Corporate Governance at Banks: Is It Different?

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Abstract

This paper reviews some of the recent distress in Indian banking system and asks whether there was a link with corporate governance. It revisits the theory of bank governance and tries to see how governance at banks is different from governing a joint stock limited liability company. This paper attempts to understand some of the issues typical with the corporate governance at banks and financial institutions, despite the academic literature on the corporate governance of banks being scarce. In conclusion, the author argues that bank governance is different and requires more radical departures from traditional governance for non-financial firms.

Introduction

The financial year 2017-18 started on a great note for the Indian banking. State Bank of India (SBI) broke into global top 50 after merging with itself five of its associate banks. By the fourth quarter of the fiscal year, however, Punjab National Bank was left with nearly Rs 140-billion fraud perpetrated by jeweller Nirav Modi.

Banks struggled with their bad debt throughout the year. The gross NPA (non-performing assets) ratio of the industry was at 7.69 per cent of total advances as on March 2016. It rose to 10.32 per cent (Rs 8.86 trillion) by the end of December 2017 quarter. Gross NPA ratio of public sector banks (PSBs) stood at 13.03 per cent at the end of December quarter. The banking industry had suffered losses during the year. The loss was entirely due to Public Sector Banks which struggled to keep up provisioning against their ballooning bad debt.

On the other hand, ICICI chief executive Chanda Kochhar and Axis Bankchief executive Shikha Sharma have gone from being icons of the banking sector to targets of serious allegations and criticism. Both of them were summoned by the Serious Fraud Investigation Office of the Ministry of Corporate Affairs in relation to the probe in Mehul Choksi'sGitanjali Gems fraud, other reasons emerged for their distress. The Central Bureau of Investigation has registered a preliminary enquiry to probe alleged nexus between Kochhar's husband Deepak Kochhar and Videocon chairman Venugopal Dhoot.Later, Shikha Sharma's resigned after the Reserve Bank of India's directive to the Axis Bank board that Sharma's tenure to be extended for only a year, and not three years, as was decided in July last year.

Thus, the currents state of affairs of banking sector in India and few of the recent incidences highlights the need for having good corporate governance systems at the banks- both public as well as private.The recent governance issues in India's banking sector reiterate the need to improve risk managementand maintain strong governance practices.

Corporate Governance

Corporate governance broadly refers to the mechanisms, relations, and processes by which a corporation is controlled and is directed. It involves balancing the many interests of the stakeholders of a corporation. The term corporate governance is a multidimensional concept and so is difficult to understand and comprehend. In paragraphs below few definitions of corporate governance are presented.

Corporate Governance is the relationship among various participants [chief executive officer, management, shareholders, employees] in determining the direction and performance of corporations"

- Monks and Minow, Corporate Governance, from 1995 version.

Corporate Governance is about how suppliers of capital get managers to return profits, make sure managers do not misuse the capital by investing in bad projects, and how shareholders and creditors monitor managers.

- American Management Association

Corporate Governance. is the relationship between corporate managers, directors and the providers of equity, people and institutions who save and invest their capital to earn a return. It ensures that the board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations.

- International Chamber of Commerce

"Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society" (Sir Adrian Cadbury in 'Global Corporate Governance Forum', World Bank, 2000)

[a] corporate governance system is the combination of mechanisms which ensure that the management (the agent) runs the firm for the benefit of one or several stakeholders (principals). Such stakeholders may cover shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business.

- Goergen and Renneboog, 2006

Corporate Governance deals with the conflicts of interests between the providers of finance and the managers; the shareholders and the stakeholders; different types of shareholders (mainly the large shareholder and the minority shareholders); and the prevention or mitigation of these conflicts of interests.

- Marc Goergen, 2012.

Corporate Governance is about how companies are directed and controlled. Good governance is an essential ingredient in corporate success and sustainable economic

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growth. Research in governance requires an interdisciplinary analysis, drawing above all on economics and law, and a close understanding of modern business practice of the kind which comes from detailed empirical studies in a range of national systems.

- Simon Deakin,

Robert Monks Professor of Corporate Governance

In most countries the corporate governance debate has mostly focused on misuse of authority by dominant executives because of weak shareholders; insufficiently engaged small and widespread shareholders; and powerful but conflicted large-block shareholders. The traditional conflicts between shareholders, managers, and boards are also present in banks. Many banks, including the big ones, are limited liability companies. Like any other type of corporation, they can be afflicted by board failure on strategy and oversight, misaligned or perverse incentives, empire building by powerful executives, conflicts of interest, weaknesses in internal control systems, managerial incompetence, and fraud.

Figure 1: Provisions and Contingencies in Indian Banks

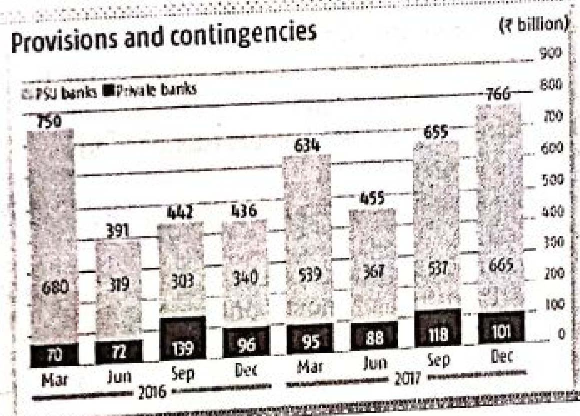


Figure 2: Net Profit/ Loss of Indian Banks

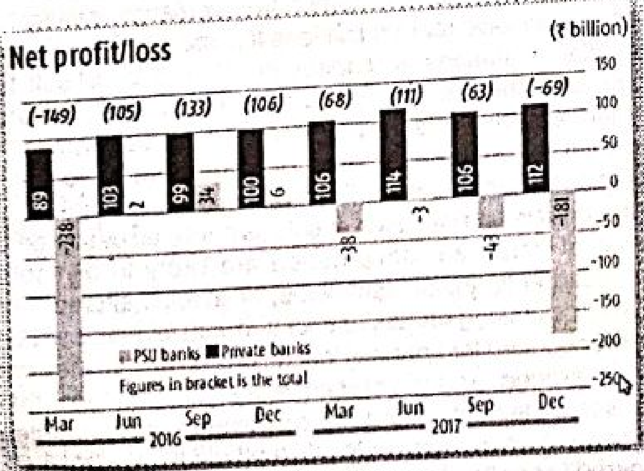


Figure 3: Market Capitalization

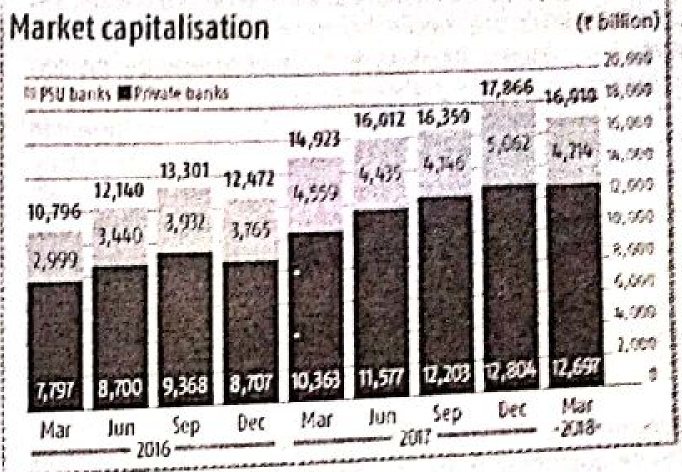
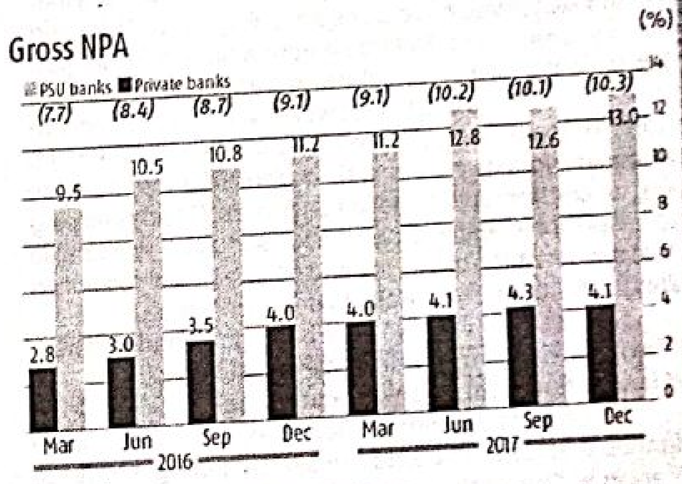


Figure 4: Gross NPAs



But banks and financial institutions also have specific governance issues. The very nature of the banking business weakens the traditional corporate governance institutions of board and shareholder oversight. Banks have the ability to take on risk very quickly, in a way that is not immediately visible to directors or outside investors. A multitude of quickly evolving and technically complex business activities need to be monitored by banking specialists who are in short supply. In widely held banks, shareholder oversight is expensive and often left to institutional investors and/or insufficiently qualified directors. Regulation and valuation difficulties also weaken the potential role of the market for external corporate control. Large-Block shareholder conflicts may also be aggravated in banks, as bank lending can easily be steered to their pet projects and exposing banks to high risks. Finally, while banks are heavily regulated, and have significant government holding, they may also be subject to strong political influence, fostered by political appointments on the board and favoring preferred political projects, schemes and businesses.

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Banks are multi-constituency organizations. Depositors and bondholders contributealmost all of a bank's capital, yet most decisions are taken by managers, boards, and shareholders. Bank executives do not have to seek permission from depositors before changing a bank's risk profile.

These depositors in most countries are indifferent to the bank's financial prospects because they are protected by some sort of insurance or a state guarantee. In this context, what should be the role of unprotected creditors, insurers, and the state-as the ultimate provider of guarantees for protected creditors-in bank governance? Is bank regulationa complement or a substitute for corporate governance? These are some of the issues that arises in governance of banks and financial institutions.

Empirically it has been difficult to establish a link between bank failures and corporate governance, partly because government rescues have masked the true extent of the banks' problems, and partly because so many other factors have contributed to bank failures. The latest Basel Principles for enhancing corporate governance recognize that boards andexecutives have a responsibility to creditors and not just to shareholders. But these norms have not changed the fundamental power structure in banks. Shareholders continue to have the exclusive power to appoint and remove directors. To make bank governance more effective it might be necessary to experiment with deeper reforms, such as allowing for creditor representation on boards. Besides helping mitigate risk-shifting, this type of representation would also facilitate the operation of bail-ins and other types of resolution requiring debt-to-equity swaps at very short notice.

Next section reviews why bank governance differs from the governance of non-financial institutions.

What is different about bank governance

The nature of banks' activities presents unique challenges that need to be addressed by their governance mechanisms. This section explores some of the specificities of financial intermediation and their implications for corporate governance.

The academic literature on the corporate governance of banks is scarce. More problematic is that those few studies that do consider banks often look at banks through the lens of the Anglo-Saxon model of corporate governance, focusing on shareholder value creation while abstracting from the interests of non-shareholder stakeholders and financial stability considerations. And the extensive literature on the corporate governance of non-financial firms has limited applicability to banks because it abstracts from regulatory distortions that affect banks.

Limits of Traditional Corporate Governance

Financial institutions play an important role in the allocation of capital for productive uses. If financial institutions are well-managed and allocate capital to their most productive use, this will contribute to growth (Levine, 2005). Sound corporate governance contributes twofold to this outcome. First, it assures that the providers of capital to financial institution (depositors, debt holders, and shareholders) get a return on their investment, without the managers stealing the capital. Second, it prevents managers of financial institutions from investing in bad projects.

It is therefore worrying that there are stories abound of rogue businesses and fraudulent behavior at banks. These highlight that the internal governance of firms, despite the presence of sizeable risk management and compliance functions in all the major financial institutions, does not work effectively. The recent cases reported for ICICI, PNB and AXIS bank, illustrates this internal governance failure.

It is fair to say that the corporate governance problems that plague non-financial companies, namely those associated with the separation of ownership and control, also apply to financialinstitutions. Corporate governance of financial institutions also depends on the legal protection of investors, which is not always adequate (Shleifer and Vishny, 1997). And standard solutions proposed in the literature to align the interests of managers and outside investors also apply to banks. These include concentrated ownership, incentive contracts for managers, hostile takeovers, and large creditors. However, financial institutions have special attributes that can intensify standard governance problems and limit the effectiveness of corporate control.Financial institutions are different from non-financial firms in at least four aspects:

- They are highly leveraged
- They have diffused debtholders (depositors)
- They are large creditors
- They are systemically important and therefore heavily regulated

The typical leverage ratio of a bank is about 10, which is much higher than that of most nonfinancial firms. The typical bank holds the majority of this debt in the form of deposits, taken from a large number of diffuse depositors. Financial institutions are also major creditors to the real economy, even sitting on corporate boards in their capacity as major investors in many countries. They therefore play a potentially important corporate governance role to the broader economy. In this sense, poor corporate governance of financial institutions can have real implications.If corporate governance of financial institutions is inadequate, then it is difficult to imagine that they in turn will promote sound corporate governance in the firms they lend to. This ultimately means that capital will not be allocated to its most productive use. These special attributes of financial institutions imply that agency conflicts and valuation effects as predicted by standard theories of corporate governance are likely to be more pronounced in financial institutions, or at least altered. For example, risk taking effects associated with leverage will be more pronounced for financial institutions given that they are highly leveraged. And the presence of small depositors that enjoy some deposit insurance or government guarantee weakens the monitoring role of debtholders in banks as compared to nonfinancial firms.

Deposit insurance and financial regulation

High leverage, diffuse debt, and large creditors can in principle also be found in nonfinancial companies. What

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ally sets financial institutions apart is that they are subject to deposit insurance and heavily regulated. Firms in several other industries are also regulated, but none are as heavily regulated as financial institutions, especially banks. Regulation comes in many forms, including capital requirements, ownership, and activity restrictions, etc.

There are good reasons for why banks enjoy deposit insurance and are heavily regulated. Deposit insurance is there to deal with liquidity risk, which is inherent to banking where short-term obligations are transformed into long-term claims. And regulation is there to correct the displacement of market discipline arising from deposit insurance, and to prevent bank failures and associated negative externalities on the financial system and broader economy.

The implications of high leverage are different for banks than for non-financial companies because it raises the probability of bank failures and the threat of systemic risk. Capital requirements in particular are seen as effective regulatory instruments to prevent banks from taking on excessive leverage, although regulatory arbitrage has allowed banks to circumvent leverage rules in some circumstances and many argue that minimum capital requirements are set too low.

The problem with deposit insurance and financial regulation is that they alter the traditional channels of corporate governance. Take deposit insurance. By reducing incentives of depositors to monitor banks, deposit insurance displaces market discipline, hindering corporate governance. Moreover, deposits are not only a form of diffuse debt but also of uninformed and unsophisticated debt, further hampering corporate governance. Most households only know deposit insurance when there is a banking crisis, in other words, when it is too late.

Financial regulation, in trying to correct the behavior of managers and investors of financial institutions with a view to safeguard financial stability, may be counterproductive and introduce new distortions that reduce the ability of investors to exert control, lowering valuations of financial institutions, which ultimately could have negative ramifications for financial stability. In particular, bank regulation is partly responsible for the ineffectiveness at banks of traditional corporate governance solutions to align the interests of managers and outside investors. These solutions include: concentrated ownership, managerial incentivecontracts, hostile takeovers, and large creditors. Let me elaborate on the limits of each of these four devices in the case of banks.

Concentrated ownership

The most direct way to align the interests of managers and shareholders is concentrated ownership. Large investors have the incentive to collect information and monitor management, limiting managerial discretion. While large shareholdings of non-financial companies are common in most countries, this is less the case for banks. The reason is that "most countries restrict the concentration of bank ownership and the ability of outsiders to purchase a substantial percentage of bank stock without regulatory approval (Caprio and Levine, 2002)." These restrictions usually come in the form of limits on the percentage of bank capital that can be owned by a single entity or constraints on ownership by non-banks.

For example, the U.S. imposes specific limits on the block holdings of bank holding companies that prevent representation on the board of directors of the banking organization. The practical implication of these limits has been that most non-controlling investments in banks have been kept below 10 percent of voting shares so that the investor could obtain aboard seat without itself becoming a bank holding company. Similar ownership limits are in place in about 40 percent of countries around the world (Caprio and Levine, 2002).

The rationale at the time to limit the controlling influence of bank owners over the banking organization was the so-called "source of strength" doctrine: any company that acquires control of a bank holding company needs to be prepared to use its resources to financially support the bank holding company should the need arise. This doctrine presents a major obstacle for the acquisition of control of a banking organization by most investors. In addition, this regulation was driven by a desire to limit the comingling of banking and commerce, effectively preventing non-financial companies with commercial interests from exercising a controlling influence over banking organizations.

As a result of such ownership restrictions, ownership of banks is more diffuse than it otherwise would have been. This raises the possibility that the relatively small size of their investment keeps diffuse shareholders from effectively exerting corporate control on financial institutions.

It is important to note that concentrated ownership is not a panacea. Large investors may act in their own interest at the expense of minority shareholders, debt holders, and other stakeholders in the firm. Furthermore, large investors may encourage the firm to invest in risky assets, since they benefit on the upside while debt holders bear the costs of failure (Jensen and Meckling, 1976). Expropriation of minority shareholders can be particularly problematic in countries with poor protection of minority shareholder rights.

Executive pay

Another way to deal with the principal-agent conflicts arising from the separation of ownership and control is to give managers a highly contingent, long term incentive contract to align their interests with those of investors. Executive compensation contracts generally include such high-impact incentives. The scale of the recent financial crisis and the seemingly exorbitant executive pay amassed by bankers has led to much discussion on executive compensation and whether it helps align interests of managers and shareholders. In principle, the risk-taking incentives of bank managers will depend on the degree to which their interests are linked to those of value-maximizing stockholders, including through executive compensation contracts (Berle and Means, 1932). However, the incentives of managers also depend on their bank-specific human capital skills and private benefits of

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control. As a result, bank managers may advocate for less risk taking than stockholders without those skills and benefits, even in the presence of incentive contracts (Jensen and Meckling, 1976; Demsetz and Lehn, 1985; John et al. 2008). In practice, bank managers often do not hold much bank stock, placing them at odds with bank owners in their views on risk taking (Laeven and Levine, 2007).

Moreover, high-powered incentives contracts, such as bonus pay and option contracts, can "create enormous opportunities for self-dealing for the managers, especially if these contracts are negotiated with poorly motivated boards of directors rather than with large investors" (Shleifer and Vishny, 1997, p. 745). It is therefore not surprising that regulators and the public at large have questioned such incentive contracts. Indeed, there is empirical evidence that banks with managers whose incentives were more aligned with the interests of shareholders performance significantly worse during the recent financial crisis (Fahlenbrach and Stulz, 2011). This suggests that executive pay should not be seen as a panacea for solving corporate governance problems.

Market for corporate control

Hostile takeovers are another mechanism to solve the problem of managerial discretion over the firm's free cash flow. In a typical hostile takeover, successful bidders acquire control over poorly performing firms through tender offers, typically ousting management in the process. However, despite their apparent success in the western countries, they are virtually absent in the rest of the world. As regards banks, most countries explicitly limit the possibility of hostile takeovers. Any legally permissible mergers require prior approval from the country's bank regulator. And some countries explicitly prohibit takeovers of banks by non-banks. This is not to say that takeovers necessarily reduce agency costs. Corporate bidders frequently overpay for target firms in acquisitions that bring them private benefits of control.

Large creditors

Large creditors can act as another disciplining device on bank management. The power of debtholders "comes in part because of the control rights they receive when firms default or violate debt covenants and in part because they typically lend short terms, so borrowers have to come back at regular, short intervals for more funds (Shleifer and Vishny, 1997, p. 757)." The distinguishing feature of debt is that creditors do not need to coordinate to take actionagainst a delinquent firm. Since banks have diffuse debt in the form of many small depositors, this makes debt renegotiation difficult, weakening corporate governance.

Policy Implications and Concluding Remarks

This review of the literature on the corporate governance of banks has important policy implications. The current approach to bank supervision and regulation that relies on internationally established capital regulations and supervisory practices is questionnable. Instead, private governance mechanisms exert a powerful influence over bank risking and the same regulation has different effects on bank risk taking depending on the bank's governance structure. Since governance structures differ systematically across countries, bank regulations must be custom designed and adapted to local governance systems and practices. Regulations should be geared toward creating sound incentives for bank stakeholders, not toward harmonizing national regulations across economies with very different governance structures.

This review also emphasizes the complementary nature of corporate governance and financial regulation. By focusing on the valuation of individual financial institutions, sound corporate governance will be insufficient to protect the financial system as whole. It should be complemented by macroprudential regulation. Corporate governance and its ability to monitor and control default risk of financial institutions is little defense against macroprudential risks that come with the economic cycle, and is therefore not effective in dealing with aggregate risk. Of course, regulators need help as well because the politics ofbooms and supervisory discretion may render prudential regulation ineffective. Therefore, the market should join forces with regulators to discipline financial institutions.

Key elements to success will be to increase the role of owners including the depositors and other stakeholders in limiting bank risk taking and to improve resolution frameworks. This would act to reduce systemic risk both by improving incentives to lower the probability of default and by raising the probability of regulatory intervention into ailing financial institutions.

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