Banking governance: New Approaches

Phd Victor Mihăiţă Duţă[1]
[1]University of Craiova

Abstract. *Banks are companies like any other. However, banks are distinguished by certain intrinsic characteristics of companies that have a different impact on the motivation of stakeholders. Among these features, we mention: partnership and shareholders governance agreements; banks are heavily regulated companies; banking assets is the main source of haze banking and information asymmetry; between the bank and depositors there is a problem of moral hazard.*

Keywords: governance, companies, banks, bank assets, information asymmetry.

JEL Classification: E32, G14

1. Introduction.

The concept of "banking governance" has undergone profound changes in recent decades. Some of these changes were the determined result by the existence on the market of other financial intermediaries. However, we believe that it should not be omitted the effects induced by more complex and controversial phenomenon of economic globalization and, naturally, financial globalization.

2. A Partnership and Shareholders Governance Agreements

From the point of view of many researchers like Andres and Vallelado (2008), Macey and O`Hara (2003), Adams and Mehran (2003), there is the opinion that the bank is a knot of contracts established between stakeholders and shareholders. The latter are not the only ones to bear a residual risk. Moreover, high transaction costs of contracting entails difficult. This is proof of the legitimacy of the governance shareholders in banks.

The shareholding model, managers and administrators have no fiduciary obligations to shareholders, although they are considered to be the only ones who bear the residual risk. Unlike shareholders, stakeholders are protected by comprehensive contracts. Then, managers are challenged to maximize shareholder value while shareholders have an entirely different challenge to control managers. The right is assigned to the control that supports a residual risk, just because it is the most challenged to scrutinize and ensure better efficiency of the company.

Knowing that between maximizing shareholder value and shareholders is an important link, but given the limited liability of shareholders is reached in position to generate expenditure of creditor stakeholders. Therefore, maximizing shareholder value will not be optimal in terms of the collective. From this perspective, Macey and O`Hara (2003) state that, in banks, fiduciary obligations of managers must take into account the security and solidarity of the banks. Indeed, bank liquidity is producing and cope in the event of generation, a conflict between shareholders and of creditor agent. Notice also that the bank is heavily indebted and is subject to a deposit insurance system. For all these reasons, Adams and Mehran (2003, p. 125) has called “a hybrid approach to banking governance”, meaning *a partnership and shareholders governance agreement*.

Later, Gianfaldoni and Richez-Battesti (2008, p. 19) will note that “companies are governed by a model American shareholders while banks are governed, according to the German-Japanese paradigm, through a partnership model”. Of course, within this framework, “bank managers must expand their fiduciary obligations beyond the shareholders include stakeholders, depositors”. Adams and Mehran (2003) hold great significance to clarify specificity banks. In terms of empirical specification, these authors are interested in the difference between the governance of banks and industrial firms governance. The authors have developed a study for a period of 10 years (1986-1996) and identified several features for banks:

• they have, in general, a large boards of managers;
• external managers are the most numerous;
• there are many committees and frequent meetings;
• challenge directions through “stock-options”[1] is rarely used.

Adams and Mehran (2003) suggest that these characteristics are due to differences in regulations and investment opportunities between banks and industrial companies. Therefore, the two authors, based on differences in the characteristics identified systemic banks and industrial companies, says the government has certain specificity: *banking predominant partnership governance*. Adams and Mehran (2003) state that stock-options are for nonfinancial companies and are a good tool to motivate managers to create values in their own interest. However, for the banking, stock-options conflict with the objectives aiming to protect stakeholders (for instance depositors and taxpayers).

Also, on the stock-options, Adams and Mehran (2003) note that there is high dependence of the rising cost of debt repurchase stock-options. Thus, to reduce the cost of debt, banks can resort to this form of remuneration. The authors confirmed the rising cost though; argue that sensitivity as managers’ remuneration by stock-options for performance is weaker in the banking sector than in other sectors.

Polo (2007), reviewing several books on governance of banks, highlights two different views. On the one hand, researchers such as Adams and Mehran (2003) and Macey and O`Hara (2003) reveal the specific governance of banks. In their work, these researchers concluded that governance mechanisms available companies (especially industrial ones) are not appropriate to the banks. This mismatch legitimizes the intervention of regulatory authorities. Place the control exercised by private mechanisms, regulators through the intervention of their influence and dominate the banking governance. On the other hand, researchers and Arun and Turner (2004) and Barth, et al (2006) states that “governance mechanisms affecting companies and banks”. Barth et al (2006) also considered that the evolution of banks is influenced by two variables: the protection of shareholders and ownership. Prudential regulation, in contrast, seems to have no impact on the evolution of banks or taking on risk. “The purpose of the excessive risk taking better achieved through motivation behind the development of specific behaviour of shareholders and depositors of creditor” (Barth et al, 2006, p. 235).

Regarding the idea of banking governance formal shareholder partners, we express confidence in researchers’ arguments Polo (2007), Barth, etc. (2006), Arun and Turner (2004), Adams and Mehran (2003), Macey and O’Hara (2003). After all, the special nature of banks, which have a special contractual form and paramount in financial and economic stability, generate conditions for governance entire vision of

[1] Stock-options is a specific form of variable remuneration, especially the American industrial firms. Stock-options enter in the global remuneration components as medium-term incentive remuneration (usually 5 years). This form of remuneration of managers and employees allows a company to purchase its shares at a date and at a price fixed in advance. Stock-options has the advantage of causing employees to act to increase the company's share value.

partnership to be better adapted to banks (Macey and O'Hara, 2003; Arun and Turner, 2004). Governance is not limited to banking agent relationship between shareholders and managers (Polo, 2007), and governance mechanisms (especially domestic) take into account the good of the various stakeholders (Barth et al, 2006).

3. Banks, High Regulated Companies

Because of the importance of banks in the financial and economic stability, regulators impose multiple regulations. Of course, throughout Europe, the banking sector is highly regulated. But we must note that, compared with the regulator and legal environment of non-financial firms, there is considerable disagreement. The main source of disagreement is the great difference between nature and effectiveness of control mechanisms of banks and nonfinancial firms (Arun and Turner, 2004). Soon Charreaux (2004/2005) come with two strong arguments to explain the banking regulator. The two arguments are the protection of depositors and systemic risk (bankruptcy). To protect depositors and ensure the stability of the banking system, regulators are implementing "tire safety" as a guarantee of deposit insurance and central bank as lender of last resort. Spulbăr (2008, p. 17) states that "In order to protect the interests of depositors and ensuring the stability of the entire banking system, the National Bank of Romania ensures the prudential supervision of credit institutions, Romanian legal persons, including their branches established in other Member States and third countries through the establishment of standards and indicators prudential. National Bank of Romania follows the rules and prudential indicators both individually and on a consolidated or sub-, as appropriate, to prevent or limit specific banking risks".

Polo (2007), Levine (2004), Macey and O'Hara (2003), in their work, says that affect deposit insurance agent issues that motivate shareholders to excessive risk taking. Then, a high regulation of the banking sector is likely to worsen in banks, principal-agent problems. As regards, moral hazard, to limit its effects, Barth, etc. (2004, p. 221) argue that "requirement the implementation of a surveillance and prudential regulation". In this context, we notice that regulators are forcing banks to maintain a sufficiently high level of own funds. On the other hand, it should be noted that the regulatory and supervisory bodies is one of the stakeholders of banks and divergent interests that can port some shareholders, depositors and of creditor. Agent problems are also more complex in the banking sector. More generally, Polo (2007) states that an important control mechanism in banking regulatory intervention. By nature highly regulated banking sector, regulators can influence and also dominate the governance of banks.

Therefore, regulators in order to act against systemic risk, they brought tires to ensure the safety of deposits and the central bank. From the perspective of the challenge for excessive risk taking was introduced minimum threshold regulated and generally was developed prudential regulatory capacity. The latter can be considered as the principal mechanism of control of the bank.

The importance of the economic role of banks makes supervision and control of banking indispensable. Exercising this role rests on public regulatory and supervisory powers of bank management to ensure good governance, stability of the banking system and avoid systemic risk event. Through a proper regulation and supervision, a bank's management is supported to fulfill its objectives and its roles. Spulbăr (2008, p. 5) identifies the bank management, two main objectives: "optimization of assets and liabilities in order to increase profitability and choice of option risk mitigation".

Banking management roles are manifested in the process of management. In this process plays three roles: "banks' main intermediary in the savings-investment relationship, protecting the resources available at a time and transfer of parts between account holders." The state is challenged to maximize the collective good. Mulbert (2010, P. 143) notes: "The state, in its capacity as guardian of the common good, is challenged for good control and good supervision of banking activities and it defends the interests of stakeholders". From this perspective, the State may deviate from its capacity as protector of the common good.

In case of deviation, the State tends to not operate to achieve social comprehension, which means that regulators do not serve social interests which they are made. Such situations occur when regulatory and supervisory bodies are 'captured' by local public power. This time, the State loses its collective protective role and becomes a protector of a particular interest group power. The state dysfunction can worsen governance problems in banks and, consequently, questions arise: Who will control the control? And how can state as regulator and supervisor, to serve the collective interest? Of course, we formulate questions that have no answers, but we believe in the arguments of other researchers. For example, Beck et al (2002) proves that the probability that private companies and vicious maintain relations with banks to get loans increased in the presence of public oversight bodies. Beck, et al (2002) concluded that the independence of supervisory bodies mitigates the situation of "political capture" and allows companies to escape the influence and constraints of public courts of their powers. Barth et al (2004) show, in turn, investigating a sample of 107 countries, when control banking activities are performed by a private agent, politically independent, the banking sector is more stable and more solid. Conclusion: regulation plays an important role being a control mechanism, so that political interference has a weak potential.

4. The Opacity of Bank Assets and Their Specificity

From the beginning we must note that the information asymmetry inherent to all companies, it is evident in banks. In the banking sector, information asymmetry holds an important place in the decisions of banks. In turn, banks are characterized by a high opacity of bank assets. Levine (2004), referring to the term of opacity, opacity appreciate a situation of great difficulty in which the external participants in the audit of the internal behavior.

The main source of haze is information asymmetry banking assets. However it should be noted that the haze occurs banking sector, predominantly in the lending process. "The assets are difficult to observe and manipulate their risk is a potential managers" (Levine, 2004, p. 64). Also Levine (2004, p. 67) also draws attention to the difficulty of observing credit quality. "This can be hidden for a long time because only the bank is able to know the exact value of its assets." This is an accurate assessment because only the bank has precise knowledge, safe on loans they grant.

In the model Diamond and Dybvig (1983, p. 401-419), the bank is deemed, for the account of investors, a delegated controller which is designed to select and control the requested loan. Moreover, banks are able to adjust the composition of risk assets faster than other companies. But, banks can hide problems paying credit risk management and customers who do not honor their previous commitments. Banks also can mask favorable conditions regarding interest rates, guarantees and loan volumes.

According to researchers Andres and Vallelado (2008, p. 2570-2580), the opacity of banks is likely to worsen bank governance, because opacity agent amplifies problems. Occur if the agent issues, the two situations. First, the shareholders face multiple difficulties to control banking activities and decisions of the management team. In the second, having claims will be unable to control the risk assumed by shareholders and managers.

Also Andres and Vallelado (2008) find that domestic participants may facilitate removal of external participants. This is true because of information asymmetry interns power is much greater than the external. In the banking sector, the minority shareholders (usually external) and claims against (all external) bank executives can not control (interns). The asymmetry of information does not allow external to rely on attractive contracts (incentive) to align their interests with those of managers (Polo, 2007).

So, the force causes the opacity of bank assets executives and shareholders (internal) to behave opportunistically by one and adopt strategies to eliminate unsafe acts or other stakeholders (usually outside the bank). Opacity of bank assets generate multiple complications in respect of managers and control the implementation of agreements to harmonize the goals of shareholders and managers. Essentially, opacity accentuates conflicts agent bank assets.

Regarding specificity balance sheet, banks balance sheet shows a structure characterized by a significant level of indebtedness. In their study, Macey and O'Hara (2003) state that "90% of assets are financed by debt in the form of deposits". Of course, bank liabilities are in overwhelmingly composed of deposits being returned to depositors in the event of withdrawal request. In this context it can be said that the banks' assets take the form of assets that maturation longer than those of deposits. From this difference, the banks get a win. Of course, banks have multiple sources of earnings. After all, the rationale of a bank's liquidity is to ensure production. This production function of liquidity highlights the specificity of bank governance.

5. The Assurance of Depositors and Moral Hazard between the Bank and Depositors

Pollin (2011) and in particular Arun and Turner (2004) argue that the deposit insurance system can generate moral hazard problems from banks, which causes a reduction in the depositors motivations of controlling shareholders. There is therefore a moral hazard problem between the bank and depositors. Banks, being aware of the existence of moral hazard, seeking to place the problem of executives accusing them of opportunistic behaviour towards depositors.

An undeniable fact is that banks are the main providers of depositors, not shareholders. Depositors are opponents of the risk that depositors get a fixed return after formation of deposits. Depositors may record losses if the bank fails to excessive risk taking. Then, as the bank is overwhelmingly funded in the debt (in the form of deposits), if depositors withdraw their deposits in full, the bank will be in problems of solvency and liquidity. Therefore, the deposit insurance system was designed to respond to the threat of bank panics and their negative externalities. In the absence of deposit insurance system, the central bank, as lender of last resort, applying the principle of solidarity to place calls other banks to save the ailing bank.

For a more solid depositors and ensuring proper risk taking moral Labornne and Abdelkader (2008, p. 743-775) suggests firms to use external control mechanisms. Such a suggestion would be more welcome in the banking sector where the roles of internal governance mechanisms external control mechanisms are less important. By increasing share of the overall control external mechanisms of governance mechanisms, banks may be based on an honest and complete information. Through such information, banks can promote better contractual discipline, they become stronger against the threat of bankruptcy and they allow to labor markets and to the takeover of the control department to be more operational.

6. Conclusions

Our research has given us the opportunity to mention once again if it was the case that banks differ from other entities through certain intrinsic characteristics that generate a different impact on stakeholders. In such a case, we focused on different opinions of prestigious authors about the coagulation and induced effects of these developments on the concept of banking governance.

References

Adams, R.,Mehran, H., Is Corporate Governance Different for Bank Holding Companies?, Economic Policy Review, Vol.9, 2003.

Arun, T. G., Turner, J. D., Corporate governance of banks in developing economics: Concepts and issues, Corporate Governance: An International Review, Vol. 12, no. 3, 2004.

Andres, P., Vallelado, E., Corporate governance in banking: The role of the board of directors, Journal of banking and finance, Vol. 32, no.12, 2008.

Charreaux, G., Les grands auteurs en theorie des organisations: Michael Jensen: la theorie positive de l'agence et ses applications à l'architecture et à la gouvernance des organisations, Cahier du FARGO, no. 1041203, 2004/2005.

Levine, R., The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence, World Bank Policy Research Working Paper 3404, September 2004.

Macey, J. R., O`Hara, M., The corporate governance of banks, Economic Policy Review, Vol. 9, No. 1, 2003.

Polo, A., Corporate governance of banks: The current state of the debate, SSRN Working Paper, 2007.

Spulbăr, C., Banking Management, second edition, Sitech, Craiova, 2008.