFC) concentrates on the corporate governance of individual financial institutions, since the IFC bases its decision whether to invest in a particular bank partly on an in-depth due diligence of the bank's corporate governance.[14]

Finally, research into banks' corporate governance had picked up even before the onset of the financial crisis, as is evidenced by the publication of an increasing number of empirical studies[15] and theoretical works,[16] as well.

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[10] *OECD,* Principles of Corporate Governance (see n. 5).

[11] Basel Committee on Banking Supervision, "Enhancing corporate governance for banking organizations," 4 n. 10 (see n. 8).

[12] Eidgenössische Bankenkommission, "Überwachung und interne Kontrolle," EBK-RS 06/06 (2006), http://www.finma.ch/archiv/ebk/d/regulier/rundsch/index.html; see Jean-Baptiste Zufferey, "Private Banking Governance," *Zeitschrift für Schweizerisches Recht* 126:1 (2007): 235-257.

[13] Banca d'Italia, "Supervisory Provisions concerning banks' organization and corporate governance," (Decree of March 4, 2008), http://www.bancaditalia.it/vigilanza/banche/normativa/disposizioni/provv; see Renzo Costi and Francesco Vella, "Banche governo societario e funzioni di vigilanza," *Quaderni di Ricerca Giuridica* 62 (2008): 8-38, http://www.bancaditalia.it/pubblicazioni/quarigi/qrg62/qrg_62.

[14] For more information see International Finance Corporation World Bank, "Corporate Governance Financial Institution," http://www.ifc.org/ifcext/corporategovernance.nsf/Content/CGTools_FinancialInstitutions.

[15] See, *inter alia*, Kose John and Yiming Qian, "Incentive Features in CEO Compensation in the Banking Industry," *FRBNY Economic Policy Review* 9 (2003): 109-121; Renee B. Adams and Hamid Mehran, "Is Corporate Governance Different for Bank Holding Companies?," *FRBNY Economic Policy Review* 9 (2003): 123-142; Kenneth R. Spong and Richard J. Sullivan, "Corporate Governance and Bank Performance" (SSRN Working Paper, Federal Reserve Bank of Kansas City, August 31, 2007), http://ssrn.com/abstract=1011068; Eduardus Tandelilin et al., "Corporate Governance, Risk Management, and Bank Performance: Does Type of Ownership Matter?" (EADN working paper no. 34, 2007), http://www.eadn.org/eduardus.pdf; Luc Laeven and Ross Levine, "Bank Governance, Regulation, and Risk Taking" (SSRN Working Paper, 2008), http://ssrn.com/abstract=1142967; Pablo de Andres Alonso and Eleuterio Vallelado Gonzalez, "Corporate Governance in banking: The role of the board of directors," *Journal of Banking & Finance* 32 (2008): 2570-2580.

[16] See, *inter alia*, Stephen Prowse, "The Corporate Governance System in Banking: What Do We Know?," *Banca del Lavoro Quarterly Review* (March 1997): 11-40; Penny Ciancanelli and José A. Reyes-Gonzalez, "Corporate Governance in Banking: A Conceptual Framework" (SSRN Working Paper, Department of Accounting and Finance, University of Strathclyde, Glasgow, 2000), http://ssrn.com/abstract=253714; Jonathan R. Macey and Maureen O'Hara, "The Corporate Governance of Banks," *FRBNY Economic Policy Review* 9 (2003): 91-107; Ross Levine, "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence," (World Bank Policy Research Working Paper no. 3404, 2004), http://www-wds.worldbank.org; Johan Devriese et al., "Corporate governance, regulation and supervision of banks," in *Financial Stability Review 2004*, ed. National Bank of Belgium (Brussels: National Bank of Belgium, 2004), 95-120, http://nbb.be/pub/06_00_00_00_00/06_03_00_00_00/06_03_02_00_00/FSR_20040602.htm?l=en; Heinz Christian Hafke, "Anmerkungen zur Corporate Governance in der Kreditwirtschaft," in *Festschrift für*

3.2 Mood swings in the financial crisis

3.2.1 Phase 1: irrelevance of banks' corporate governance

After the beginning of the financial turbulences in summer 2007, the issue of banks' corporate governance, with the notable exception of remuneration, went out of focus for some time.

To be sure, the Banca d'Italia only published its aforementioned decree[17] in spring 2008 and in mid-2008 Switzerland's UBS moved to modernize its corporate governance structures mainly by introducing a clear separation of the roles and responsibilities between the Board of Directors and Executive Management and a strengthening of the oversight role of the Board through the operation of its Committees.[18]

On the other hand, numerous reports, documents and statements published in 2008 dealing with the causes and consequences of the financial crisis do not even mention the corporate governance of banks. This holds true, *inter alia*, for the reports prepared by the (US) President's Working Group on Financial Markets,[19] the Financial Stability Board (FSB; formerly known as FSF),[20] the IMF[21], the Institute of International Finance (IIF),[22]

Walther Hadding, ed. Franz Häuser et al. (Berlin: de Gruyter, 2004), 863-874; Peter Nobel, "Corporate Governance im Bankbereich: Rechtliche Grundlagen und Compliance," in *Liber Amicorum Guy Horsmans*, ed. Bruylant (Brussels: Bruylant, 2004), 819-842; Andy Mullineux, "The corporate governance of banks," *Journal of Financial Regulation and Compliance* 14 (2006): 375-382; Kern Alexander, "UK Corporate Governance and Banking Regulation: The Regulators Role as Stakeholder," *Stetson Law Review* 33 (2004): 991-1034; same, "Corporate governance and banks: The role of regulation in reducing the principal-agent problem," *Journal of Banking Regulation* 7 (2006): 17-40; Kern Alexander et al., *Global Governance of Financial Systems* (Oxford: OUP, 2006), 239-250; Zufferey, "Private Banking Governance," 235-257 (see n. 12); Mülbert, "Bankenaufsichtsrecht und Corporate Governance," 349-360 (see n. 8); Große and Boos, "2005 – ein Fortschritt bei den Corporate Governance-Regeln?" (see n. 8); Andrea Polo, "Corporate Governance of Banks: The Current State of the Debate" (SSRN Working Paper, Said Business School, University of Oxford, 2007), http://ssrn.com/abstract=958796; Dirk Heremans, "Corporate governance issue for banks: A financial stability perspective" (SSRN Working Paper, Center for Economic Studies, Catholic University of Leuven, 2007), http://ssrn.com/abstract=1024693; Birgit Sauerzopf, "Corporate Governance and Credit Institutions," in *Financial Stability Report No. 16,* ed. Oesterreichische Nationalbank (Vienna: Oesterreichische Nationalbank, 2008), 135-148; also available online at http://www.oenb.at/en/presse_pub/period_pub/finanzmarkt/finanzmarktstabilita/financial_stability_report.jsp; Vasile Cocris and Maria-Cristina Ungureanu, "Why are Banks Special? An Approach from the Corporate Governance Perspective," Scientific Annals - Al.I.Cuza University of Iasi, Economics Series, 2007, http://ssrn.com/abstract=1090291; Costi and Vella, "Banche governo societario," 8-38 (see n. 13); Maria-Cristina Ungureanu, "Banks: Regulation and Corporate Governance Framework," *Journal of Ownership & Control* 5 (2008): 449-458; Hopt, "Corporate Governance von Banken," (see n. 8).

[17] See *supra* n. 13.

[18] See UBS, Investor release of July 1, 2008, http://www.ubs.com/1/e/investors/releases?newsId=144611.

[19] The President's Working Group on Financial Markets, "Policy Statement on Financial Markets," March 2008, http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.

[20] Financial Stability Forum, "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 7, 2008, http://www.financialstabilityboard.org/list/fsb_publications/page_3.htm.

[21] International Monetary Fund, "The Recent Financial Turmoil – Initial Assessment, Policy Lessons, and Implications for Fund Surveillance," April 9, 2008, http://www.imf.org/external/np/pp/eng/2008/040908.pdf.

the G-20 Study Group,[23] the Declaration of the Washington Summit of the G-20 proposing the "Action Plan to implement Principles for Reform",[24] and the German Council of Economic Experts.[25] Specifically, the report by the Senior Supervisors Group mentions that in November 2007 the national supervisors belonging to the group met with the senior management of selected banks to elicit their perspective on how well or how poorly key elements of their corporate governance had worked up to that point in time. [26] The respondents could not have reported any more serious problems since subsequently the document does not refer to corporate governance any more. Arguably an exception to the rule is the Report of the CRMPG III with its particular emphasis on the adequate status of key control personnel, in particular on their independence from front-line business units, and on risk monitoring and risk management.[27]

By way of exception, banks' remuneration practices attracted much interest from the outset of the crisis. Even without any hard evidence being available so far, the heavily-incentivized, short-term oriented remuneration structures, together with a fair amount of greed on the part of bankers were seen as a major or even the single most important cause of the financial turbulence. As a consequence, proposals for reform of this area soon abounded at international as well as at national level, resulting in the meantime in rather detailed regulation by many banking supervisory authorities.[28]

3.2.2 Phase 2: banks' corporate governance as a major cause of the crisis

During the second year of the financial crisis, the issue of banks' corporate governance has begun to resurface with a vengeance, starting with the OECD. The OECD Steering Group on Corporate Governance, based on the premise that corporate governance problems of banks are not fundamentally different from those of generic corporations, first commissioned a fact-finding study with respect to four areas of corporate governance (remuneration, risk-management, board practices, and exercise of shareholder rights).[29]

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[22] Institute of International Finance, "Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practices Recommendations," July 2008, http://www.iif.com/download.php?id=Osk8Cwl08yw=.

[23] G-20 Study Group, "Report on Global Credit Market Disruptions," October 2008, http://www.g20.org/pub_further_pubs.aspx.

[24] G-20 Declaration of the Summit in Financial Markets and the World Economy, November 15, 2008, http://www.g20.org/pub_communiques.aspx.

[25] Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Die Finanzkrise meistern - Wachstumskräfte stärken*, Jahresgutachten 2008/09 (Wiesbaden: 2008), 116-191. Also available online at http://www.sachverstaendigenrat-wirtschaft.de/gutacht/ga-content.php?gaid=53.

[26] Senior Supervisors Group, "Observations on Risk Management Practices during the Recent Market Turbulences," March 6, 2008, http://www.financialstabilityboard.org/list/fsb_publications/page_3.htm.

[27] Counterparty Risk Management Policy Group III, "Containing Systemic Risk: The Road to Reform," August 6, 2008, 9-12, 71-74, 77-101, http://www.crmpolicygroup.org/.

[28] See in more detail see sections 5.4.2/3.

[29] See Grant Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis," *Financial Market Trends* (2009): 1-30. Also available online at http://www.oecd.org/document/48/0,3343,en_2649_34813_42192368_1_1_1_1,00.html.

Based on those findings, the Steering Committee recently published a full report on the key results and main lessons inside and outside of the banking industry, finding, in particular, that there is no immediate call for a revision of the OECD Principles, but a need for a more effective implementation of standards already agreed.[30] The G20, at its London summit in April 2009, acknowledged the importance of the issue as well, albeit somewhat indirectly.[31] At the European level, former EU Commissioner McCreevy declared his commitment to rethink the roles of directors, managers, and shareholders of financial institutions with a view to strengthening the role of non-executive directors and shareholders, and to prioritizing long-term shareholder value over short-term bonus payments,[32] and the High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, stated flatly in its report that banks corporate governance "is one of the most important failures in the present crisis."[33] At the level of EU Member States, very similar assessments are voiced in the UK, in particular. The Association of Chartered Certified Accountants (ACCA) "believes that the credit crunch can … be viewed, in large part, as a failure in corporate governance."[34] For Sir David Walker, charged with an independent review of corporate governance in the UK banking industry by the UK government, the "need is now to bring corporate governance issues to center stage" since serious deficiencies in prudential oversight and financial regulation in the period before the crisis were accompanied by major governance failures within banks[35]. Even the Financial Services Authority (FSA), albeit somewhat reluctantly, probably due to its own track-record in this area, states that "poor governance [as| …only one of many factors contributing to the crisis, … has widely been acknowledged to have been an important one."[36]

Not surprisingly, the changed perception of the interrelationship between the crisis and banks' corporate governance is also reflected in recent empirical studies[37] and theoretical works.[38]

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[30] OECD, "Corporate Governance and the Financial Crisis: Key Findings and Main Messages," June 2009, 7, http://www.oecd.org/document/48/0,3343,en_2649_34813_42192368_1_1_1_1,00.html. As to a follow-up report, see same, "Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles," 24 February 2010, http://www.oecd.org/document/48/0,3343,en_2649_34813_42192368_1_1_1_1,00.html.

[31] G20 Working Group 1, "Enhancing Sound Regulation and Strengthening Transparency," March 25, 2009, http://www.internationalepolitik.de/ip/dossiers/g20/enhancing-sound-regulation-and-strengthening-transparency.html.

[32] Charlie McCreevy, "Address to the Association of European Journalist," December 8, 2008, http://ec.europa.eu/ireland/press_office/speeches-press_releases/mccreevy-aej-speech_en.htm.

[33] "Report of the High-Level Group on Financial Supervision in the EU, February 2009," no. 110, http://ec.europa.eu/internal_market/finances/committees/index_en.htm#delarosierereport.

[34] Association of Chartered Certified Accountants, "Corporate Governance and the Credit Crunch," November 2008, 4, http://www.accaglobal.com/economy/analysis/acca.

[35] David Walker, "A review of corporate governance in UK banks and other financial industry entities - Final recommendations," November 26, 2009, 9, http://www.hm-treasury.gov.uk/walker_review_information.htm.

[36] Financial Services Authority, "Effective corporate governance," (Consultation Paper 10/3, January 2010), http://www.fsa.gov.uk/pubs/cp/cp103.pdf.

[37] Nestor Advisors, *Banks Boards and the Financial Crisis* (London: Nestor Advisors, 2009); Renee B. Adams, "Governance and the Financial Crisis," (ECGI Finance Working Paper No. 248/2009, April 2009), http://ssrn.com/abstract=1398583.

4. Banks' corporate governance: theory

4.1 Differences between banks and the ordinary firm

Banks differ substantially from a generic firm in several important respects.

Foremost among the well-known differences is the liquidity producing function of banks based on a maturity mismatch between the two sides of a bank's balance sheet. More technically, a bank's core business is to accept voluntarily a mismatch in the term structure of its assets and its liabilities. As a corollary, the existence of banks depends crucially on uninterrupted continuous access to liquidity, be it deposits, short-term funding on the interbank market, funding on secured financing markets or funding from a central bank as the liquidity provider of last resort. The importance of banks' access to liquidity was forcefully demonstrated in the financial crisis when all possible sources of liquidity dried up at the same time for all banks in (most) Western countries and central banks had to intervene to prevent a collapse of the banking systems in the countries affected. Hence, for regulators, one of the important lessons of the crisis is to provide for more demanding prudential regulation pertaining to banks' liquidity risk and its management.[39]

Second, banks are highly leveraged institutions. Banks are compensated for accepting a maturity mismatch by a premium charged to creditors, i.e., a bank's creditors have to pay a higher interest rate than the bank pays for its refinancing. Hence, *ceteris paribus*, a bank's profit increases directly in proportion with the volume of lending to creditors. The upper bound for an increase in lending is derived from the marginal cost of a bank's refinancing, given that an increase of the bank's leverage will increase its probability of default, and depositors as well as other debtholders will demand a higher risk premium as compensation for the higher risk of insolvency, and from minimum capital requirements provided for by prudential regulation.

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[38] Peter O. Mülbert, "Corporate Governance von Banken," *ZHR* (Zeitschrift für das gesamte Handels- und Wirtschaftsrecht) 173 (2009): 1-11; Gottfried Wohlmannstetter, "Corporate Governance von Banken," in *Handbuch Corporate Governance*, ed. Peter Hommelhoff et al., 2nd ed. (Köln: Otto Schmidt, 2009), 779-804; cf. Eddy Wymeersch, "Corporate Governance and Financial Stability," (Financial Law Institute Working Paper 2008-11, Ghent University, October 2008), http://ssrn.com/abstract=1288631.

[39] See Basel Committee on Banking Supervision, "Principles for Sound Liquidity Risk Management and Supervision," (Basel: BIS, September 2008), http://www.bis.org/publ/bcbs144.htm; same, "International framework for liquidity risk measurement, standards and monitoring" (consultative document, December 2009), http://www.bis.org/publ/bcbs165.htm. At the level of the EU, see the Directive amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own fund items, large exposures, supervisory arrangements, and crisis management, *OJ* 2009 L 302/07 (known as Capital Requirements Directive (CRD) II), providing for changes to Annexes V and XI of the original CRD; Committee of European Banking Supervisors, "Consultation Paper on Liquidity Buffers & Survival Periods," (Consultation Paper 28, July 2009), www.c-ebs.org/Publications/Consultation-Papers/All-consultations/CP21-CP30/CP28.aspx.

Third, banks' balance sheets are notoriously more opaque than those of generic firms, i.e., firms in other sectors of the economy.[40] The quality of bank loans is not readily observable where the quality of assets of industrial firms, in particular physical assets such as machinery, plants etc, is much more easily discernable by third parties. The same holds true for other assets banks invest in, e.g., securities, such as Asset-Backed Securities (ABSs), Collateralized Debt Obligations (CDOs), and Credit-Default Swaps (CDSs). In fact, to a large extent, the financial turbulence in the autumn of 2008 was caused by these difficulties. After the collapse of Lehman Brothers, the inter-bank-market virtually crashed even for (very) short-term lending since, all of a sudden, an all-out distrust prevailed among banks about the quality of other banks' assets. Put differently, even banks themselves find it difficult to assess the riskiness of other banks accurately.[41] This hypothesis is not only supported by the recent financial turbulences but, for example, also by two studies that found that analysts disagree more with respect to the quality of bonds issued by banks than with the quality of bonds issued by other firms.[42] As a response to the problem of banks being arguably more opaque than generic firms, Pillar 3 of the Revised Framework of the Basel Committee on Banking Supervision (Basel II) sets out disclosure requirements covering quantitative and qualitative aspects of overall capital adequacy and capital allocation, as well as risk exposure and assessment, all with a view to promoting market discipline, i.e., better informed monitoring and controlling activities by market participants.[43]

Fourth, banks do a substantial and or even a major part of their business with other banks, i.e., more technically, banks are highly interconnected among themselves. Important elements of the interbank business are, *inter alia*, activities on the interbank market, the OTC derivates market, and the foreign exchange market. Hence, unlike the situation in other industries, from a bank's perspective, competitors are also important business partners and, hence, pose a major counterparty risk. Moreover, the banking system is prone to contagion, i.e., problems at one bank will spread to other banks and system-wide at a very fast rate.

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[40] Succinctly developed by Mullineux, "The corporate governance of banks," 377-378 (see n. 16). For a contrary assessment based on bank stocks' trading behavior see Mark J. Flannery et al., "Market evidence on the opaqueness of banking firms' assets," *Journal of Financial Economics* 51 (2004): 419-460; for further references see Bhanu Balasubramanian and Ken B. Cyree, "Market Monitoring of Banks: Do short sellers monitor banks?," (SSRN Working Paper, Emporia State University, Emporia, Kansas, January 2008), 7-8, http://ssrn.com/abstract=1089865.

[41] But see Craig H. Furfine, "Banks as Monitors of other Banks: Evidence from the Overnight Federal Funds Market," *Journal of Business* 74 (2001): 54: The price of a federal funds loan reflects, in part, the credit risk of the borrowing institution.

[42] Donald P. Morgan, "Rating Banks: Risk and uncertainty in an opaque industry," *The American Economic Review* 92 (2002): 874-888; Giuliano Iannotta, "Testing for Opaqueness in the European Banking Industry: Evidence from Bond Credit Ratings," (SDA Bocconi Working Paper No. 122/04, June 2004), http://ssrn.com/abstract=570483.

[43] Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," updated November 2005 (Basel: BIS, November 2005), 184-200 no. 808-825, http://www.bis.org/publ/bcbs118.htm.

Fifth, in contrast to the typical non-financial firm, a bank holding a substantial portfolio of derivatives and securities with embedded options is subject to sharp changes in its risk-profile even if the bank does not take new positions. The possibility arises from the fact that complex derivatives often have exposure to risk factors that are extremely sensitive to market conditions and, thus, even incremental changes on the market may effect a drastic change in the value of the derivative.[44]

Sixth, because of the mismatch in the term structure of assets and liabilities banks are subject to creditor runs.[45] Since, in the case of a run, readily available liquidity reserves will be exhausted very rapidly and most of a bank's assets will not be readily liquidated, only the very first creditors to withdraw their money will receive a payout (in time and in full). Because dispersed creditors (depositors, bondholders, other banks) face a classic prisoner's dilemma even a solvent bank can become the victim of a collective action problem in the form of a run. Ideally, a run can be started either by (small) depositors, by bondholders, or by other banks in the inter-bank market. As a practical matter, once a bank runs into financial distress all three groups of creditors will withdraw their money. Still, while the run on UK's Northern Rock can be seen more as a "classical" run of (small) depositors, the downfall of Lehman Brothers and the takeover of Merrill Lynch were more the result of an (imminent) run by other banks in the inter-bank market. Of course, depository insurance can substantially mitigate the danger of bank runs. However, its effectiveness in this respect crucially depends on the details of the protection accorded. In particular, not only the maximum amount protected but also the kind of deposits protected can be of pivotal importance. Prior to the events in autumn 2008, most mandatory depository insurance protection schemes worldwide were geared only to protect (small) depositors.[46] The "trust crisis" in the wake of Lehman Brothers' insolvency, however, caused most countries soon to raise the maximum coverage under existing deposit protection schemes and, even more quickly, to establish additional insurance and guarantee schemes that enabled banks to issue state-backed new debt. For example, the EU amended Directive 94/19/EC on deposit-guarantee schemes to the effect that Member States will have to raise the existing minimum coverage level (20,000 Euro) to 50,000

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[44] See, e.g., Rene Stulz, "Risk management failures: What are they and when do they happen?," *Journal of Applied Corporate Finance* 20, no. 4 (2008): 39-48. Also available at http://ssrn.com/abstract=1317102.

[45] See, e.g., Macey and O'Hara, "The Corporate Governance of Banks," 97 (see n. 16).

[46] Voluntary schemes, i.e., schemes set up by banks on a voluntary basis are often different. For example, in Germany, each of the three pillars of the German banking sector – private banks, cooperative banks, and public sector banks – has created an additional scheme on a voluntary basis. Cooperative banks are protected as such by the other members of the scheme, i.e., a cooperative bank will not become insolvent, and the same holds basically true for savings banks (*Sparkassen*) whereas each depositor of a private bank is protected to a maximum of 30 % of the liable capital of said bank (as to more details see Ute Brunner-Reumann, "Deposit Protection and Investor' Compensation," in *Banking Regulation in Germany*, ed. Peter Scherer and Sven Zeller (Frankfurt: German Law Publishers, 2009), 209-225). However, it remains to be seen whether the EU Commission will intervene against those German voluntary protection schemes which protect the bank as such on the grounds of a violation of EU competition rules.

Euros by 30 June 2009 and to 100,000 Euros by 31 December 2010,[47] and in the US, the Federal Deposit Insurance Corporation (FDIC) raised the minimum coverage level of 100,000 US-Dollars temporarily, i.e., through 31 December 2013, to a hefty 250,000 US-Dollars. Prime examples among the second type of initiatives are the US Temporary Liquidity Program (TLGP) set up by the Federal Deposit Insurance Corporation (FDIC) which allowed US banks to issue certain senior unsecured debt guaranteed by the FDIC,[48] and the German program that allows participating German banks to issue new bonds guaranteed by the German SoFFin (*Sonderfonds Finanzmarktstabilisierung*).[49]

Seventh, because of their systemic importance[50] on the one hand and their vulnerability to runs on the other hand, banks are heavily regulated and supervised entities. Basically, banking regulation

- limits the amount of risk a bank may take, in particular, under Pillar 1 of the Revised Framework of the Basel Committee on Banking Supervision (Basel II) by stipulating risk-adjusted minimum capital requirements, i.e., by linking the required regulatory capital for a bank's assets (loans, securities, and other assets) in a rather sophisticated approach to the adjusted risk-weight of the different assets,
- limits a bank's exposure to a single creditor or group of creditors, and
- addresses the risk from disruptions in the access to sufficient liquidity by setting standards for liquidity management.

In addition, as a lesson from the market turmoil, regulators and supervisors have very recently committed themselves to introduce an additional backstop-ceiling – similar to, but not identical with existing US regulations – that would limit a bank's non-risk-adjusted total exposure to an arbitrary multiple of its capital.[51] Such a leverage ratio serves as a safety valve for the weaknesses and shortcomings of risk-weighted requirements, in particular for underestimation of risk. However, in order to prevent banks from some countries from

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[47] Directive 2009/13/EC amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay, *Official Journal* 2009 L 68/3.

[48] For details see Federal Deposit Insurance Corporation, „Temporary Liquidity Guarantee Program,“ http://www.fdic.gov/regulations/resources/TLGP/index.html.

[49] For details see Bundesanstalt für Finanzmarktstabilisierung, “”Leistungen – Guarantien,” http://www.soffin.de/leistungen_garantien.php?sub=3.

[50] Systemic importance (risk) is not a unique characteristic of banks although large firms in other sectors of the economy are less likely to pose a systemic risk, see Devriese et al., “Corporate governance, regulation and supervision of banks,” 98 (see n. 16). With respect to the insurance sector the (US) “monoliners”, e.g., FSA, AMBAC, MBIA et al. and AIG may serve as prime examples of systemically important companies. Whether (large) insurance firms are of systemic importance in general, is as different question. For an answer mostly to the negative – only to non-core activities of insurers could have the potential for systemic relevance – see Geneva Association, “Systemic Risk in Insurance – An analysis of insurance and financial stability,”(March 2010), 31-63, http://www.genevaassociation.org.

[51] For more details, see Basel Committee on Banking Supervision, “Strengthening the resilience of the banking sector,” (consultative document, December 2009), no. 202-238, http://www.bis.org/publ/bcbs164.htm. For a rather critical assessment of an additional non-risk adjusted leverage ratio see, e.g., Bundesverband deutscher Banken, “Positionspapier des Bankenverbandes zu Maßnahmen für eine angemessene Ausstattung der Eigenkapitalvorschriften,” (15 July 2009), 5-8, http://www.bankenverband.de/bundesverband-deutscher-banken/presse/presse-informationen/basel-ii-nicht-in-frage-stellen-aber-anpassen.

being put at a competitive disadvantage, the accounting rules for measuring the capital base will have to be harmonized at international level. On an even more fundamental level the leverage ratio-concept is the exact opposite to the Basel II-philosophy in that a bank's leverage is limited on non-risk-adjusted basis. This may create additional incentives for banks to substitute less risky assets by more risky assets with a higher yield in order to compensate the "losses" due to business restrictions imposed by the leverage ratio ceiling. Hence, the leverage ratio will have to be supported by additional risk-adjusted safeguards which, in turn, may raise doubts as to the efficiency of the whole concept.

4.2 Principal-agent analysis

In important respects, the particularities of banks just described impact on their corporate governance. For a more detailed analysis of these problems, agency theory provides a suitable framework,[52] since, after all, corporate governance is all about agency conflicts among different stakeholders, in particular about the principal-agent conflict between shareholders and directors/managers, and about how to solve possible conflicts among them. Treating the corporation (firm), i.e., banks, as a nexus of explicit or implicit contracts among the different stakeholders acting as agents for each other allows us to identify possible agency conflicts as well as possible solutions to these conflicts.

The following analysis starts with a brief overview of the different types of agents, agency conflicts and solutions to these conflicts in general (1.) before taking up the implications for banks in particular (2.).

4.2.1 Agents, conflicts, and solutions

The different stakeholders that may act as an agent in the context of firms are well known:

- shareholders, owning a large stake (blockowners) or small stakes (dispersed shareholders);
- directors, i.e., members of the board performing the supervisory function (board of directors/supervisory board), fruitfully discriminated according to the two mutually non-exclusive qualifications inside/outside directors and non-independent/independent directors;
- officers/executive directors or managers/members of the management board, i.e., the persons performing the management function at top level;
- creditors, i.e., employees, bondholders, depositors, commercial creditors, the state.

[52] Critical, however, Ciancanelli and Reyes-Gonzalez, "Corporate Governance in Banking: A Conceptual Framework," (see n. 16).

Possible agency conflicts fall into three categories, each comprising two major sub-categories:

- Type 1: the conflict between shareholders and managers/directors resulting from the separation of ownership and control: (i) Managers show a higher degree of risk aversion than diversified shareholders since "pure" managers have most of their wealth tied up in the firm and, hence, are less diversified; (ii) Managers are underperformers with respect to their managerial tasks because of a preference for empire building, shirking, and/or wasting the company's assets for personal expenses.
- Type 2: the conflict between blockowners and dispersed shareholders: (i) Blockowners will prefer to receive payouts from the firms in the form of private benefits instead of dividends since the latter payments would also benefit other (dispersed) shareholders; (ii) Blockowners will very often show a comparatively higher degree of risk-aversion since, typically, a higher percentage of their wealth is tied up in the firm.
- Type 3: the conflict between shareholders and creditors (bondholders/depositors): (i) Creditors in general, and bondholders/depositors in particular, are more risk-averse than shareholders given that the former are only interested in their claims being paid back in full on time and, hence, in the firm choosing the least-risky strategy possible, whereas shareholders are interested in a riskier business strategy with a higher expected return; (ii) Specifically, shareholders benefit from ex post-opportunism on the part of the firm, i.e., from a firm's subsequent shift to a riskier business strategy and/or from a subsequent distribution of company assets to its owner.

Numerous solutions for mitigating these agency conflicts have been identified, as well as possible costs ensuing from each of these mechanisms. Most important and probably best-known are the following:

- Type 1 conflicts: (i) Blockholders have a high(er) incentive to monitor management closely while, on the other hand, the presence of a blockowner creates or intensifies type 2 agency conflicts; (ii) Activist shareholders exercise a more active monitoring function, but their incentives for monitoring are either less pronounced than those of blockowners or are detrimental to the company for other reasons (e.g., strike suits); (iii) Performance-based compensation, in particular equity-based compensation such as stock-options and share grants, may effectively align the interest of managers and shareholders, provided that a remuneration scheme achieves the long-term alignment of these interests; (iv) Takeovers or, more, precisely, the threat of an unfriendly takeover may incentivize management to pursue the goal in shareholder value maximization in order to discourage any attempt at an unfriendly takeover.
- Type 2 conflicts: (i) Independent directors may serve to protect minority interests at board level, even though such directors, precisely because of their independence,

may have less experience with the firm's business and, as a consequence, may cause substantial opportunity costs for the company; (ii) Minority self-help, either by means of a shareholder agreement with a larger blockowner or, more realistically, by making use of legal remedies provided for by mandatory corporate law.

- Type 3 conflicts: (I) Creditor/bondholder self-help based on pertinent covenants agreed with the company; (ii) Providing for (financially) disinterested directors, i.e., decoupling directors' remuneration from the stock price development; (iii) Public intervention and supervision to ensure that a firm takes creditors' interests into proper account.

4.2.2 Agency conflicts in banks

The particularities of banks described above have a substantial impact on the agency conflicts present in banks by changing the incentive structures as well as the spectrum of solutions available for mitigating these conflicts.

(i) To begin with, banks hold a portfolio of financial assets, i.e. debt claims and securities, the composition of which and thus the corresponding risk-profile they can alter much faster than, for example, a car manufacturer can do, who will make much more firm-specific and, hence, less readily marketable investments in production equipment (machines) and property.[53] The technique of securitization even allows banks to easily liquidate long-term debt claims, e.g., mortgages, and securities lacking a viable secondary market by transforming them into tradable assets and investing the proceeds in new assets with a very different risk-profile. In fact, Citigroup's rapidly growing investment in CDO's following Charles O. Prince's taking office as CEO in 2003[54] can serve as a good example of a bank's ability to rapidly change its risk profile, and many more banks followed the same pattern, in particular UBS[55] and some of the German state-controlled public sector banks (*Landesbanken)*, e.g., WestLB, HSH Nordbank, BayernLB, and Landesbank Baden-Württemberg (LBBW).

Depending on the situation, the management or shareholders will benefit from the greater flexibility in risk shifting. Managers, whose remuneration is (partly) performance-based, will find it easier to change the bank's risk-profile in order to meet the agreed performance targets. This holds true, in particular, for more short-term performance

[53] This situation is to be distinguished from even sharper involuntary changes in a bank's risk-profile that result from changes in the value of its portfolio of derivatives and securities with embedded options. See *supra* n. 44 and accompanying text.
[54] See Eric Dash and Julie Creswell, "Citigroup Saw No Red Flags Even as It Made Bolder Bets," *The New York Times*, November 23, 2008. Also available online at http://www.nytimes.com/2008/11/23/business/23citi.html.
[55] UBS, "Shareholder Report on UBS's Write-Downs," April 18, 2008, 12-16, http://www.ubs.com/1/g/investors/releases.html?newsId=140340.

targets. Shareholders, on the other hand, will find it easier to exploit depositors and other debtholders by an opportunistic (ex post) switch to a riskier business strategy.

Additional factors act to exacerbate both problems even more:

(ii) Due to the greater opaqueness of banks' balance sheets, incentive contracts with managers will be (even) less effective in aligning the interests of managers and shareholders.[56] The board of directors will find it difficult to observe whether management did actually meet their performance targets and whether this resulted from the shift to a riskier business strategy than expected and anticipated. By the same token, outside monitoring by shareholders, depositors, and other debtholders will be much more difficult and, thus, less effective.

(iii) If a substantial part of management's total remuneration is equity based in order to align managers and shareholder interests more closely, managers will focus on short-term results. In addition, they will have an excessively low risk aversion because a riskier business strategy will increase the stock price. Specifically, managers have an incentive to increase the bank's leverage which, in turn, gives an incentive to increase the bank's leverage even more, and so on and so forth.

(iv) Dispersed shareholders face even stronger incentives for a bank to operate with a high leverage than managers with equity-based remuneration. Prudential regulation stipulating minimum capital requirements acts as an upper bound to such tendencies. From a shareholder's perspective, such regulation has the effect of exacting a higher investment in the bank than they would make otherwise and, hence, acts as an incentive to favor a riskier business strategy as compensation for the higher investment.[57] Admittedly, this effect only holds true if minimum capital requirements are not risk-sensitive, i.e., if they only reflect the nominal value but not the riskiness of the bank's assets. Hence, the risk-based Basel II framework should have eliminated this effect to a large degree.

(v) Deposit insurance is often said to weaken the incentives for outsider control[58] and, as a corollary, to cause banks to take on more risk by pursuing a riskier business strategy, e.g., by offering higher interest rates for deposits.

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[56] Levine, "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence," 7-8 (see n. 16).
[57] Laeven and Levine, "Bank Governance, Regulation, and Risk Taking," 15 (see n. 16).
[58] See, e.g., Levine, "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence", 10-11 (see n. 16); Macey and O'Hara, "The Corporate Governance of Banks," 98-99 (see n. 16); Devriese, "Corporate governance, regulation and supervision of banks," 98 (see n. 16).

As regards explicit deposit insurance, however, this effect may well be of only limited importance in practice. Mandatory insurance coverage is often limited to a certain (low) amount. Given a rather low cap, deposit insurance eliminates incentives for control only for small depositors, and, very often, these are non-experts and would not serve as capable monitors, anyway. In addition, the deposit insurer may serve as a substitute for small depositors, provided that the insurance charges paid by banks are risk adjusted and the insurer is provided with sufficient monitoring rights. Moreover, before the intervention of states during the financial crisis,[59] large creditors, and in particular expert monitors, faced undiminished incentives to monitor since deposit insurance did neither protect bondholders nor other banks. The upshot, then, is that the distortional impact of mandatory explicit deposit insurance is mostly relevant for small banks since small depositors will play a comparatively much more important role for small banks' refinancing. If, in addition, a bank is also member of a voluntary protection schemes the incentives will change depending on the scope of a bank's liabilities protected and the amount protected. For example, if as is at present the case with German cooperative banks and savings banks (*Sparkassen*) other banks will have to step in to prevent a member bank from becoming insolvent all depositors and debtholders are covered and their monitoring incentives will be rather small, at best.

The situation is very different with respect to implicit deposit guarantees by central banks, states or other public entities resulting from the "too big to fail" dilemma. Such implicit guarantees are very often interpreted by market participants as extending to all claims on a bank and, hence, will distort the incentives of all actors, i.e., those of depositors and other debtholders, as well as those of the banks themselves.

(vi) The market for control functions less well than for other industries, at least within the EU. While the merger market for non-publicly traded small and medium banks is quite active, for example in Germany with respect to savings banks and cooperative banks, the situation is different regarding large listed banks, and cross-border takeovers in particular. Among the reasons are the higher opaqueness of banks' balance sheets and the potential large-scale loss of human capital (investment bankers).[60] With respect to cross-border takeovers in particular, two additional factors act as additional impediments: the fit and proper requirement for large shareholders, mandated by EU law, and some EU Member States' protectionist inclinations[61] which, in turn, are (partly) due to the large banks' systemic importance for the economy as a whole.

[59] See *supra* nn. 47-49 and accompanying text.
[60] For additional reasons from an US-perspective see Adams and Mehran, "Is Corporate Governance Different for Bank Holding Companies?," 126 (see n. 15).
[61] Banca d`Italia's handling of attempted cross-border acquisitions of Italian banks even prompted the EU to adopt a Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as

(vii) To sum up, the particularities of banks described above act to exacerbate the multiple agency conflicts present within banks and to reduce the effectiveness of some of the mechanisms for mitigating these conflicts. The overall effect is for banks to take on more risk than a generic firm would do.

4.2.3 Consequences

4.2.3.1 Shareholders' perspective

From a shareholder's perspective, the holy grail of banks' corporate governance is to check management's short-term orientation without creating incentives for choosing a suboptimal low level of risk. With a view to that goal, remuneration should be structured to include a higher, not a lower amount of equity compensation, i.e., stock, not stock options, and to require managers to hold such stock on a long-term basis (restricted stock).

The well-known downside of such a remuneration arrangement is that the company and, hence, ultimately the shareholders, in absolute numbers, will have to pay a higher total amount of remuneration. By accepting a higher amount of stock, (less diversified) managers take on an additional firm-specific risk, and they will require compensation in the form of an additional non-variable cash component: The more stock (-options) the company grants, the higher will be the amount of additional non-variable compensation demanded by managers – an economic logic supported indeed by some anecdotal evidence from the banking industry.

4.2.3.2 Depositors'/other debtholders' perspective

Depositors and other debtholders are only interested in a bank's ability to pay its debts when they fall due. Consequently, the management remuneration structure preferred by creditors is very different from the one favored by shareholders. If remuneration includes performance-based elements at all, performance criteria should not be volume-based (e.g., not on sales volume) and should discourage taking on risk as much as possible. Specifically, compensation should not include any equity or any equity-related element or, at the very least, the fraction of equity-based compensation should be as small as possible.[62]

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regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector, *Official Journal* 2007 L 247/1.

[62] See, e.g., John and Qian, "Incentive Features in CEO Compensation in the Banking Industry," 110 (see n. 15); cf. from a banking stability perspective, Devriese et al., "Corporate governance, regulation and supervision of banks," 100 (see n. 16).

The presence of large shareholders, and of powerful large shareholders in particular, is an ambiguous mechanism for mitigating any conflicts between depositors/other debtholders and management.[63] On the one hand, large shareholders will typically be more risk-averse and have higher incentives for monitoring management. On the other hand, large shareholders will be interested in extracting private benefits, thus reducing the value of their higher monitoring activities. Empowering large shareholders further increases the risk that a blockowner will extract private benefits to the detriment of depositors and other debtholders, even though small shareholders are hurt more by such behavior.

As a corollary, with respect to directors' qualifications, requiring some or even all directors to be independent from large shareholders is ambiguous, too. Whether depositors and other debtholders benefit from the presence of directors that are independent from a large blockowner depends*, ceteris paribus*, on whether, on balance, the positive effects of a blockowner's more intense monitoring activities are greater than the costs associated with his extraction of private benefits. By contrast, the presence of financially independent directors, i.e., directors whose remuneration is not equity-related in any form, is beneficial to depositors and other debtholders since they lack the incentive to exercise their monitoring and controlling functions with a view to stock price development.[64]

A more general mechanism for mitigating the conflict between depositors/other debtholders and shareholders is to expand corporate governance with a view to encompass debt governance. The more sweeping approach is to substitute shareholder supremacy by stakeholder supremacy either by substituting the shareholder-only-oriented goal of value maximization by that of depositor-restrained value maximization, or, slightly less far-reaching, by requiring the (board of) directors – and possibly even officers/executive directors – to take the interests of depositors and other debtholders into account[65]. A somewhat less sweeping approach is to empower the supervisor to appoint one or, to uphold the balance in case of a board subject to co-determination, even two members to the board of directors.[66]

Finally, depositors and other debtholders will favor the existence of a powerful supervisor with far-reaching powers to regulate, to monitor and to control a bank's activities in the interest of financial stability.

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[63] Cf., from a banking stability perspective, Devriese et al., "Corporate governance, regulation and supervision of banks," 100 (see n. 16).
[64] Cf., Heremans, "Corporate governance issue for banks: A financial stability perspective," 19 (see n. 16); cf. from a banking stability perspective, Devriese et al., "Corporate governance, regulation and supervision of banks," 106 (see n. 16).
[65] In favor of the latter approach Macey and O'Hara, "The Corporate Governance of Banks," 102-103 (see n. 16); Mullineux, "The corporate governance of banks," 375 (see n. 16); cf. from a banking stability perspective, *infra* n. 82 and accompanying text.
[66] See Wohlmannstetter, "Corporate Governance von Banken," 795-96 (see n. 38).

4.3 Supervisors' perspective

4.3.1 Financial stability concerns

The supervisors' taking on the issue of banks' corporate governance is sometimes referred to as a financial stability perspective.[67] Indeed, supervisors, in pursuing their primary objective of maintaining and even enhancing the stability of the financial sector, are concerned with the financial soundness of all banks, even the smallest ones. Put differently, supervisors, with a view to financial stability, seek to prevent the collapse of even a single small bank, regardless of whether that event results from criminal or disloyal behavior by directors or top managers, or from the bank taking on too much risk. With respect to the latter, the role of banking supervisors is sometimes said to complement regulations to further limit excessive risk-taking.[68] However, their primary responsibility is to enforce existing prudential regulation and, if the legislator vested them with the power to promulgate pertinent binding rules, to promulgate such prudential regulation.

4.3.2 Enhancing corporate governance with a view to fostering financial stability

4.3.2.1 The Basel Committee on Banking Supervision's guidance

The supervisors' perspective on the issue of banks' corporate governance has been articulated most comprehensively by the Basel Committee on Banking Supervision in its guideline "Enhancing corporate governance for banking organisations" In a nutshell:

Supervisors (and governments) as stakeholders have a keen interest in sound corporate governance since effective oversight of a bank's business and affairs by its board and senior management contributes to the maintenance of an efficient and cost-effective supervisory system and, in addition, permits the supervisor to place more reliance on the bank's internal processes.[69] In order to assist supervisors and banking organizations worldwide with the implementation of such sound practices, the guidance paper presents eight high-level principles accompanied by more detailed standards and explanatory passages. These guidelines, in principle, apply to all types of banking organizations regardless of their legal form, regardless of the board structure (one/two-tier), regardless of the ownership structure and regardless of whether they are publicly listed or not, but, on the other hand, should be applied in proportion to the size,

[67] See, e.g., Devriese et al., "Corporate governance, regulation and supervision of banks," 95 (see n. 16).
[68] Ibid., 99.
[69] Basel Committee on Banking Supervision, "Enhancing corporate governance for banking organisations," 4, no. 11 (see n. 8).

complexity, structure, economic significance and risk profile of the bank and banking group, respectively.[70]

The eight principles, accompanied by some more details, are as follows:

(1) *Board members* should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank: Since the board of directors is ultimately responsible for the operations and financial soundness of the bank, the board, *inter alia*, should understand the bank's risk profile, approve its overall business strategy, including the overall risk policy and risk management procedures, select, monitor and, where necessary, replace key executives, provide oversight of the senior management, and meet regularly with senior management and internal auditors. In addition, with respect to board structure, the board should include an appropriate number of independent directors (qualified non-executive directors), have an adequate collective knowledge of each of the types of material activities of the bank, and establish specialized committees. At a minimum, large banks should have an audit committee, with a majority of its members being independent and having a firm understanding of the role of the audit committee in the bank's risk management and governance.

(2) The *board* of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation: Setting the professional and ethical "tone at the top" requires the board to ensure that the bank has adequate policies and procedures in place for identifying, avoiding and, where unavoidable, managing all types of conflicts throughout the bank (e.g., by establishing information barriers and providing for separate reporting lines and internal controls), as well as rules prohibiting or limiting related-party transactions

(3) The *board* of directors should set and enforce clear lines of responsibility and accountability throughout the organisation, i.e., on a group-wide basis.

(4) The *board* should ensure that there is appropriate oversight by senior management consistent with board policy. In particular, senior management should establish an effective system of internal controls, including the compliance and legal functions.

(5) The *board* and *senior management* should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions: The bank, *inter alia*, has to have sound internal control functions, including an effective compliance function which, in appropriate situations, reports directly to the board of directors, and an internal audit function which, as sound practice, should report to the board of directors through an audit committee or an equivalent structure.

[70] Ibid., 5 no. 14 et seq., 2 no. 3, 5. With regard to fundamental issues of corporate governance that are specific to listed companies, such as effective shareholder rights, the guidance paper refers to the OECD Principles of Corporate Governance, see ibid., 2 no. 5).

(6) The *board* should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment: In particular, the remuneration of non-executive directors should not be unduly related to the short-term performance of the bank, and performance-related remuneration of executive directors and senior managers should be set, within the scope of general business policy, in such a way that incentives do not overly depend on short-term performance, such as short-term trading gains.
(7) The *bank* should be governed in a transparent manner: Timely, accurate, and in-depth disclosure of a broad set of corporate governance-related items should assist market participants and other stakeholders in monitoring the soundness of the bank, thereby facilitating market discipline.
(8) The *board* and *senior management* should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (i.e., "know-your-structure"): In particular, the bank's use and/or sale of transparency-impeding structures, i.e., complex financial structures (e.g., special purpose vehicles (SPVs) and corporate trusts), instruments and products should be governed by appropriate policies established by the board.

4.3.2.2 Characteristics of the Basel Committee's approach

The Basel Committee's approach to banks' corporate governance is driven exclusively by supervisors' concerns. The eight principles, discussed elsewhere in more detail,[71] aptly reflect this perspective. To summarize the pertinent aspects:

The board has to take the interests of depositors, not just those of shareholders into account.[72]

The principles focus on the board of directors and, albeit to a much more limited extent, on top management, in particular on executive directors. The role of shareholders and that of the market for corporate control (external governance) is relegated to the sideline. Indeed, supervisors whose focal concern is the soundness of a bank will be primarily interested in the soundness of a bank's business practices, and in particular in a bank having effective risk management, control, compliance and audit functions. By the very nature of these functions, it is up to the board and top management to take all the actions necessary to realize this goal, i.e., to establish and implement adequate policies, as well as internal structures and mechanisms.

[71] Mülbert, "Bankenaufsichtsrecht und Corporate Governance," 354-360 (see n. 8); Hopt, "Corporate Governance von Banken," 860-80 (see n. 8).
[72] Basel Committee on Banking Supervision, "Enhancing corporate governance for banking organisations," 9 no. 25, 19 no. 59 (see n. 8; also see p. 3 no. 8 and); Devriese et al., "Corporate governance, regulation and supervision of banks," 107 (see n. 16).

The principles are partly concerned with internal firm-wide structures below the board level, i.e., below the level of the supervisory function (board of directors) and the management function (management board/officers/executive directors), for example by requiring an internal control function, including the compliance and legal functions, and an internal audit function.

The principles focus very much on the duties of the board and/or individual board members and, although to a lesser degree, on the duties of top management and top managers, Particularly striking in this respect is an extensive list – albeit not intended to be a "checklist" – detailing activities of the board and its members that the Committee has observed to contribute to enhancing the financial soundness of a bank.[73] Indeed, given supervisors' prime concern of keeping a bank safe and sound, corporate governance is about business management practices, in particular management decisions dealing with the structure of the organization and with the mechanism of managing and controlling all kinds of risk. As the Banca d`Italia succinctly puts it: "Banks' organizational and corporate governance structures must not only respond to the corporate interest but also ensure conditions of sound and prudent management, the essential objective of regulation and supervisory controls."[74]

The upshot, then, is that from a supervisor's perspective the purpose of banks' corporate governance is less to safeguard the integrity of the promises made by corporations to investors,[75] but to safeguard the promises made to depositors and other debtholders.

4.3.3 Implementation of the Basel Committee's approach through EU law

The implementation of the eight principles, as detailed in the Basel Committee's guidance paper, has been most comprehensive in the EU, so far. To a large extent, the principles are derived from Pillar 2 (entitled: Supervisory Review Process) of the Basel II framework[76] and the EU has introduced the whole Basel II framework for all banks through the Capital Requirements Directive (CRD) which, in turn, comprises the recast Banking Directive[77] and the recast Capital Adequacy Directive[78]. In contrast, the U.S. has opted for a much more restrictive implementation. Only some large international banks are

[73] Basel Committee on Banking Supervision, "Enhancing corporate governance for banking organisations," 6 no. 17 (see n. 8).
[74] Banca d'Italia, "Supervisory Provisions concerning banks' organization and corporate governance," 1 (see n. 13).
[75] See Macey, *Corporate Governance*, 2 (see n. 3).
[76] Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards," 162-183 no. 719-807 (see n. 43).
[77] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), *Official Journal* 2006 L 177/1.
[78] Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast), *Official Journal* 2006 L 177/201.

required - while other qualifying banks may opt in - to use an internal ratings-based approach (IRB) and other methodologies to calculate risk-based capital requirements for credit risk, and advanced measurement approaches (AMA) to calculate risk-based capital requirements for operational risk.[79]

At EU level, in addition, the Committee of European Banking Supervisors (CEBS), as part of its Lamfalussy level 3-activities to co-ordinate Member States' application of EU law, has published guidelines containing, *inter alia*, a list of requirements regarding the internal governance of a bank that, according to CEBS, are to be derived from the recast Banking Directive.[80]

4.4 Functional relationship between corporate governance and banking regulation/supervision

The relationship between corporate governance and banking regulation/supervison in functional terms is often seen either as substitutive or as complementary. However, the antithetical characterizations relate to the practical effects from the existence of banking regulation and supervision at the level of banks' boards and top management. For example, the existence of a powerful supervisor may allow shareholders to tolerate a lower level of remuneration and of incentive-based compensation at the level of top management as well as a lower level of remuneration at the level of the board, the latter being a well-documented feature of US banks in the 1990s.[81]

On a theoretical level, the relationship between bank's corporate governance and banking regulation/supervision is more intricate. For a fruitful analysis, one has to distinguish between debtholder governance and equity governance.

With respect to debtholder governance, the supervisor's interest in maintaining the financial stability of individual banks parallels the perspective of a bank's depositors and its other debtholders. Indeed, the banking supervisory authority is often regarded as a functional substitute to debt governance of banks, i.e., the monitoring activities of depositors and other debtholders.[82] Even more to the point, banking

[79] As to the U.S. implementation of the Basel II advanced approaches framework see Federal Register, Dezember 7, 2007, vol. 72, no. 235: final rule and supplementary information by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). The final rule became effective April 1, 2008.
[80] See Committee of European Banking Supervisors, "Guidelines on the Application of the Supervisory Review Process under Pillar 2," (January 25, 2006), 11-20, http://www.c-ebs.org/Publications/Standards-Guidelines.aspx.
[81] See Adams, "Governance and the Financial Crisis," 11 (see n. 37); David A. Becher, Terry L. Campbell, and Melissa B. Frye, "Incentive Compensation for Bank Directors: The Impact of Deregulation," *Journal of Business* 78 (2005): 1753-1777.
[82] Devriese et al., "Corporate governance, regulation and supervision of banks," 95-98 (see n. 16); Heremans, "Corporate governance issue for banks: A financial stability perspective," 8 (see n. 16).

regulation/supervision serves as a necessary fill in for deficiencies in depositor/debtholder governance that result from depositor/debtholder monitoring of a bank's risk-taking

- being difficult because of banks' opaqueness,
- being a public good encouraging free-riding, and
- being dis-incentiviced by the existence of deposit insurance.

Hence, with respect to the latter, banking regulation and supervision has to compensate the adverse effects on depositors' and other debtholders' incentives to monitor a bank's risk-taking.

The impact of banking regulation/supervision on equity governance is very different since the interests of shareholders and supervisors are not fully aligned. Both shareholders and the supervisor want banks to have high-quality corporate governance mechanisms, structures and procedures in place. In particular, both are interested that banks design effective internal control systems and observe effective risk-management practices, that banks' boards are staffed with members who boast pertinent experience and sufficient time for board-work, and that banks' boards function effectively, e.g., by setting up an appropriate committee structure. However, one fundamental difference remains: The supervisor is interested in the long-term existence of the bank whereas shareholders are interested in high stock returns, and with well-diversified shareholders, the divergence is even more pronounced. As a consequence, with respect to corporate governance standards for substantive issues, i.e., a bank's objective and the criteria for decisions taken by senior management or the board, a supervisor will favor rather different standards. Prudential regulation, e.g., arbitrary limits on leverage and requirements for liquidity, is a case in point, In addition, a supervisor's notion of good corporate governance will be different with respect to corporate governance mechanisms that have an indirect bearing on the substantive standards for decision-making by the board or top management. The most important area in this respect is the structure of remuneration systems. Pay arrangements that would be preferred by shareholders are by no means identical to those that are preferred by the supervisor as a socially optimal solution.[83] Tellingly, the restrictions for banks' remuneration structures recently designed or even implemented by regulators/supervisors are much tougher than the incentive structures in place before the crisis, and which served the (short-term) interests of shareholders rather well.

[83] The point is most forcefully developed by Lucian A. Bebchuk and Holger Spamann, "Regulating Bankers' Pay," Georgetown Law Journal 98, no. 2. Also available online at http://ssrn.com/abstract=1410072.

5. Banks' corporate governance after the financial crisis: evidence and reforms

5.1 Evidence

Whether and to what extent corporate governance failures can be considered to be a cause of the financial crisis seems easily answered by a resounding "Yes, we matter." Banking supervisors, Sir David Walker and Nestor Advisors, to name but a few, can point to numerous examples of unsound corporate governance practices before the crisis and undoubtedly, over time, even more anecdotal evidence will come to light. Still, even egregious cases of unsound corporate governance practices do not support the claim that major governance failures were one important or even the most important cause for the crisis, and, more generally, neither will any number of anecdotal evidence serve as proof. Proof of widespread corporate governance failure at banks can only come from empirical studies.

Systematic empirical studies, so far, do not provide strong support for the corporate governance failure-hypothesis. For example, Beltratti and Stulz found not evidence that banks with better governance when governance is measured with data used in the well-known Corporate Governance Quotient (CGQ score) performed better during the crisis but found strong evidence that banks with more shareholder-friendly boards performed worse in terms of stock return performance during the crisis and better in 2006, i.e., before the crisis.[84] Similarly, Erkens, Hung, and Matos studying 296 financial firms from 30 countries arrive at the conclusion that their results obtained are inconsistent with the hypothesis that the firms losses suffered during the financial crisis were the result of lax oversight by boards and investors. Rather, firms with more independent boards and greater institutional ownership were not only more likely to replace their CEOs for poor performance, but also experienced worse stock returns and recognized larger write-downs during the crisis.[85]

Arguably, these results should not serve as an all-out argument against any reforms designed to improve bank's corporate governance even more. Some areas, most notably risk management, indeed warrant substantial improvement, albeit to a widely-varying degree with different banks. On the other hand, the deficiencies highlighted, *inter alia*, by supervisors often relate to faulty management practices, not to the ways shareholders assure themselves of getting a return on their investment. A case in point is the over-reliance on VaR or other quantitative risk measures as a means to assess the firm's

[84] Andrea Beltratti and Rene M. Stulz, "Why Did Some Banks Perform Better During the Credit Crisis?," (Charles A Dice Center Working Paper No. 2009-12, Ohio State University, July 2009), http://ssrn.com/abstract=1433502.

[85] David Erkens, Mingyi Hung, and Pedro P. Matos, "Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide," (ECGI - Finance Working Paper No. 249/2009, December 2009), http://ssrn.com/abstract=1397685 (equating independent directors with non-executive directors).

current risk position. Moreover, even if all banks had followed exemplary corporate governance practices because of the incentives created by states (e.g., prudential regulation), central banks (e.g., very low interest rates), and supervisors in all probability, the crisis would have erupted anyway within a few years.[86] For example, if boards were not involved in setting the risk appetite of a firm it does not follow that level of risk appetite would have been any different from the one chosen by the board if the latter had been involved. Theory suggests that, depending on the situation, executive managers/officers will chose a suboptimal low level of risk just as likely as a suboptimal high level of risk.

5.2 Risk management

Apart from remuneration,[87] risk management has attracted most interest in the debate on lessons to be learned from the crisis with a view to improve banks´ corporate governance.

The list of causes advanced to explain the sometimes almost complete failure of risk management at some banks, at least, is long:[88] Risk management focused more on measuring instead of identifying risks, the riskiness of structured products such as CDOs, ABSs and others was not fully realized,[89] areas of risk concentration were not properly identified below top management level (silo structures), risk stress-tests were performed using past events instead of identifying new risks and looking at possible new scenarios respectively, boards relied too much on quantitative risk models (daily value at risk (VaR) and similar techniques) and failed to see the "fat" risks which should be a board's foremost concern, and even failed to understand the firm's current risk position relative to its risk appetite. In particular, a key lesson from the crisis is said to be that the directors on bank boards should not take false comfort from their regulatory capital ratios.[90]

For the boards to take on a more active role in risk management presupposes not only that (some) members have adequate financial expertise or, at the very least, a background that enables them to learn to understand the tools and concepts for risk management used by the firm quickly. It also presupposes that the board is presented

[86] For a very similar assessment see Brian R. Cheffins, "Did Corporate Governance 'Fail' During the 2008 Stock Market Meltdown? The Case of the S&P 500," (ECGI Law Working Papier No. 124/2009, July 2009), http://ssrn.com/abstract=1396126.
[87] See *infra* 5.4.2./3.
[88] As to the following, see Nestor Advisors, *Banks Boards and the Financial* Crisis, 46-92 (see n. 37); Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis," 6-12 (see n. 29); Basel Committee on Banking Supervision, "Enhancements to the Basel II framework," (Basel: BIS, July 2009), http://www.bis.org/publ/bcbs157.htm. Cf. Senior Supervisors Group, "Risk Management Lessons from the Global Banking Crisis of 2008," (October 21, 2009), 20-28, http://www.financialstabilityboard.org/list/fsb_publications/page_1.htm; Association of Chartered Certified Accountants, "Corporate Governance and the Credit Crunch," 8-9 (see n. 34). For an informative survey on sources and causes of risk management failures drawing in part on the observations from the recent crisis see Stulz, "Risk management failures: What are they and when do they happen?,", passim.
[89] See Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis," 8 (see n. 29): CDO investments far exceeded (some) banks' understanding of the risks inherent in such instruments.
[90] Nestor Advisors, *Banks Boards and the Financial* Crisis, 10 (see n. 37);.

with information on the firm's risk position in a way and to an extent that allows the board to participate in setting the firm's risk appetite and to assess its current total risk position in relation to the goals set.[91]

By contrast, improving the organization of risk management responsibility at the top level seems to be less warranted. While the Walker review strongly recommends the establishment of a standalone risk committee, i.e., a risk committee apart from the audit committee that focuses on the current and forward-looking aspects of risk exposure,[92] the existence of such a committee may be advisable but not indispensable.[93] Indeed, the key lesson seems to be for bank to have a comprehensive and independent[94] risk management function under the direct responsibility of a (totally independent)[95] Chief Risk Officer at the highest level of top management (executive director/*Mitglied des Vorstands*)[96] who has direct access (reporting)[97] to the board or, where a risk committee or a audit committee exists, to the committee, and who as an individual, possesses the authority and standing to impress the importance of sound risk management practices throughout the organization, thus vesting the risk function with the necessary authority and organizational powers.

5.3 Requirements for board members

With respect to the qualification of board members, a relatively higher proportion of independent directors does not affect performance in either way. More surprising is another finding that distinguishes banks' boards from those at other firms. The financial industry expertise of the chairman of the board is positively related to bank performance,

[91] In more detail, see Senior Supervisors Group, "Risk Management Lessons from the Global Banking Crisis of 2008," 23-24 (see n. 88); Basel Committee on Banking Supervision, "Enhancements to the Basel II framework," 14-15 no. 22-24 (see n. 88).

[92] Walker, "A review of corporate governance in UK banks and other financial industry entities," 93-94 no. 6.10-6.12 (see n. 35; for more details see pp. 96-98 no. 6.16, 6.18-6.20).

[93] See Nestor Advisors, *Banks Boards and the Financial* Crisis, 37-40 (see n. 37);

[94] Committee of European Banking Supervisors, "High level principles for risk management," (February 16, 2010, No. 9), 25, http://www.c-ebs.org/Publications/Standards-Guidelines.aspx.

[95] Walker, "A review of corporate governance in UK banks and other financial industry entities," 98-99 no. 6.21-6.22 (see n. 35); "Report of the High-Level Group on Financial Supervision in the EU," no. 123 (see n. 33); OECD, "Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles," 15 no. 40 (see n. 30).

[96] OECD, "Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles," 15 no. 40 (see n. 30); but see Basel Committee on Banking Supervision, "Enhancements to the Basel II framework", 13 no. 19 (see n. 88); CEBS, "High level principles for risk management," no. 21 (see n. 94); Walker, "A review of corporate governance in UK banks and other financial industry entities," 99 no. 6.22 (see n. 35); "Report of the High-Level Group on Financial Supervision in the EU," no. 123 (see n. 33): CRO may report to the CFO or CEO.

[97] Basel Committee on Banking Supervision, "Enhancements to the Basel II framework," 13 no. 19 (see n. 88); CEBS, "High level principles for risk management," no. 21 (see n. 94); Walker, "A review of corporate governance in UK banks and other financial industry entities," 98 no. 6.22 (see n. 35); "Report of the High-Level Group on Financial Supervision in the EU," no. 123 (see n. 33);; OECD, "Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles," 15 no. 40 (see n. 30).

and this holds true regardless of whether the chairman is a former chief executive of the bank or has acquired his/her expertise at another institution.[98] This finding has an obvious bearing on whether for financial firms, the independency-requirement stipulated by law or enshrined in corporate governance codes should be construed more strictly or, as is increasingly argued, more loosely.[99]

The role and the qualifications of the non-executive directors (NEDs) on boards, in particular, are of major concern for the Walker review, in particular given that several banks on both sides of the Atlantic, strategies of which appear to have been determined by long-entrenched executives with little external input to their internal decision-making, seem to have fared materially worse than those where there was opportunity for effective challenge within the boardroom.[100] The Review calls for NEDs to deviate from the "accepted convention" by demonstrating greater readiness to test and challenge the plans, strategies, and ideas presented by the executive board members.[101] With a view to this transition, the Review recommends more stringent qualifications for NEDs, both in terms of knowledge, expertise, and experience, and in character[102], the ability to allot more time to board activities[103] and the implementation of procedural safeguards designed to ensure that NEDs will be able to comply with the higher standards, e.g., the availability of internal support[104], the existence of a program for induction, training, and development,[105] and a more active role of the Financial Services Authority (FSA).[106]

5.4 Remuneration

Whether the industry-wide remuneration structures creating high-powered incentives for short-term risk taking are an important or even the major cause for the financial crisis is still open to debate. However, regulators, politicians and society at large are united in favoring tough new rules on remuneration issues at banks, in particular and, albeit to somewhat lesser extent, at large and/or listed companies in general.

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[98] Nestor Advisors, *Banks Boards and the Financial* Crisis, 19-21, 28 (see n. 37);
[99] See Walker, "A review of corporate governance in UK banks and other financial industry entities," 44 no. 3.10 (see n. 35); Adams, "Governance and the Financial Crisis," (see n. 37).
[100] Ibid., 37 no. 2.12. Hau und Thum present corroborative evidence in a study of the 29 largest German banks (private banks and state-controlled public sector banks, i.e., *Landesbanken*). They find that the level of financial expertise at the supervisory board correlates with crisis performance at a 5 % statistical significance level by linking the comparatively higher losses suffered by *Landesbanken* (controlling for size, on average their losses were twice as large as those of their private competitors) to a lower level of financial expertise of supervisory board members of *Landesbanken*. See Harald Hau and Marcel P. Thum, "Subprime Crisis and Board (In-)Competence: Private vs. Public Banks in Germany," (CESifo Working Paper Series No. 2640 and ECGI Finance Working Paper No. 247/2009, April 2009), http://ssrn.com/abstract=1360698.
[101] Walker, "A review of corporate governance in UK banks and other financial industry entities," 55 no. 4.11 (see n. 35).
[102] Ibid., 55 no. 4.11.
[103] Ibid., 47-49 no. 3.19-3.23.
[104] Ibid., 47 no. 3.17-3.18.
[105] Ibid., 46 no. 3.16.
[106] Ibid., 49-50 no. 3.24-3.25.

5.4.1 Empirical evidence

So far, empirical studies do not offer clear-cut support for the claim that the high-powered short-term remuneration structures were a (major) cause for the crisis. While some early studies found that high executive compensation was prevalent for the riskiest financial institutions,[107] others did not find any correlation between remuneration structures and risk.[108] Fahlenbrach and Stulz studying 98 US banks found that banks led by an CEO whose interests were better aligned with the bank's interests had worse stock returns and a worse return on equity during the crisis but performed significantly better before the outbreak of the crisis.[109] Even more to the point, they claim that lack of alignment of bank CEO incentives with shareholder interests cannot be blamed for the credit crisis or the performance of banks during that crisis since CEOs did not sell shares ahead of the crisis.[110]

In response to this argument – which, incidentally, reflects a broader consensus among many observers – Bebchuck, Cohen and Spamann recently showed that the five top executives at Bear Stearns and Lehman Brothers, respectively derived cash flows from cash bonuses and equity sales during the period 2000-2008 that substantially exceeded the value of the executives' initial holdings at the beginning of the period and, thus, the executives' net payoffs for the period were decidedly positive. Hence, they correctly point out, the large paper losses that the executives suffered when their companies collapsed should not provide a basis for either dismissing or accepting the claim that the prevailing remuneration structures acted as an important cause of the financial crisis. Still more importantly, the top executives' proven inability to foresee the crisis does not rule out the possibility that their decisions were in fact influenced by their heavily-incentivized short-term-oriented remuneration packages.[111] But, then, the study by

[107] See Audit Integrity, "Insights," September 2008, http://www.researchrecap.com/index.php/2008/09/22/poor-corporate-governance-highlights-risk-of-bank-failure/. As to the predictive value of the governance rating produced by Audit Integrity, AGR, see Robert Daines, Ian D. Gow, and David F. Larcker, "Rating the Ratings: How Good are Commercial Governance Ratings," (Stanford Law and Economics Olin Working Paper No. 360, Stanford University, September 2009), 48, http://ssrn.com/abstract=1152093: "we find some relation between AGR and both future operating performances and excess returns"; for older studies that found a lower pay-performance sensitivity for banks' CEOs compared to those of other firms' CEOs see John and Qian, "Incentive Features in CEO Compensation in the Banking Industry," (see n. 15); Adams and Mehran, "Is Corporate Governance Different for Bank Holding Companies?," 131-32 (see n. 15).

[108] Nestor Advisors, *Banks Boards and the Financial* Crisis, 95-98 (see n. 37); Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis," 13-14 (see n. 29).

[109] Rüdiger Fahlenbrach and Rene M. Stulz, "Bank CEO Incentives and the Credit Crisis," (Charles A Dice Center Working Paper No. 2009-13, Ohio State University and ECGI Finance Working Paper No. 256/2009, December 2009), http://ssrn.com/abstract=1439859.

[110] Ibid., 25.

[111] Lucian A. Bebchuk, Alma Cohen, and Holger Spamann, "The Wages of Failure: Executive Coompensation at Bear Stearns and Lehman 2000-2008," (working paper, Harvard Law and Economics Discussion Paper No. 657, Harvard Law School, November 2007), http://ssrn.com/abstract=1513522.

Fahlenbrach and Stulz found that the amount of stock options and cash bonuses granted had no effect on a bank's performance, either in terms of stock returns or in terms of accounting return on equity (ROE).

5.4.2 Reform initiatives before and after the G20 Pittsburgh Summit

(i) The FSB Principles of Sound Compensation Practices of September 25, 2009[112] prepared by the Financial Stability Board for the Pittsburgh Summit on September 24/25, 2009 following a request from the G20, mark a turning point in the effort of numerous countries to limit bankers' pay and, at the same time, serve as a useful point of reference for categorizing the numerous initiatives at international and national level.

By setting internationally agreed minimum standards, the Principles ended any attempts at an international race to the bottom in regulating banks' remuneration practices. Before that, draft regulations published by national regulators were usually watered down before final implementation as a result of severe criticism by interested parties. In particular, this held true for the UK Financial Services Authority's (FSA's) code of remuneration practices[113] and the Swiss Financial Market Supervisory Authority's (FINMA's) Circular (*Rundschreiben*) on remuneration arrangements,[114] respectively.

By contrast, the Basel Committee on Banking Supervision's very recently published assessment methodology for compensation principles and standards,[115] in detailing the principles and rules suggested by the FSA, in part goes even further than the FSB. Similarly, in August 2009, the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*; BaFin) first published a revised version of its Circular "Minimum Requirements for the Risk Management of Credit Institutions"[116] providing for rather generic rules broadly in line with the FSF Principles for Sound Compensation Practices of April 2, 2009[117] and the CEBS High-level Principles for

[112] Financial Stability Board, "Principles of Sound Compensation Practices – Implementation Standards," (September 25, 2009), http://www.financialstabilityboard.org/list/fsb_publications/index.htm; for a less detailed prior version see "FSF Principles for Sound Compensation Practices," (April 2, 2009), http://www.financialstabilityboard.org/list/fsb_publications/page_2.htm.

[113] Compare Financial Services Authority, "Reforming remuneration practices in financial services," (Policy Statement 09/15, August 2009), http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf to same, "Draft code on remuneration policies," (March 2009), http://www.fsa.gov.uk/pubs/other/remuneration.pdf; see also FSA, "Reforming remuneration practices in financial services," (consultation paper 09/10, March 2009), http://www.fsa.gov.uk/pages/Library/Policy/CP/2009/09_10.shtml.

[114] Compare Swiss Financial Market Supervisory Authority FINMA, "Rundschreiben 10/1: Vergütungssysteme - Mindeststandards für Vergütungssysteme bei Finanzinstituten," (November 11, 2009), http://www.finma.ch/d/aktuell/Seiten/mm-rs-verguetungssysteme-20091111.aspx to Same, "Rundschreiben 2009/...: Vergütungsssteme - Mindeststandards für Vergütungssysteme bei Finanzinstituten," (March 6, 2009), http://www.finma.ch/d/aktuell/Seiten/mm-rs-verguetungssysteme-20090603.aspx.

[115] Basel Committee on Banking Supervision, "Compensation Principles and Standards – Assessment Methodology," (Basel: BIS, January 2010), http://www.bis.org/publ/bcbs166.htm.

[116] Bundesanstalt für Finanzdienstleistungsaufsicht, "Rundschreiben 15/2009(BA) – Mindestanforderungen an das Risikomanagement – MaRisk," (August 14, 2009), http://www.bafin.de.

[117] *Supra* n. 112.

Remuneration Policies of April 20, 2009.[118] In December, then, BaFin stipulated much more detailed and stringent requirements in its Circular “Supervisory Requirements for Remuneration Systems at Financial Institutions.”[119] Finally, the EU Commission Recommendation on remuneration policies of April 30, 2009[120] provides for less detailed “rules” than the Proposal for a so-called Capital Requirements Directive III (CRD III) which amends Annex V of the Capital Requirements Directive by introducing a new Section 11 with a view to obliging credit institutions and investment firms to have remuneration policies that are consistent with effective risk management.[121]

By way of exception, in the US, Title II of the Wall Street and Consumer Protection Act of 2009[122] introduced in Congress in December incorporates the Draft Corporate and Financial Institution Compensation Fairness Act of 2009[123] introduced in Congress in July without making the substantive rules on remuneration at large financial institutions substantially stricter.

(ii) In addition to these initiatives directly targeting remuneration at large and/or listed banks and, sometimes, at other financial institutions some national legislatures have tightened corporate law provisions on remuneration issues or, at least, are in the process of introducing new rules.[124] For example, the German legislature, referring to the financial crisis and the misincentives from short-term oriented remuneration structures tightened the criteria for the statutorily mandated Appropriateness (*Angemessenheit*) of management board remuneration enshrined in Sect. 87(1) of the Stock Corporation Act through the Act on the Appropriateness of Management Board Remuneration (*Gesetz zur Angemessenheit der Vorstandsvergütung – VorstAG*)[125] coming into force on August 4,

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[118] Committee of European Banking Supervisory, “High-level principles of Remuneration Policies,” (April 2009), http://www.c-ebs.org/Publications/Standards-Guidelines.aspx.

[119] Bundesanstalt für Finanzdienstleistungsaufsicht, “Rundschreiben 15/2009(BA) – Aufsichtsrechtliche Anforderungen an die Vergütungssysteme von Instituten,” (December 21, 2009), http://www.bafin.de.

[120] Commission Recommendation on remuneration policies in the financial services sector, *Official Journal* 2009 L120/22.

[121] See Commission Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, COM(2009)362 final, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52009PC0362:EN:NOT; for the text of the Presidency compromise see Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies (Interinstitutional File: 2009/0099 (COD) 14732/09, October 28, 2009), http://register.consilium.europa.eu/pdf/en/09/st14/st14732.en09.pdf.

[122] Wall Street Reform and Consumer Protection Act of 2009, HR 4173, 111th Cong., 1st sess., http://thomas.loc.gov/cgi-bin/query/D?c111:1:./temp/~c111wFzEm6:.

[123] Corporate and Financial Institution Compensation Fairness Act of 2009, HR 3269. 111th Cong., 1st sess., http://www.thomas.gov/cgi-bin/query/z?c111:H.R.3269:.

[124] For a comprehensive overview and see Guido A. Ferrarini, Niamh Moloney, and Maria-Cristina Ungureanu, “Understanding Directors’ Pay in Europe: A Comparative and Empirical Analysis,” (ECGI Law Working Paper No. 126/2009, August 2009), http://ssrn.com/abstract=1418463.

[125] See as to the newly introduced appropriateness critera, e.g., Daniela Weber-Rey, “Änderungen des Deutschen Corporate Governance Kodex 2009,” *WM* (Zeitschrift für Wirtschafts- und Bankrecht) 63 (2009): 2257-2260.

2009 and, following the regime in place in the UK, extended the power of the general meeting by introducing the possibility of a non-binding vote on the remuneration system for the executive board (Sect. 120(4) of the Stock Corporation Act). Similarly, the Draft Wall Street and Consumer Protection Act of 2009, with respect to issuers, provides for a non-binding annual vote of approval on the compensation of executive officers (Sect. 2002) and for the requirement that all members of a compensation committee or, in the absence of such committee, all board members must be independent, i.e., apart from in their capacity as board members must not accept any consulting, advisory, or other compensatory fee from the issuer (Sect. 2003).

5.4.3 Overview of substantive issues

As regards substantive issues covered by the numerous initiatives, the following areas should be distinguished:
- field of application
    - type, size etc. of financial institutions covered
    - persons covered: board members, top executives, individual risk takers, others
- governance structures
    - committee at board level
    - remuneration committee at the top management level
    - “say on pay” by shareholders
- substantive rules on remuneration systems
- disclosure
- prudential regulation.

(i) Field of application: Some new rules or guidelines target only a particular set of financial institutions, for example only significant financial institutions (FSB Principles) or financial institutions with assets of more than $ 1 billion (Sect. 2004 of the Draft Wall Street and Consumer Protection Act of 2009).

In addition, some of the substantive rules target only particular relevant subsets of the employees at the institutions covered, such as:
- senior executives and other employees whose actions have a material impact in the risk exposure of the firm (FSB Principles; BaFin Circular 22/2009 (BA)) or, in a very similar definition, those categories of staff, including senior management, whose professional activities have a material impact on the risk profile of the said credit institution (Annex V Sect. 11 Point 23 of Directive 2006/48/EC (Banking Directive) as amended by the Proposal for a CRD III – Presidency compromise),
- employees in the risk and compliance function (FSB Principles)

(ii) Governance structures: A remuneration committee should exist with the power, *inter alia,* to oversee the compensation systems' design and operation (FSB Principles). Alternatively, given the particularities of the two-tier system, the supervisory board should be responsible for the remuneration system of the management board members whereas the management board should design the remuneration system for lower-level employees, while a remuneration committee composed of top executives and employees from different functions, e.g. the compliance function, should supervise such a system (BaFin Circular 22/2009 (BA)).

In addition, as already mentioned, corporate law sometimes provides for a voluntary or even mandatory vote on the compensation of top executive/management board members (UK; Germany; US).[126]

(iii) Substantive rules on remuneration systems target staff whose professional activities have a material impact on the risk exposure of the firm, and who also have a risk and compliance function.

With respect to the first group, the overarching goal of all substantive rules is to foster compensation practices that reduce employees' incentives to take excessive risk. Well-known mechanisms to achieve this goal include the linking of remuneration to levels of residual risk and the calculation of bonuses based on long-term performance through the choice of appropriate performance measures (risk-adjustment, time-horizon), deferred payout of variable compensation, malus components/clawback provisions, payout of a substantial portion (> 50%) of the variable compensation in shares or share-linked instruments, and the prohibition of guaranteeing bonuses for more than one year, etc. (e.g., Basel Committee;[127] Annex V Sect. 11 Point 23 of Directive 2006/48/EC (Banking Directive) as amended by the Proposal for a CRD III – Presidency compromise).

For employees in the risk and compliance function remuneration should be independent of other business areas and, as a corollary, performance-based remuneration should be based solely on the achievement of the objectives of their functions (FSB Principles; Annex V Sect. 11 Point 23(da) of Directive 2006/48/EC (Banking Directive) as amended by the Proposal for a CRD III – Presidency compromise).

(iv) Disclosure: An annual report on compensation is to be mandated including, *inter alia*, information on the decision-making process, with details on the remuneration committee,

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[126] Given the UK experience, the effectiveness of a non-binding shareholder vote in curbing remuneration excesses is doubtful, at best. See, e.g., Cheffins, "Did Corporate Governance 'Fail' During the 2008 Stock Market Meltdown?," 41 (see n. 86); Jeffrey N. Gordon, "'Say on Pay': Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In," (Columbia Law School Working Paper No. 343, August 2009), http://ssrn.com/abstract=1331482.

[127] See, in particular, Basel Committee on Banking Supervision, "Compensation Principles and Standards – Assessment Methodology," 11-23 no. 36-67 (see n. 115).

the most important design characteristics of the compensation system, and aggregate quantitative information on compensation (FSB Principles; BaFin Circular 22/2009 (BA); Annex 12, Part 2, Point 15 of Directive 2006/48/EC (Banking Directive) as amended by the Proposal for a CRD III – Presidency compromise).

(v) Prudential Oversight:
- Financial institutions have to be obliged to have remuneration policies and practices that are consistent with and promote sound and effective risk management (Art. 22(1) Directive 2006/48/EC (Banking Directive) as amended by the Proposal for a CRD III).
- Supervisors should be empowered to take measures to address problems arising from ill-designed or ill-operated remuneration systems, either by requiring the firm to make appropriate changes with regard to its remuneration system ("qualitative requirement") or/and by requiring the firm to hold additional own funds against the operational risk ("quantitative requirement") (Art. 54(2) Directive 2006/48/EC (Banking Directive) as amended by the Proposal for a CRD III – Presidency compromise). In all probability, supervisors will prefer the first approach. Within the risk-based Basel II framework requiring a bank to hold additional own funds presupposes the possibility of somehow quantifying a firm's risks due to a given remuneration system, i.e., the probability and the amount of unexpected losses the firm will suffer because of the incentives created by a particular remuneration structure. Given the emerging empirical evidence, such a calculation would amount to a formidable challenge, at best.

5.5 Dampening banks' risk appetite by corporate law mechanisms?

5.5.1 Requiring a bank to act in the interest of depositors/other debtholders, too

From a corporate law perspective, two strategies primarily exist for requiring a bank to act in the interest of depositors/other debtholders: incorporate these interests into a bank's corporate objective by mandatory law or stipulate a fiduciary duty of directors and officers to depositors, and even to other debtholders.

Regarding the first approach, one may want to point to the blurred line between equity and debt resulting from the existence of hybrid debt, i.e., subordinated debt or even loss-taking debt. Moreover, banks are of systemic importance and perform a general interest function. Finally, the acute information asymmetry and complexity present in banks is only to be overcome by explicitly taking the interests of other stakeholders into account, as well. However, the counter-arguments should prevail.[128] First, hybrid debt can

[128] In the same sense Walker, "A review of corporate governance in UK banks and other financial industry entities," 137 (see n. 35).

protect its interest through self-help, in particular by requiring adequate contractual protection in the form of covenants. Second, firms outside of the banking sector can be of systemic importance as well, whereas small and medium-sized banks cannot, by virtue of their size, cannot carry such risk. Put differently, the systemic importance criterion fails to clearly distinguish banks from other firms and to explain why (all) banks should be subject to a unique legal regime. Third, and most important, stakeholder instead of shareholder supremacy does not provide for a higher degree of depositor protection, at least not in practice. German banks are arguably subject to a stakeholder regime.[129] Nevertheless, anecdotal evidence from the current financial crisis strongly suggests that, all in all, German listed banks did not fare any better than their competitors in the UK or even Switzerland.[130] The theoretical argument for preferring a monistic corporate goal is very well-known: Stakeholder supremacy allows directors/officers an unbridled pursuit of their own interests in the guise of balancing the interests of different stakeholders.

The second strategy is to assert that directors and officers also have a fiduciary duty towards depositors,[131] and to require that banks' (executive) directors pursue a less risky business strategy than their counterparts at other firms.[132] Such an approach begs the question why corporate law should intervene over and above the standards for an acceptable level of risk-taking established by prudential regulation. In response, one may want to point out that regulators are less suited to the task of setting pertinent standards because of informational asymmetries, time-lags in processing the information received and acting on it because of, *inter alia*, limited resources, etc.[133] Indeed, "a key lesson from the recent crisis is that directors of bank boards should not take false comfort from their regulatory capital ratios."[134] Still, defining the (lower) level of risk-taking that is still acceptable from the point of view of depositors and other debtholders will always be an arbitrary decision for which no ready-made yardstick exists. Moreover, if a deposit insurance scheme does exist, at best, a fiduciary duty should extend to the insurer but not to depositors.

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[129] See, e.g., Uwe Hüffer, *Aktiengesetz*, 8th ed. (München: C. H. Beck, 2008), § 76 n. 12a et seq.; but see also Peter O. Mülbert, "Shareholder Value aus rechtlicher Sicht," *ZGR* (Zeitschrift für Unternehmens- und Gesellschaftsrecht) 26 (1997): 147-156; same, "Soziale Verantwortung von Unternehmen im Gesellschaftsrecht," *AG* (Die Aktiengesellschaft) 54 (2009): 770-772.
[130] See the table "Share price trough as a % of share price peak," in Nestor Advisors, *Banks Boards and the Financial* Crisis, 3 (see n. 37).
[131] See *supra* n. 65 and accompanying text.
[132] Macey and O'Hara, "The Corporate Governance of Banks," 102 (see n. 16).
[133] But see Walker, "A review of corporate governance in UK banks and other financial industry entities," 31 no. 2.8 (see n. 35); for a somewhat nuanced assessment: "even the most experienced and disciplined board is likely to be less well-placed than the regulator to assess the implications of new risks that may be building up in the financial system at large."
[134] Nestor Advisors, *Banks Boards and the Financial* Crisis, 10 (see n. 37).

5.5.2 Applying a higher standard of care to directors/officers of banks

The alternative to requiring directors and officers to act in the interest of depositors, too, is to subject their actions to a higher standard of care than would apply in a generic firm. The most sweeping approach is not to apply the business judgment rule (BJR) or its national equivalents (e.g., Sect. 93(1)(2) German Stock Corporation Act). A somewhat less intrusive measure would be an expanded application of the bad faith-exception of the business judgment rule and, if a director or officer failed to take any action because of a lack of adequate information or a deficient reporting system, to concentrate on the lack of a business decision (BJR not applicable) instead of on the deficiencies in the information-gathering process (BJR applicable).

However, even in the US, with the notable exception of New York,[135] most courts nowadays apply the business judgment rule to directors and officers of banks in the same way as to those of other corporations. The arguments advanced in favor of stricter standards – the relationship of directors and officers with depositors is close to a fiduciary relationship, and because of deposit insurance, directors and officers put taxpayers' money on the line[136] – cannot refute the main argument in favor of applying the business judgment rule in full: Banks are entrepreneurial risk-takers just like any generic corporation, and the objective of the business judgment rule is precisely to reflect the particular problems that face a director or officer taking an entrepreneurial decision under risk.

6. Concluding remarks

Banks' corporate governance differs from that of a generic firm. Given banks' high leverage, debtholders, i.e., depositors and bondholders, as well as a bank's management will prefer the firm to take on substantially less risk than diversified shareholders. However, deposit insurance and prudential regulation, although aimed at compensating for deficits in the monitoring and control of banks, weaken debtholder monitoring and control. Highly incentive-based remuneration can neutralize management's aversion to take on more risk, in particular if a substantial part is in the form of short-term cash bonuses.

Banking regulators'/supervisors' interest in maintaining financial stability parallels the interest of debtholders and, hence, the monitoring and controlling activities of supervisors act as a substitute for poor debtholder monitoring and control. It follows that, with respect

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[135] See, very critical, Joel B. Harris and Charles T. Caliendo, "Who Says the Business Judgment Rule Does not Apply to Directors of New York Banks?," *Banking L. J.* 118 (2001): 493 et seq.

[136] See William M. Fletcher, *Fletcher Cyclopedia of the Law of Corporations* (Eagan Minnesota: West Group, 2002), § 1042.10.

to banks' corporate governance, their activities will affect shareholders and debtholders unevenly. Both groups will benefit from improvements in corporate governance mechanisms, structures and procedural standards, i.e., from rules designed to improve internal control systems and risk-management practices, as well as the expertise of board members and the board structure. In contrast, shareholders will benefit less from substantive rules on decision-making, i.e., from rules that prescribe financial stability-oriented decision-taking. This also holds true with respect to mechanisms etc. that serve to induce a bank's management to take decisions that are in line with the supervisor's financial stability interests. Banking regulation prescribing substantive standards for remuneration systems are of particular relevance in this respect.

Against this backdrop, banks' corporate governance should not provide a generalized way forward for corporate governance.. In particular, while advances with respect to risk-management practices and internal controls may serve as a model for firms of similar size and complexity outside the financial sector, the shortcomings of bank corporate governance does not warrant public intervention in generic firms though either setting standards or prescribing even detailed rules for the structure and substantive contents of remuneration systems.[137]

[137] In the same sense Bebchuk and Spamann, "Regulating Bankers' Pay," 40 (see n. 83).

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