Corporate Governance within Financial Institutions: Asset or Liability?

Dan CHIRLEŞAN, Marius Constantin APOSTOAIE

1. Introduction

The financial crisis which started off in the summer of 2007 in the United States and then spread throughout the world through the contagion effect was particularly significant given its extent and its effects in most world economies. It subsequently turned into a recession (at global level) and then into an abrupt narrowing of economic activity, following the deepening of the financial crisis through the bankruptcy of the Lehman Brothers in the autumn of 2008 (September). Its occurrence opened numerous debates concerning the responsibility of the financial institutions and the transformations required to guarantee the stability of the global financial system.

Because financial institutions take on a significant role in the process of financial intermediation they are considered to be important players in the financial system, especially in the Euro Area (where banks are the primary source of financing for the real economy). For this reason, defining and enforcing corporate governance (CG) within their strategic structure is of great importance; when referring to CG we consider those conducts and practices that are ethical, transparent and accountable. In elaborating their strategies, financial actors must consider and measure the impact of their different actions in order to achieve not only a good market position but also to preserve social welfare for all partners involved.

The paper aims at setting out a framework that will enable us to analyze and reflect on the core meaning of the concept in question, the advantages and long term benefits and also the direction of specific practices regarding CG in financial institutions (and more generally, in a company). To highlight some of the features of CG we conducted an investigation on a sample panel of 125 financial institutions within EU-15 for the year 2007. This paper represents ongoing research. Nevertheless, we consider this pilot research a launching platform for a more comprehensive investigation in the field of CG in financial institutions.

2. Corporate governance: theoretical considerations

Regarding the theoretical content of the concept ‘corporate governance’ there are numerous points of view due to the fact that there is an array of different phenomena and economic operations encompassed within its scope. Specialists in various branches of the economic area have come up with theoretical approaches based on different views of the area of activity. Nevertheless, trying to establish a clear and strong definition of the concept may in turn lead to a failure in its clarification; ironically, over time, the approaches and interpretations of the concept multiplied instead of simplifying making the task of determining a single definition of CG a real challenge. For this reason, we will only list some of the definitions that we have encountered in our research and that offer a wider and more comprehensive view on the CG phenomenon.

In the view of Milton Friedman [11] CG is “... to conduct the business in accordance with owner or shareholders’ desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs”.

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In UK, according to the Cadbury Report, CG is “...the system by which companies are directed and controlled to do with Power and Accountability: who exercises power, on behalf of whom, how the exercise of power is controlled”. Many of the recommendations of the Cadbury Code have been incorporated into the OECD Principles of Corporate Governance [22] and into other national Corporate Governance Codes [8]. In Nederland, the point of departure for the activities of the Tabaksblat Committee was established by the Peters Report (Peters Committee, 1997) which specified that “The concept of Corporate Governance has been understood to mean a code of conduct for those associated with the company consisting of a set of rules for sound management and proper supervision and for a division of duties and responsibilities and powers effecting the satisfactory balance of influence of all the stakeholders”. After 2009, the Dutch Corporate Governance Code Monitoring Committee presented a revised Dutch Corporate Governance Code. In Belgium, the Cardon Report (1998) states that "Corporate governance’ refers to the set of rules applicable to the direction and control of a company”.

A strand of the theory considers CG as that area of the economy that explores the means of ensuring an efficient management of corporations, by using stimulating mechanisms, such as contracts, organizational development and legislation. In most cases this is limited to the actions that shareholders undertake to motivate managers in order to improve the financial output.

For others, CG is a that mix of laws, regulations and behavioural codes that companies wilfully adopt in order to draw in financial and human capital on the one hand, and to maximize the efficiency of the productive operations on the other hand. Wolfensohn [29] refers to CG as “promoting fairness, transparency and responsibilities within a company”.

From an institutional point of view, the Organization for Economic Cooperation and Development, CG consists in a network of relations between the company management, the managing board, its shareholders and other interest groups within the company. Also it refers to the structure by which company objectives are set as well as the means for achieving these objectives and monitoring performances; the stimuli system granted to the management board and administration in order to increase the objectives that are in the company's and shareholders’ best interest and to facilitate monitoring, thus encouraging companies to use their resources more efficiently.

If we were to characterize CG as a strand of the economy, we would describe it as that branch of the literature which studies and analyzes the ways and means by which companies could increase the efficiency of resource allocation and maximizing the financial results through the use of institutional configurations, such as articles of association, bodies and the legislative frame.

In the traditional view CG is a "complex set of constraints that shape the ex post bargaining over the quasi-rents generated by a firm" [30] or "as every device, institution or mechanism that exercises power over decision making within a firm” [19].

From our point of view, CG represents an assemblage of principles and practices adopted by the Board of Directors which not only ensure the key shareholders that the company is well managed but also establishes the structure of the company where the objectives are clearly determined, the instruments and measures are employed in order to achieve these objectives and the performances are strictly monitored.

According to ECB [9] three main pillars lay at the foundation of CG. Thus, the three important pillars are:

1. Internal CG; this pillar refers to the mechanism that enable shareholders to exercise management control. The mechanism includes: the adequate organisation of the board of directors, effective arrangements for the exercise of shareholders rights, and a well developed internal audit function.
2. External CG; this pillar refers to the controlling function performed by financial markets. From an institutional approach, because primary markets provide direct access to financing they are considered to be part of the checks and balances of CG.
3. Transparency and disclosure; this specific pillar represents the link between the first two pillars. In this regard, adequate accounting standards and an effective framework for external audit are of vital importance.

Another significant aspect we would like to highlight before focusing our attention on financial institutions is the fact that in emerging economies two important models of CG are adopted: the shareholder model and the stakeholder model.

After a thorough examination of the economic literature one can distinguish two important approaches that are, to a certain point, opposite: the “stakeholders approach” and the “shareholders approach”. The “shareholders’ approach” disregards CG activities because the sole purpose of a company is to obtain profit, thus maximizing the wealth for the shareholders. As to the “stakeholders’ approach”, CG initiatives are welcome and encouraged given the fact that not only the shareholders are involved in the activity of the company but also other parties too. In the 1970’, Milton Friedman was an important promoter of the “shareholders’ approach”. In the words of the economist “the responsibility of firms and their management is singularly defined by reference to the need to make choices that maintain and enhance shareholder value within the framework of the law” [12]. Nevertheless, after 1980’ the “stakeholders’ approach” changed
Friedman’s point of view converting him into a sympathizer of this theory. The studies show that some emerging countries (like India or South Korea) tend to adopt the “shareholders’ approach”, despite the fact that this approach is based on mechanisms such as efficient markets and equity financing [24, 28]. Even so, the majority of emerging economies have adopted the “stakeholders approach”, like Croatia, Romania, Bangladesh etc. [27, 10, 26]

La Porta et al. [17] indicated that there is an important link between the model of CG and legal traditions and highlighted that that common-law countries have stronger legal protection of investor rights than civil law counties. The same author [18] proved that the most efficient legal systems in protecting shareholders’ rights is the Anglo-Saxon system of common law as opposite to the Roman system of civil law. In current times the resulting legal systems reflect not only the two traditions mentioned above but also the changes introduced by individual countries over time.

3. Corporate governance for financial institutions

Episodes of financial turbulences that occurred in history like the credit institutions’ crisis in USA at the end of the ’80, the crisis in East Asia at the end of the ’90 and the fall of Enron and WorldCom have shown us the importance of a sound CG and a good risk management. The lessons draw then must not be forgotten.

If we were to highlight some of the bad/poor practices of CG that many financial institutions have embraced in the current financial crisis, these are: misalignment between the interests of different parties involved in creating and selling of over-complex financial products that even the management could not evaluate its risk; the prominent manifestation of human greed; lack of correctly assign remuneration incentives to specific levels of risks (as regard to the business activities); inadequate remuneration structures and huge bonuses that encouraged excessive risk taking and short-termism; the incompetence, negligence or lack of power of risk management departments within financial institutions; lack of accountability not only within the financial organization but also between them and their shareholders.

Incorporating CG in the strategies of financial institutions is of great importance given its wide economic and financial implications. In the current context it became more important from a macroeconomic perspective. Sound CG within financial institutions provides an incentive element in the process of resource allocation, thereby creating the premises for economic growth and financial stability. These positive results reflect on the efficiency of resource allocation and risk management of the entire financial system. Solid CG can reduce the risks of financial imbalances by busting the overall market confidence.

There are many advantages for financial institutions when incorporating CG in their strategies. Among them, we can distinguish: increased efficiency of the institution to attract investments and financial resources; enhanced financial and economic performances and competitiveness on the long run; transparent relations between investors and creditors; decrease the risk of concentration the power on a limited circle of insiders thus avoiding abuse and managerial malpractice; safeguard the financial and human resources of companies, through a monitoring system insuring corporate accountability.

Also from the point of view of a financial institution CG includes in its ambit the manner in which the board of directors governs the business and affairs of individual institutions and their functional relationship with senior management. This is determined by how banks: set corporate objectives (including generating economic returns to owners); run the day-to-day operations of the business and; consider the interests of recognized stakeholders i.e., employees, customers, suppliers, supervisors, governments and the community and align corporate activities and behaviors with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and, of course, protect the interests of depositors, which is above all.

But what is the social function of a financial institution? We found the answer in the works of Argandoña [3, 5], Haig and Hazleton [13], Hogan and Sharpe [15], Merton and Bodie [21]: to provide financial services that facilitates the flow of savings towards investment. A financial intermediary issues liabilities that it places among savers, either directly or through another intermediary, and buys assets (provides credit) from those who plan to make an investment. For example, a commercial bank offers savers a broad range of assets with varying features as regards maturity, liquidity, return etc., so that they may place their wealth in the manner that suits them best, including access to an efficient payment system with low transaction cost. Accordingly, this function contributes to the wellbeing of families and businesses by enabling them to manage their wealth with acceptable liquidity return and risk levels. On the other side of the financial brokerage function, the bank makes available the resources received from savers to those who wish to make investments (credits, loans, securities), with a broad range of features as regards cost, term, collateral.

Thus, we can define three levels of the social function - of the financial system as a whole, of each type of institution and of a specific institution - which in turn define three levels of social responsibility [4]:

1) responsibility shared by all institutions, each one in their respective sphere, and by the regulators and supervisors, each one within their respective function;
2) in the second level, the social function is defined for each type of institution (a commercial bank, for example, cannot ignore the restrictions imposed by law and regulation or the social function of commercial banking: the maturity transformation of assets and liabilities (banks “borrow short and lend long”), the provision of liquidity, the management of debtors’ risk etc.).

3) at the third level of social responsibility each institution defines which services it will render and to whom (what type of deposits it will promote, which loan customers it will seek most aggressively etc.).

In short, the primary social responsibility of a financial institution is to perform its social function. To this must be added, as is logical, the responsibilities that arise from its nature as a business (profitability, self-continuity, social efficiency) and as an organization (care for the interests and needs of its internal stakeholders) and from any social, philanthropic and patronage activities it wishes to engage in.

4. Corporate governance features in the EU-15 financial institutions

In the following part we will present the results of an analysis of some of the CG features of EU financial institutions. The database includes data for a number of 125 financial institutions. Regarding the CG characteristics we analysed the main features of the board (like board size, average board length of tenure or the majority of the gender within the board) and the main characteristics of the CEO (age and average tenure in the bank). In Table 1 the following variables are presented: the total number of financial institutions, the number of institutions included in the sample as well as the results of the study.

<table>
<thead>
<tr>
<th>Country</th>
<th>Overall (no.)</th>
<th>Sample (no.)</th>
<th>Size BD (no.)</th>
<th>BD ALT (years)</th>
<th>Gender (%)</th>
<th>Age CEO (years)</th>
<th>ATFI CEO (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>111</td>
<td>2</td>
<td>15.6</td>
<td>6.4</td>
<td>85</td>
<td>61.5</td>
<td>11.5</td>
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<tr>
<td>Denmark</td>
<td>158</td>
<td>3</td>
<td>14.1</td>
<td>3.3</td>
<td>90</td>
<td>55.9</td>
<td>9.3</td>
</tr>
<tr>
<td>Germany</td>
<td>1,985</td>
<td>38</td>
<td>12.1</td>
<td>5.1</td>
<td>89</td>
<td>52.4</td>
<td>11.2</td>
</tr>
<tr>
<td>Ireland</td>
<td>81</td>
<td>2</td>
<td>22.1</td>
<td>2.8</td>
<td>85</td>
<td>52.1</td>
<td>3.2</td>
</tr>
<tr>
<td>Greece</td>
<td>62</td>
<td>1</td>
<td>13.9</td>
<td>2.6</td>
<td>89</td>
<td>61.3</td>
<td>10.2</td>
</tr>
<tr>
<td>Spain</td>
<td>357</td>
<td>7</td>
<td>14.8</td>
<td>6.8</td>
<td>91</td>
<td>55.3</td>
<td>13.8</td>
</tr>
<tr>
<td>France</td>
<td>768</td>
<td>14</td>
<td>17.9</td>
<td>5.9</td>
<td>82</td>
<td>55.4</td>
<td>6.8</td>
</tr>
<tr>
<td>Italy</td>
<td>806</td>
<td>15</td>
<td>17.5</td>
<td>3.5</td>
<td>95</td>
<td>56.8</td>
<td>10.9</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>156</td>
<td>3</td>
<td>13.7</td>
<td>5.3</td>
<td>96</td>
<td>57.9</td>
<td>8.9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>93</td>
<td>2</td>
<td>10.9</td>
<td>3.7</td>
<td>93</td>
<td>51.6</td>
<td>7.5</td>
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<tr>
<td>Austria</td>
<td>796</td>
<td>15</td>
<td>19.5</td>
<td>6.1</td>
<td>87</td>
<td>61.3</td>
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<tr>
<td>Portugal</td>
<td>178</td>
<td>4</td>
<td>18.1</td>
<td>7.6</td>
<td>91</td>
<td>61.2</td>
<td>18.5</td>
</tr>
<tr>
<td>Finland</td>
<td>358</td>
<td>7</td>
<td>10.8</td>
<td>4.5</td>
<td>81</td>
<td>44.5</td>
<td>8.9</td>
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<tr>
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<td>4</td>
<td>23.2</td>
<td>3.9</td>
<td>78</td>
<td>45.9</td>
<td>10.5</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>396</td>
<td>8</td>
<td>14.9</td>
<td>3.5</td>
<td>87</td>
<td>58.8</td>
<td>1.2</td>
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<tr>
<td>EU-15</td>
<td>6491</td>
<td>125</td>
<td>16</td>
<td>4.8</td>
<td>88</td>
<td>55.5</td>
<td>11</td>
</tr>
</tbody>
</table>

Note: all values refer to the year 2007; t = total, a = average; Source: Eurostat, Bankscope, Authors calculations

As Arnaboldi and Casu [6] also demonstrate, the two most important features extensively studied regarding the Board of Directors are the size and the composition. One of the core objectives of CG initiatives undertaken by international regulators [23, 7] is improving the board structure.

As we can see in Table 1, the average size of the Board of Directors within the EU-15 financial institutions ranges from 13 to 23 members. In the study conducted by Adams and Mehran [1] and Andrés and Valdelado [2] the mean size of a board in the banking sector ranges from 16-18 directors. In the study elaborated by Arnaboldi and Casu [6] the board size is of fifteen members on average. In our sample of EU-15 financial institutions the average is of 16 members. In Ireland and Sweden the Board of Directors exceed 22 members as opposite to Finland and Netherlands where the number of members is bellow 11. In conclusion, there are important differences among European countries as regard to the first feature of CG, meaning the size of Board of Directors (see figure 1).
According to Hermalin and Weisbach [14], the composition of the board is another relevant board feature which, according to Hermalin and Weisbach [14], is crucial to aligning the interest of management and shareholders. The indicator “Gender” reflects the composition of the board and is a percentage computed as the share of male members in the total members of the board. The high values of the indicator that we have obtained on the sample of 125 financial institutions reflect the low diversity of the board, i.e. a male-dominated board (see figure 3).
In the studies conducted by Mateos de Cabo et al. [20] they highlight the fact that women are less likely to be found on smaller boards and where preference for homogeneity is stronger. As our results show, there are important differences in board composition with regards to the gender across the 125 financial institutions. The presents of male-members range from 78% (in Sweden) to 96% (in Luxembourg). Finland is a particular case that can confirm the theory of Mateos de Cabo et al. [20] where a board is relatively small (an average of 11 members) and the presence of women directors is relatively high (an average of 19%), in comparison to the other cases.

One of the main characteristics of the CEO we have analyzed is the average age of the person within the financial institution. At a first glance, on the “age” indicator there aren’t big differences across financial institutions in different EU-15 countries (see figure 4). The difference between the biggest average value of the indicator (for the CEO in financial institutions in Belgium – sixty-one and a half years) and smallest one (for the CEO in financial institutions in Finland – forty-four and a half years) is of just seventeen years. Let’s not forget that Finland registered also the smallest value of the average size of the Board of Directors. This could reflect itself on the quality of the financial institutions’ CG.
Another important feature of the CEO is the average tenure in the financial institution (ATFI). Our results show an average on the EU-15 financial institutions of eleven years thus reflecting an experienced CEO at the head of the institutions. A bigger value of the indicator not only represents experience but also provides proxies for reputation and power within the institution. United Kingdom however registers a very low number but this could also mean opportunities given to young graduates and the need for “fresh minds”.

5. Conclusions and final remarks

Solid corporate governance (CG) of the financial institutions is of a vital concern not only to the institutions themselves but also for the entire financial system. After four years of financial turbulences, the issue of CG is more important than never especially for financial institutions who take on a significant role in the process of financial intermediation as they are considered to be important players in the financial system, especially in the Euro Area.

Given their specific features that differentiate them from the industrial companies, financial institutions are subject to stringent prudential regulation of their capital and risk which are reflected in the CG practices observed in the financial sector. The concept studied in this paper has gained an increasingly high profile in recent years. Having researched the origins, current status and trends of the CG concept, we can conclude that, despite being out of focus for some time after the beginning of the financial turbulences in 2007, CG has started to resurface (with the OECD taking a leading role) and now it is considered as an important asset in the balance sheet of the major financial institutions.

To exemplify some of the features of CG and how they differ across financial institutions we analyzed a sample data for 125 representative financial institutions in EU-15 in 2007. Our analysis on the five indicators of CG (board size, average board length of tenure, the majority of the gender within the board, age of CEO’s, average tenure in the bank of CEO’s) show very clearly that although EU efforts are being made in the direction of financial integration, major discrepancies still exist across countries. Nevertheless, we think of this pilot research as an ongoing study and also consider it as a launching platform for a more comprehensive investigation in the field of CG in financial institutions.

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