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Corporate Governance of Banks

Is More Board Independence the Solution?

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1. Introduction

The global financial crisis has intensified the reflection on the corporate governance of banks both in the context of academic discussions and in the context of policymaking.[1] While a multitude of factors contributed to the crisis, some studies suggest that weaknesses of corporate governance may be largely responsible for the excessive risk-taking by bankers, the systemic fragility of banks, and the financial instability stemming from it. For example, in a report published in 2009, the OECD emphasized that failures and weaknesses in the corporate governance of some financial institutions can be regarded to an important extent as a major cause of the financial crisis.[2] Remuneration policies and practices adopted by some banks are considered as an example of the corporate governance failures that contributed to the crisis. For example, Professor Bebchuk et al., in their case study on the executive compensation at Bear Stearns and Lehman Brothers during the period of 2000-2008, observe that executives of these failing banks made substantial personal gains out of their performance pay and also that their pay incentives may have encouraged excessive risk-taking.[3] Therefore, along with other initiatives aimed at regulating bankers' compensation, a more stringent regime regarding the establishment of compensation committees and their independence was included in the package of financial reforms meant as a response to the crisis.[4]

Policymakers on both sides of the Atlantic recognized the inevitability of financial reforms as well as the need to reconsider the adequacy of the existing corporate governance framework.[5] In the European Union (the EU), the European Commission concluded that the

> non-binding nature of a substantial part of the corporate governance framework, based essentially on voluntary codes of conduct, did not facilitate the effective implementation of sound corporate governance practices by institutions.[6]

This resulted, *inter alia*, in ineffective oversight of managerial decision-making that was driven by short-termism and overly risky strategies. Remarkably, re-regulation of corporate governance takes priority in the regulators' agenda in a broad context of issues considered relevant for restoring trust in the banking sector. For

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1. We use the notions of "the global financial crisis", "the financial crisis" or simply "the crisis" interchangeably to denote the sequence of adverse financial events that occurred after the collapse of financial markets in Autumn 2008. For a synthetic overview of global efforts towards financial reform since the start of the financial crisis, see Véron 2012. For a summary of research providing explanation on how failures in corporate governance contributed to the crisis, see Tarraf, available at: <http://ssrn.com/abstract=1731044> accessed 16 February 2013.
2. See Kirkpatrick 2009, available at: <www.oecd.org/dataoecd/32/1/42229620.pdf> accessed 16 February 2013.
3. See Bebchuk *et al.* 2010.
4. We use the terms "compensation committees" and "remuneration committees" interchangeably. We follow the application of the term "remuneration committee" in the EU as used by the European Commission, 2010, p. 669. Available at: <www.europa-nu.nl/id/vifzf0za3mzm/commission_staff_working_document> accessed 16 February 2013.
   The terms "board" and "management body" are used interchangeably and consistently with the terminology by the European Commission in the following document of the European Commission: *Staff Working Document. Corporate Governance in Financial Institutions: Lessons to be Drawn from the Current Financial Crisis, Best Practices. Accompanying Document to the Green Paper Corporate Governance in Financial Institutions and Remuneration Policies.* SEC (2010) 669, p. 7. Available at: <www.europa-nu.nl/id/vifzf0za3mzm/commission_staff_working_document> accessed 16 February 2013. The term "board" is used to envisage the oversight function of the unitary board system (one tier board). In respect to the dual board system (two tier boards), the term "board" is used to address a supervisory board. In order to address executive management, we make a clear specification. The term "executive board members", *i.e.* "executive directors", denotes executive members of the unitary board as well as members of a management board in the dual board structure. By referring to "non-executive board members", *i.e.* "non-executive directors", we mean non-executive, independent members of a unitary board as well as members of a supervisory board in the dual structure.
5. In response to the crisis, the European Commission announced in 2009 a programme for reforming the regulatory and supervisory framework for financial markets. This programme advocated critical reflection on corporate governance within financial institutions. European Commission, *Communication for the Spring European Council. Driving European Recovery,* COM (2009) 114 final. In the United States, *"The Obama Plan"* was introduced and provided the foundation for a financial regulatory reform. The US Department of the Treasury, *Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation,* 2009.
6. COM (2011) 453 final, Recital 43, p. 20.

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example, issues regarding bank capital, leverage, liquidity, and protection of consumers of financial services were put simultaneously on the reforming agenda.[7] More delicate problems, which are arguably more important for financial stability, have not been addressed with the same speed. These include the crisis management and resolution of banks; the coordination of cross-border supervision; and, particularly in the EU, the realization of a Banking Union.[8] Despite some doubts as to what extent corporate governance should be really considered a cause of the financial crisis, regulators significantly address corporate governance issues in the post-crisis financial reforms being engineered on both sides of the Atlantic.

This article focuses on one of these corporate governance reforms: the enhancement of the independence standards for compensation committees. The presence of independent directors in the compensation committees of listed companies was already a common practice prior to the crisis. The New York Stock Exchange (NYSE) and the NASDAQ altered their listing rules in response to the post-Enron corporate governance reforms. Consequently, these self-regulatory authorities required that boards of domestic US listed companies consist of a majority of independent directors and that entirely independent audit, nominating and compensation committees be established.[9] In the EU, prior to the crisis, independent remuneration committees were part of non-binding recommendations contained in the corporate governance codes and in the European Commission's Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board.[10] In the aftermath of the financial crisis, the matter of executive remuneration and remuneration committee has been explicitly addressed by mandatory regulation, particularly – but not exclusively – in the context of banking.

The choice of the focus of this article stems from the circumstance that all regulatory initiatives concerning the corporate governance of banks revolve around the problem of managerial remuneration. As we are going to show, regulating the remuneration of bank management makes economic sense. However, entrusting such remuneration decisions to a board committee is not going to help so long as shareholders ultimately appoint the members of the committee. This shareholder-centric approach to the post-crisis regulation of the corporate governance characterizes a broad range of financial reform initiatives on both sides of the Atlantic.[11] We, therefore, regard the emphasis placed by regulators on the (supposed) independence of the remuneration committee as an example of misguided regulation of the corporate governance of banks.

In this context, the reforming acts of our interest are the most recent proposal to overhaul the EU Capital Requirements Directive (CRD IV)[12] and the US Dodd-Frank Act[13] as implemented by the delegated authority of the Securities and Exchange Commission (SEC).[14] Both legislations refer, among other things, to corporate governance arrangements that should be improved by

7. See Véron 2012.
8. In 2012, the European Commission presented its view that the European banking union should be set up. The following documents have been published: European Commission, *Communication to the European Parliament and the Council, A Roadmap Towards a Banking Union,* Brussels, 2012, COM (2012) 510 final. This document outlines the Commission's vision for the banking union and covers the single rulebook, single supervisory mechanism and steps regarding single resolution mechanism. Subsequently, the European Council published its proposal for a regulation that is to confer specific tasks on the European Central Bank in respect to policies regarding prudential supervision of credit institutions. Council of the European Union, *Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions,* Brussels 2012, EF 316, ECOFIN 1080. Available at: <www.europa-nu.nl/id/vj5i5cpxbyyn/proposal_for_a_council_regulation> accessed 16 February 2013. In the same time, the Council published a proposal for aligning the existing regulation on the European Banking Authority (EBA) with the novel set-up of banking supervision. The objective of the proposed legislation is to ensure that the EBA's decision making remains balanced and that this institution will preserve the integrity of the Single Market. Council of the European Union, *Proposal for a Regulation of the European Parliament and the Council Amending Regulation (EU) No. 1093/2010 Establishing a European Supervisory Authority (European Banking Authority) as Regards its Interaction with Council Regulation (EU) No…/… Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions,* EF 317, ECOFIN 1081, CODEC 3057. For more information, see the European Systemic Risk Board (ESRB), *Report of the Advisory Scientific Committee*, 2012. Available at: <www.esrb.europa.eu/pub/pdf/asc/Reports_ASC-1210.pdf?> accessed 16 February 2013.
9. Becht *et al.* 2012.
10. 2005/162/EC, OJ L 52. For a list of corporate governance codes in the Member States of the EU, see the website of the European Corporate Governance Institute. Available at: <www.ecgi.org/codes/all_codes.php> accessed 16 February 2013.
11. Another example of the post-crisis shareholder-oriented reforms is the "say on pay" provision contained in Section 951 of the *Wall Street Reform and Consumer Protection Act of 2010*. According to this section, listed companies are obliged to consider shareholders' advisory vote in regard to particular executive remuneration arrangements. This should occur with the frequency of at least every three years. A similar shareholder-centric trend of reforms can be recognized in the EU See, for example, European Commission, *Communication. Action Plan: European Company Law and Corporate Governance – A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies*, COM (2012) 740 final. This Action Plan calls for, among other things, the oversight of remuneration policies by shareholders.
12. COM (2011) 453 final. The Capital Requirements Directive (CRD IV) forms a package (CRD IV Package) together with the Capital Requirements Regulation (CRR).
13. The Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
14. Section 952 of the Dodd-Frank Act, amending the Securities and Exchange Act of 1934 by inserting Section 10C regarding compensation committees, mandates the Securities and Exchange Commission (SEC) to adopt rules prohibiting national securities exchanges and national securities associations from listing any issuer that does not comply with specified requirements regarding the independence of the compensation committee members and their advisers. Consequently, the SEC adopted the final version of Rule 10C-1 under the Securities Exchange Act of 1934 on 20 June 2012. SEC Release No. 33-9330. In compliance with this rule, NASDAQ and NYSE filed with the SEC their proposed changes modifying their listing rules relating to the independence of compensation committees. SEC Release No. 68013, 77 FR 62563 for NASDAQ's rule change. SEC Release No. 68011, 77 FR 62541 for NYSE's rule change. After a public consultation, these proposals were amended and approved by the SEC in January 2013. SEC Release No. 34-68640, File No. SR-NASDAQ-2012-109 for NASDAQ. SEC Release No. 34-68639, File No. SR-NYSE-2012-49 for NYSE.

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regulations in order to prevent, or at least contain, future financial crises.[15] However, it is worth noting that while the corporate governance provisions of the Dodd-Frank Act apply to all listed companies, banks and non-banks, the EU proposed legislation concerns banks specifically. In this respect, the European Commission argues in the Preamble to the CRD IV Proposal that, among other things,

> Weaknesses in corporate governance in a number of institutions have contributed to excessive and imprudent risk-taking in the banking sector which led to the failure of individual institutions and systemic problems in the Member States and globally.[16]

Therefore, the goal to limit excessive risk-taking in the banking sector is at the heart of the post-crisis financial reforms. In this regard, Professor Tung observed the following: "constraining bank risk-taking is an unending task for bank regulators, even outside the crisis context."[17]

The role of corporate governance and particularly of incentive compensation arrangements in determining excessive risk-taking by banks and comparable financial institutions is controversial.[18] According to a widespread belief, the global financial crisis revealed that compensation policies and the structure of pay packages might influence the level of risk-taking in financial institutions, particularly in banks. For example, next to the commonly recognized problem of pay arrangements enabling executives to realize short-term gains from stock options and cash bonuses, Professors Bebchuk and Spamann identify other features of executive compensation arrangements that encourage bank executives to engage in excessive risk-taking.[19] According to Bebchuk and Spamann, the problem is that the very structure of the bankers' pay provides them with an incentive to place highly levered bets on the value of banks' assets. Similarly, in another paper with Alma Cohen, the authors show how the remuneration practices in Lehman and Bears Stearns were flawed, at least in retrospect.[20] However, another study by Professors Fahlenbach and Stulz shows somewhat different results.[21] They examined how the performance of US banks in the period 2007-2008 related to the CEO's incentives to take risks. On the one hand, they found that banks where the CEO had stronger incentives to take risk did not perform worse than the other banks. On the other hand, they found that although the managers of failing banks cashed in substantial performance pay, they reinvested in equity most of the proceeds thereby choosing to tie their destiny to that of the banks they were running.

The potential problem with the incentives for bank management to take excessive risk makes the regulatory concern with managerial remuneration in the banking sector fully legitimate.[22] One way to deal with this concern is to enhance the independence of compensation committees in the boards of banks. The rationale behind mandating stringent independence standards for remuneration committees is that their tasks, similarly to those of the audit and the nomination committees, are located in areas where conflicts of interest are likely to arise.[23] The independence of directors involved in the pay-setting process is meant to prevent such conflicts. There are concerns expressed as to the extend remuneration committees may be beneficial for listed companies in general. For example, Professor Bainbridge has pointed out that "[…] most empirical studies have rejected the hypothesis that compensation committees' independence is positively correlated with firm performance or with improved CEO compensation practices."[24] Whether the institution of a standing remuneration committee independent from the management is likely to reduce risk-taking in banks remains an open question, which this article seeks to answer.

The remainder of the article is structured as follows. Section 2 portrays the different positions in the debate on the relevance of corporate governance of banks for the occurrence and severity of the global financial crisis. In there, arguments for banking regulation are presented along with the economic case for intervening in the corporate governance of banks. Section 3 illustrates a selection of the literature regarding the role of boards in corporate governance, paying particular attention to the relationship between board independence and bank failures. Section 4 provides a comparative analysis of the EU and the US reforms concerning the independence of remuneration committees in banks. Section 5 discusses these reforms critically, in light of the economic analysis of the determinants of financial instability. The economic analysis suggests that it is doubtful whether more stringent requirements of independence for the compensation committees can contribute to preventing bank failures through better remuneration policies and practices. High standards of independence of standing compensation committees may lead, in the case of banks, to better risk management only in the presence of a radically novel approach to the corporate governance of banks. This approach should rely, rather than on the shareholders, on the creditors who are credibly committed not to benefit from bailout. Section 6 briefly concludes along these lines.

15. It should be noted that in respect to the US post-crisis reforms preceding the enactment of the Dodd-Frank Act, the requirement of independency of compensation committees in publicly traded companies has been addressed in the Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. § 3.
16. COM (2011) 453 final, Recital 4, p. 20.
17. Tung 2010.
18. Becht, Bolton & Röell 2012.
19. Bebchuk & Spamann 2010.
20. Bebchuk *et al.* 2010.
21. Fahlenbach & Stulz 2011.
22. In the context of pay arrangements, Bebchuk, Cohen & Spamann 2010 explain the legitimacy of legislators' and regulators' concerns regarding incentives for risk-taking in banks.
23. See Gordon 2007.
24. Bainbridge 2010a. Available at: <http://ssrn.com/abstract=1698898> last accessed 16 February 2013. The author refers in particular to the contribution by Anabtawi 2005.

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2. Financial Instability and Corporate Governance of Banks

As various analyses of the global financial crises reveal, the severity, breadth and length of the turmoil uniquely resulted from the interaction of a complex set of factors including, *inter alia*, adverse macro-economic conditions, regulatory and supervisory failures, inefficiencies and risk-assessment methodologies, and mismanagement by financial institutions.[25] Views differ as regards the weight to be assigned to particular causes in terms of their impact on the crisis.[26] Particularly, the relevance of the corporate governance of banks in the unfolding of the crisis is subject of academic debate.[27] Here, we summarize some of the arguments raised in this debate.

Some authors emphasize the magnitude of corporate governance inefficiencies in the unfolding of the crisis and assign other factors only a contributory role.[28] As Professor Tarraf observes, the OECD endorsed this line of reasoning. In this report released in 2009, Kirkpatrick argues that flawed corporate governance practices failed to safeguard against excessive risk-taking.[29] An analogous position in this debate was taken in the US by the advocates of the Shareholder Bill of Rights Act of 2009.[30]

There is evidence of flawed corporate governance practices adopted at some financial institutions that failed in relation to the crisis. The analysis presented by Professor Yeoh reveals that, in case of Bears Stearns and Lehman Brothers, weak corporate governance practices were in place.[31]

In contrast, a number of scholars, both in law and in economics, cast doubts as to whether the financial crisis was really attributable to corporate governance failures in banks. For example, Professor Mülbert argues that the examples of flawed corporate governance arrangements so far discussed in academia, as well as the existing empirical evidence in this area, are not really supporting the corporate governance failure hypothesis.[32] Likewise, the findings by Professor Adams on the corporate governance practices of banks in the US add to the scepticism about the role of bank governance in financial crises. The author documents that the governance of financial firms is, on average, "not obviously worse than in nonfinancial firms."[33] More in general, as illustrated in a recent overview,[34] the economic literature struggles with the question whether the corporate governance of banks matters for financial instability. On the one hand, the mainstream approach to corporate governance, based on the norm of shareholder value maximization, tends to suggest that the impact of the corporate governance on banks' instability may be marginal compared with the failure of regulation to discipline shareholders. On the other hand, because banks are different from non-financial firms, particularly for the policy purpose, the governance of banks might have to be influenced by considerations other than the shareholders' profits.

As the foregoing discussion shows, the case for regulating the corporate governance arrangements of banks is far from straightforward. This is different from the approach of policymakers who take the need of regulatory intervention for granted. There are, however, reasons for approaching corporate governance of banks from an angle different than the standard perspectives on non-bank corporations.[35] These reasons relate to the special features of banks. It is worth noting that these special features constitute the foundation for banking regulation in general.[36] Because banks perform special economic functions in the economic system, and because they are conducive to serious externalities, banks need to be regulated. However, banking regulation is imperfect and this imperfection provides the rationale for the law to intervene with the corporate governance of banks as well.[37]

The subject of the speciality of banks has been discussed extensively as far as both banking regulation and corporate governance are concerned.[38] Below, we outline the major points of this debate.

First, banks are distinguished from other firms due to their liquidity-generation function, which is essential for financing the economy. Banks engage in the production of liquidity based on a mismatch in the term structure of banks' assets and liabilities.[39] In other words, banks manage to lend money in a long-term perspective (*e.g.*, mortgages; commercial loans) in so far as they get short-term liabilities (*e.g.*, demand deposit; interbank credit) accepted in the marketplace. This process, known as maturity transformation, consists in issuing liquid liabilities against the illiquid financial assets held by banks.[40] While essential for the funding of a capitalist economy,

25. See, *e.g.*, The High-Level Group on Financial Supervision in the EU, *Report*, Brussels, 2009; Turner 2009. Available at: <www.fsa.gov.uk/pubs/other/turner_review.pdf> accessed 16 February 2013.
26. Tarraf 2010.
27. For a commonly accepted definition of corporate governance, see OECD: *OECD Principles of Corporate Governance*, OECD, Paris, 2004, p. 1. Available at: <www.oecd.org/dataoecd/32/18/31557724.pdf> accessed 16 February 2013. For the discussion of the term "corporate governance" in the context of banks, see Mülbert 2009, Mülbert 2010, p. 151.
28. *E.g.*, Yeoh 2010. The author examines the following perspectives as regards the crisis: macroeconomic; accounting and finance; legal and governance and he supports the view that the financial turmoil is mostly attributable to flawed governance practices; Tarraf 2011.
29. Kirkpatrick 2009.
30. Shareholder Bill of Rights Act of 2009, S. Res. 1074, 111th Cong., 2009.
31. Yeoh 2010, p. 55 *et seq*.
32. Mülbert 2010.
33. Adams 2012.
34. Becht *et al.* 2012.
35. *E.g.*, Becht *et al.* 2012.
36. *E.g.*, Macey & O'Hara 2003; Ferrarini & Ungureanu 2011.
37. *E.g.*, Mülbert 2010, p. 3.
38. *E.g.*, Macey & O'Hara 2003, pp. 97-99; Ferrarini & Ungureanu 2011, p. 439; Mülbert 2010, p. 10 *et seq*.; Becht, Bolton & Röel 2012, p. 437 *et seq*.
39. *E.g.*, Mülbert 2010, p.10; Macey & O'Hara 2003, p. 97.
40. See Diamond & Dybvig 1983.

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this operation is the very source of the banking system's fragility.

Second, banks' leverage is significantly higher than the leverage of generic firms.[41] In a sense, this is obvious because money is the key factor of production in banking. A bank lends money that it does not own. This leads to a balance sheet typically characterized by some 90% of debt as opposed to a figure of roughly 40% in non-financial firm. The prevalence of debt in the funding structure of a bank exacerbates the conflict of interest between banks' debt-holders and shareholders.[42] This circumstance suggests that debt-holders may have to play a more fundamental role in the governance of banks than in non-bank enterprises. However, this does not automatically imply that the governance of banks should be regulated for that (or any other) purpose. The rationale for regulatory intervention in banking is actually another one. It has to do with the necessity to protect banks from their own fragility.

The third and perhaps the key difference of banks from other companies is the so-called "safety net" that the former – but typically not the latter – have access to. The fact that banking operates via issuing short-term liabilities creates a fragility that cannot be effectively dealt with by private ordering.[43] This fragility is known as bank run – that is, the sudden and synchronized withdrawal from deposits at a bank. In order to cope with this problem, most governments in the world have established deposit insurance. Deposit insurance is illustrative of a broader set of safety net measures aimed at preventing banking failure, notably including the lender-of-last-resort function of the central bank and the implicit commitment by the government to bailing out systemically important financial institutions.

While deposit insurance and safety net measures in general may prevent self-fulfilling panics by depositors, they create moral hazard because they encourage shareholders and managers of insured banks to embark on risk-taking activities in excess to what would be optimal for the other stakeholders. The latter notably include the state and its taxpayer, who are ultimately responsible for guaranteeing the funding of a safety net. Professors Macey and O'Hara refer to moral hazard in banking as the "regulatory cost" of deposit insurance. They observe that this phenomenon can aggravate in situations when banks approach insolvency.[44] In addition to encouraging risk-taking, deposit insurance increases the risk of fraud because it eliminates the incentive to monitor on the side of insured depositors.[45] Deposit insurance is designed to prevent banking panics. However, the threat of bank runs would be an important disciplining device for bank management.[46] The absence of such a market discipline is the fundamental reason why banking is regulated.

41. *E.g.*, Mülbert 2010.
42. Macey & O'Hara 2003, p. 98.
43. Diamond & Dybvig 1983.
44. Macey & O'Hara 2003, p. 97.
45. *Ibid.*, p. 98.
46. Calomiris & Kahn 1991.

Another important reason why the discipline of banks cannot fully rely on outside stakeholders (including debt-holders but also the government, represented by the supervisory authority) is that information asymmetries make it difficult for outsiders to assess the risk profile and the stability of banks.[47] As Professor Mülbert noted, "the quality of bank loans is not readily observable".[48] He contends that this opaque feature of banks' balance sheets was, to a large extent, the fundamental cause of the financial turbulence of the autumn of 2008 – when the global financial crisis reached its peak. As argued by Professor Sinn, the opacity of banks' operations results in the emergence of a "market for lemon" in banking: banks issue securities backed by sophisticated portfolios of which the factual risk is difficult to assess and may be higher than optimal.[49] The crisis revealed that even professional market participants, like private rating agencies armed with highly sophisticated valuation techniques, could not effectively overcome these information asymmetries.[50]

In essence, the fundamental reason why banks are special is that banking is dramatically exposed to panics. The question concerning the origin of banking panics is difficult to answer.[51] One approach to banking panics is based on the concept of asymmetric information.[52] This theory attempts to explain banking panics as phenomena caused by changes in the depositors' perception of the riskiness of bank debt whenever depositors are uninformed about the value of the bank's portfolio of assets and suddenly they face adverse information regarding the quality of this portfolio.[53] According to this theory, depositors will tend to withdraw from bank accounts as much of their savings as possible if they have reasons to expect the bank's solvency to be at risk.[54] This problem has the same logic underlying the establishment of deposit insurance, namely the risk of bank runs. The global financial crisis has revealed that the problem of bank runs is broader than demand deposits; it applies to virtually *any* of the short-term liabilities of banks. As Schooner and Taylor put it, banks

> create the illusion that anyone may have instant access to his or her deposit even while most people's

47. Ferrarini & Ungureanu 2011, p. 441.
48. Mülbert 2010, p.11.
49. Sinn 2004; Sinn 2009. The term "lemons" relates to the phenomenon of adverse selection and it was introduced in this context by George Akerlof in 1970. The concept of adverse selection is used in economics to describe a situation when market participants, *i.e.* buyers and sellers, do not have equal access to information regarding the quality of the object of their transaction. This asymmetry in information can result in what Akerlof called a "market for lemons" where the value of the goods being traded is low regardless of the effective quality of the goods. Akerlof 1970.
50. See Sinn 2008, p. 25.
51. Calomiris & Gorton 1991, pp. 109-174, p. 110. Available at: <www.nber.org/chapters/c11484> accessed 16 February 2013.
52. See, for example, Calomiris & Gorton 1991, p. 111; see *also* Diamond & Dybvig 1983.
53. Calomiris & Gorton 1991, p. 111.
54. *Ibid.*, p. 111.

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deposits have been lent out to customers who will not pay them back for months or years.[55]

Faced with the risk of widespread bank runs, governments have no choice but to intervene and back up the banks' short-term liabilities. This is effectively a bailout. Bailouts exacerbate moral hazard in banking, which is already a consequence of deposit insurance. The question then becomes twofold. First, why banking regulation and supervision is not sufficient to stop risk-taking by banks before it is too late. Second, whether bailout is really unavoidable in order to prevent financial meltdown. As it turns out, seeking to answer these questions sheds some light on why the corporate governance of banks may matter for financial stability.

The problem with banks is that they do not operate in isolation from each other. Because their business consists in intermediating money, individual banks need to rely on other financial institutions in order to meet their permanent obligations to deliver cash on demand. In other words, banks as "merchants of debt" are naturally interconnected.[56] However, it would be illusory to expect banks to closely monitor the quality of each other's portfolio of loans as a precondition for interbank lending. Banks stop lending to one another only when there is fear that insolvency is approaching. In the presence of events simultaneously affecting a multitude of banks, the natural interconnectedness between them results in a widespread counterparty risk and makes the whole banking system prone to contagion.[57] Ideally, the banking supervisory authorities should monitor this situation and prevent banks taking risks that, by increasing the probability of insolvency, would generate negative externalities on the whole system. However, banks can take risks very quickly without having to inform their creditors and supervisors; and when adverse events materialize, it is difficult to distinguish between illiquidity – which should receive temporary support – and insolvency – which should be resolved quickly and inflexibly.[58]

While counterparties unable to distinguish between illiquidity and insolvency would withdraw from lending anyhow, supervisory authorities facing the same uncertainty are inclined to support banks in trouble in order to avoid financial panic. This problem is particularly severe in the case of large banks. The latter are regarded as systemic institutions because their failure can trigger large-scale contagion and thus externalities. The externalities of banking are not only confined to the financial system, but they also stem from the close ties of credit with the real economy: if a large bank becomes illiquid, the other banks may refrain from lending altogether in order to avoid illiquidity in their turn.[59] The expression of "too-big-to-fail" describes precisely a bank's systemic character recognizing that failures of one large financial institution may disrupt the whole financial sector and, via the above-mentioned connection with the real economy, bring an entire capitalistic economy to a halt.[60] This is the reason why bailout of systemically relevant financial institutions is ultimately unavoidable.[61]

What is the consequence of this for corporate governance? If banking regulation could replace the market discipline by debt-holders leaving no scope for moral hazard, it would be difficult to argue that corporate governance matters for financial stability. Faced with regulatory constraints comparable to debt discipline in the market place, shareholders would be incentivized to choose the efficient way to monitor the management behaviour, including setting an incentive-compatible remuneration structure. However, because banking regulation is imperfect and creates significant scope for moral hazard,[62] there is a case for intervening in the corporate governance of banks too, in order to police the incentives of bank managers to take excessive risks. But at this point, the perspective should change radically. Shareholders should no longer be in the driver's seat regarding the monitoring of management because the commitment to bail out systematically relevant institution is an implicit subsidy to shareholders. This subsidy corresponds to the lower cost of funding enjoyed by banks for all their explicitly and implicitly insured liabilities. Both shareholders and bankers profit from it: the former via higher profits whereas the latter via higher

55. Schooner & Taylor 2010.
56. Minsky 1986.
57. See Mülbert 2010, p. 11.
58. Bagehot 1873.
59. The term "too big to fail", as used in the context of financial institutions, refers to the reasoning that some financial institutions can grow that much in their size and they can become so interconnected that their failure may be unacceptable for consequences on the entire real economy. The "too big to fail" approach regards a failure of such large and interconnected financial institutions as undesirable and therefore the governmental intervention in the form of a bailout is perceived as a legitimate action. For a brief analysis of the origins and the history of the use of this term, see the article by A. Faber, "Historical Echoes: "Too Big to Fail" Is One Big Phrase", published on the website of the Federal Reserve Bank of New York on 5 October 2012. Available at: <http://libertystreeteconomics.newyorkfed.org/2012/10/historical-echoes-too-big-to-fail-is-one-big-phrase.html> accessed 16 February 2013.
60. See Stern & Feldman 2004.
61. Financial risk is regarded as systemic if, in case the risk materializes, the real economy will be affected adversely in a significant way. For an explanation of the concepts of "systemic risk" and "financial system", see, e.g., G.J. Schinasi: "Safeguarding Financial Stability: Theory and Practice", Washington, D.C., International Monetary Fund 2005, p. 81. In clarifying the concept of systemic risk, the author refers to the definition contained in the report of the Group of Ten. Group of Ten: "Consolidation in the Financial Sector", Bank for International Settlements, Basel, 2001. In regard to banks, the systemic nature of risk in banking sector becomes manifest when many banks fail simultaneously or when a single bank's failure triggers the collapse of many other banks. See Acharya 2009. In this respect, regulatory concerns regarding systemic risk are legitimate when social and economic costs of failures of systemic institutions (particularly banks) are higher than private costs and when, as Llewellyn puts it "such potential social costs are not incorporated in the decision making of the firm". Llewellyn 1999, p. 13.
62. For the argument that this imperfection is unavoidable in the presence of uncertainty, see A. Pacces, "Illiquidity and Financial Crisis", forthcoming *University of Pittsburgh Law Review*. Available at SSRN: <http://ssrn.com/abstract=2202722> accessed 16 February 2013.

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performance-based remuneration. While it is true that the variable remuneration of bankers induces them to take more risk than socially optimal, shareholders do not have the incentives to stop this behaviour.

3. Boards of Banks and Their Independence

If – in the absence of an effective market discipline – shareholders are not in the best position to prevent bank management from excessive risk-taking, perhaps boards are. The duties and functions of boards are defined in various ways across time and depending on the context.[63] To summarize, boards are in charge of strategic direction, operational and financial policies, and the appointment and monitoring of the senior executive management.[64] In this regard, Professors Johnson, Daily and Ellstrand observe that the extensive research concerned with the different roles of the board mirrors the predominance of the boards' monitoring role. One crucial aspect in this literature is the directors' independence from the CEO. This is a precondition for the board to carry its monitoring role effectively.[65] Moreover, in banking, boards have a special responsibility to ensure the soundness of a bank.[66] Thus, in the context of banks, the role of boards is especially important due to the above-mentioned specificities of the banking business characterized by significant externalities on the society at large.[67]

It could seem that enhancing board independence would improve the corporate governance of banks, particularly in respect to the bankers' attitude to engage in excessive risk-taking. As Minton, Taillard and Williamson put it, "If independent directors are also acting in the interest of regulators and depositors, board independence could be associated with less risk-taking."[68] However, in their study of the relation between independence and expertise of bank boards and risk-taking, the authors found that financial expertise among independent directors of commercial banks was positively associated with levels of risk-taking.[69] Such findings suggest that the independence of bank boards may be insufficient to police excessive risk-taking in banking, and it may even be counterproductive if independent directors are also financial experts.

The regulatory aim to strengthen boards by enhancing their independence emerged in the aftermath of Enron and similar scandals at the turn of the century.[70] The reforms put pressure on listed companies to increase the presence of independent directors on their boards.[71] The norm of directors' independence was applied to listed companies across the board. For example, the main US exchanges – NYSE and NASDAQ – required US listed companies to appoint a majority of independent directors on the board and to have audit, nomination and compensation committees made entirely of independent directors.[72] In Europe, similar requirements were established by self-regulatory corporate governance codes[73] and by the Commission Recommendation on the Role of Non-Executive or Supervisory Directors and on the Committees of the (Supervisory) Board.[74] Most EU Member States based their codes on the "comply or explain" principle.[75] This principle means that compliance with the code is not mandatory provided that an explanation is given in case of non-compliance. Basically, in this context, there is no legal obligation for listed companies to have independent directors on their board. However, there is an obligation to disclose the deviation from the norm of the code and the reasons for doing so.[76] Whilst the concept of director independence is similar in many codes, the definitions of independence vary, sometimes even considerably.[77]

The data show that most of the US banks complied with the independence requirements set by legislation and/or the exchanges in the aftermath of the Enron scandal, whereas the average bank board outside the US did not.[78] Most strikingly, however, it seems that having more independent boards did not help banks through the financial crisis. Particularly, the US banks that had a higher proportion of independent directors and scored more highly on the general degree of "shareholder-friendliness" of their governance revealed a higher propensity to fail during the financial crisis.[79] The weakness of European banks appears instead to be more influenced by the incompetence of banks' directors.[80] As

63. For a summary of views on boards' duties and roles, see Van Zijl, 2012, p. 42.
64. See Mace, 1979, p. 6 *et seq*.
65. Johnson *et al.* 1996, pp. 409-438, p. 411. The authors identify additionally the following themes: control of proxy mechanism, directors' fiduciary duty, implications from the increase in institutional stockholdings.
66. Van Greuning & Brajovic-Bratanovic 2000, p. 5.
67. Andres & Vallelado 2008.
68. Minton *et al.* 2011. The authors refer here to results presented by Pathan who finds that board size and independence are negatively associated with the entire and the idiosyncratic firm risk for their sample of US bank holding companies examined in the timeframe of 1997-2004. Pathan 2009.
69. Minton, Taillard & Williamson 2011.
70. *E.g.*, Hertig 2005.
71. *Ibid.*, p. 272.
72. *E.g.*, Becht, Bolton & Röell 2012, p. 449.
73. For a list of corporate governance codes in the Member States of the EU, see the website of the European Corporate Governance Institute. Available at: <www.ecgi.org/codes/all_codes.php> accessed 16 February 2013.
74. European Commission, *Recommendation on the Role of Non-Executive or Supervisory Directors of Listed Companies and on the Committees of the (Supervisory) Board*, Brussels 2005. 2005/162/EC, O.J. L 52/51.
75. Weil, Gotshal & Manges LLP 2002. Available at: <www.ecgi.org/codes/documents/comparative_study_eu_i_to_v_en.pdf> accessed 16 February 2013.
76. MacNeil & Li 2006, pp. 486-496, at p. 486.
77. *Ibid.*, p. 55.
78. Ferreira *et al.* 2012 Available at: <http://ssrn.com/abstract=1620551> accessed 16 February 2013.
79. Beltratti & Stulz 2010. Available at: <http://siteresources.worldbank.org/INTFR/Resources/Rene_Stulz_December_7_2010.pdf> accessed 16 February 2013.
80. Hau & Thum 2009.

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mentioned earlier, another study shows that more competent and more independent bank directors were associated to higher levels of risk-taking.[81] The circumstance that the empirical evidence is mixed and sometimes even contradictory should not be particularly surprising. All of the empirical analyses of these issues suffer from problems of identification and reverse causality. It is virtually impossible to determine whether riskier banks choose more independent or competent/incompetent boards or vice versa;[82] and the answer may vary with the institutional environment, which differs from country to country and particularly between the US and continental Europe.[83]

Therefore, the answer to the question whether boards of banks can reduce risk-taking needs to be derived from theory. There exist some theoretical perspectives on boards of directors. For example, Zahra and Pearce identify four of them: agency theory, resource dependence theory, class hegemony and legalistic perspective.[84] Next to the theoretical frameworks identified by Zahra and Pearce other approaches exist. For example, some authors refer in their studies to the stewardship theory.[85] Another important theory is the stakeholder-oriented approach.[86] The theoretical pluralism in this field goes along with the focus on different aspects of boards in terms of their roles in corporate governance.

As Zahra and Pearce observe, the agency theory is the mainstream approach in the research on boards.[87] The agency theory must be understood in the context of the historical evolution of the corporate entities and company law.[88] At the end of the nineteenth century, owners of corporations could enjoy limited liability up to their equity investment whilst retaining the powers stemming from the ownership. Next to the legal status of an artificial person, corporations received some of the rights of a real person. This implied that such business entities could own property, sue, be sued and act as parties to contracts.[89] This corporate legal structure encouraged investors to trade in companies' stocks. Especially, the general public in the US and the UK enjoyed buying shares of listed companies without becoming engaged in any form of management.[90] This is commonly regarded as the beginning of the dispersed shareholding system.

In that historical context, Adolf Berle and Gardiner Means first identified the separation of corporate ownership from corporate control.[91] As Professor Tricker notes, their contribution can be perceived as the "first seminal work on corporate governance," even in the absence of the term of corporate governance from their writing.[92]

Berle and Means observed that the corporate governance structure involves three constituencies: shareholders who are the owners, hired managers who exercise the operational control, and the board charged with the duty to monitor the managers in the interest of the owners. In addition, the authors defined corporate management as a body consisting of senior officers of the corporation and a board of directors.[93] The rationale for boards to act as an internal corporate governance mechanism was based on the need to protect widely dispersed owners of open corporations from abuse by the management. As Professors Fama and Jensen subsequently argued,[94] shareholders assign internal control over the executive management to expert boards that ideally consist of a significant amount of outside directors and "act as arbiters in disagreements among internal managers and carry out tasks that involve serious agency problems between internal managers and residual claimants".[95]

In recognition of the collective action problem, Berle and Means argued that managers, while controlling the corporate assets, were in the position to extract value for their personal wealth at the expense of the owners. Along this line of reasoning, Jensen and Meckling developed a full-blown principal-agent framework in the mid-1970s.[96] The attention of researchers and policymakers for the monitoring role of boards is based on this theoretical approach. Similarly, the boards' duties are defined in terms of monitoring, evaluation, and internal regulation of the actions by executive management.[97] The agency theory has been the dominant approach applied to the study of boards of directors.[98] Accordingly, Van-Ness, Miesing and Kang find that in their sample of 156 academic papers, 57% was based on the agency theory, 22% followed the stewardship theory, 7% was founded on the resource dependency theory, whereas only 14% was theory neutral.[99]

The stewardship theory appears to be one of the most popular approaches after the agency theory.[100] The stewardship theory was introduced by Donaldson and Davis.[101] Donaldson and Davis argue that executives should be perceived as stewards motivated to perform in the best interest of their principals. This motivation stems from the assumption that the stewards' utility is maximized when the shareholders' wealth is increased through firm performance.[102] In this context, the

81. Minton 2010.
82. Mehran, Morrison & Shapiro 2011.
83. Becht, Bolton & Röell 2012.
84. Zahra & Pearce 1989.
85. *E.g.*, Davis *et al.* 1997, pp. 20-47 and Muth & Donaldson 2002, pp. 5-28.
86. *E.g.*, Van Zijl 2012, pp. 49-66.
87. *Ibid.*, p. 301.
88. For the history of corporate governance and the origins of the corporate law, see Tricker 2009.
89. *Ibid*, p. 8.
90. *Ibid.*, p. 9.
91. Berle & Means 1933, p. 69.
92. Tricker 2009, p. 9.
93. Berle & Means 1933, p. 221.
94. Jensen & Meckling 1976.
95. Fama & Jensen 1983.
96. Jensen & Meckling 1976, p. 309 argue that independently of how effective the monitoring and bonding of the agent might be, the agency costs will always occur. Agency costs represent a sum of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss.
97. See Filatotchev & Boyd 2009.
98. Huse *et al.* 2011.
99. Van Ness *et al.* 2009.
100. *E.g.,* findings by Van Ness, Miesing & Kang 2009.
101. See Donaldson & Davis 1989; Donaldson & Davis 1991.
102. Davis *et al.* 1997.

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responsibilities of boards go beyond the monitoring and concern also the coaching of the CEO, developing strategic decisions in cooperation with employees, upholding the values of the organization, and so forth. This approach implies that boards consist of persons characterized by ethical awareness, leadership, cooperative and participative attitude.[103] Differently from the agency theory, with which it shares the norm of shareholder value maximization, the stewardship theory does not assume that management is opportunistic in pursuing its self-interest. Therefore, boards are supposed to help shareholders to communicate with managers rather than to monitor them.

The other theories of boards have a broader scope than the two reviewed above. The resource dependence theory assigns to boards an important role in establishing connections between the organization and its external environment.[104] This theory argues that the standing of directors, both professionally and in the community, brings them in the position to facilitate access to scarce resources for their corporations.[105] The class hegemony theory represents another perspective on boards and, as Zahra and Pearce observe, it is conceptually rooted in Marxist sociology. Boards are perceived as a body consisting of prestigious individuals who serve the capitalist control of social and economic institutions. This concept has enjoyed less scholarly attention than the other theories.[106] Zahra and Pearce II identify also the legalistic perspective that originates in the legal mandate provided to directors by the corporate laws. Advocates of this concept derive the function of boards as internal control mechanism from the powers that directors are vested with by the company statutes.[107] Whether boards are supposed to pursue the interest of shareholder or of a boarder set of stakeholders depend on the corporate law jurisdiction.

The stakeholder approach to boards of directors focuses instead on the equal importance of all groups of stakeholders involved in a company.[108] Boards should mediate between various stakeholders making sure that the management takes the interest of various constituencies (labour, creditors and so forth) into account.[109] The stakeholder theory is often contrasted with the shareholder-oriented views on what the role of directors and the functioning of boards should be.[110] Similarly, a relatively new stream of research suggests the need to depart from a narrow perspective of maximization of shareholders value. These are the so-called behavioural theories of boards,[111] which focus on board processes and functions in order to interpret the behaviour of directors.[112] However, currently this line of research does not yet provide a rigorous alternative to the agency theory.[113]

All of the board theories that we have briefly reviewed converge on one particular point: the mission of the board includes disciplining the management for one reason or another. The mainstream agency theory gives the board a single mandate: that of protecting the interest of shareholders against managerial misbehaviour. As we have argued in the previous section, this may be at odds with the externalities that a purely shareholder-oriented corporate governance of banks would impose on the other members of the society. In line with the other, more nuanced theories of boards, the role of directors might be indeed broader and serve the purpose to protect a wider range of stakeholders in the company. In the case of banks, these stakeholders notably include the creditors that are not implicitly or explicitly insured by the government – for instance, the holders of long-term bonds – and the government itself as provider of a financial guarantee of last resort. In this perspective, the board can be effective in monitoring the bank management not just inasmuch as it is independent from the latter, but more importantly, because its mandate is to pursue goals other than the mere maximization of the shareholder profits.

Armed with this insight, we are now going to investigate whether the regulatory reform of boards of banks is likely to be conducive to less risk-taking. We focus on one particular issue that according to the recent literature provides bankers with perverse incentives to increase risk-taking, particularly in a short-term perspective: the performance-based remuneration. One way to deal with this problem is to regulate the compensation of bank executives directly. This approach, however, divides the EU – which favours it – from the United States – which does not.[114] Conversely, a corporate governance approach to managerial remuneration is supported on both sides of the Atlantic. As a response to the global financial crisis, regulation in both the US and Europe is mandating remuneration committees characterized by particularly strict requirements of independence. We are going to discuss these in the next section.

103. Martyn 2006.
104. Filatotchev & Boyd 2009.
105. *E.g.*, Zald 1967.
106. Zahra & Pearce II 1989.
107. *Ibid*.
108. Donaldson, Thomas, & Preston 1995, pp. 65-91. For a description of this theory and its implications for the board composition, see Van Zijl 2012, pp. 62-66.
109. Blair & Stout 1999.
110. For an example of the application of the shareholder/stakeholder distinction, see Adams *et al.* 2011.
111. *E.g.*, Van Ees *et al.* 2009.
112. Filatotchev & Boyd 2009.
113. Van Ees, Gabrielsson & Huse 2009.
114. The EU regulation is more prescriptive regarding the structure of remuneration, particularly on the proportion of cash within variable remuneration and the deferral of performance pay. See Directive 2010/76/EU on capital requirements for the trading book and for re-securitisations and the supervisory review of remuneration policies (so-called CRD III) and the CRD IV Proposal discussed below. On the contrary, the US regulation is more elusive on the point. Although the Dodd-Frank Act included a rule (Section 956) authorizing financial regulators to prohibit excessive incentive-based compensation for systemically relevant financial institutions, the US financial authorities have backed away from implementing this rule. See Coffee 2011.

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4. Regulation of Compensation Committees (of Banks): The US and the EU Compared

In the wake of the global financial crisis resulting in bailouts of many financial institutions, reforms concerning boards of banks have been advocated or adopted on both sides of the Atlantic. The following reforming acts are of particular interest for our discussion: The Wall Street Reform and Consumer Protection Act of 2010 in the US (known as the Dodd-Frank Act)[115] and the European Commission's Proposal of the *EU Directive on the Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms* (henceforth, the CRD IV Proposal).[116] We focus on just one aspect of these reforms being the independence of compensation committees in the boards of banks.

The notion of independence, as generally applied to board of directors, has been defined variously across different countries and over time.[117] The conceptualization of board independence varies also with respect to the parties from which directors are supposed to be independent (*e.g.*, executives, shareholders or other stakeholders).[118] For our purposes, it is worth noting that the notion of independence applied to the compensation committees focuses almost exclusively on the relationship with the management. Notably, regulation does not aim to make executive remuneration independent from shareholders, which is an issue we discuss in the next section.

The relevant provision for the US is Section 952 of the Dodd-Frank Act, which compels the SEC to prohibit the national stock exchanges from listing any company that failed to comply with rigorous independence requirements for setting the executive remuneration policy.[119] As mentioned, Section 952 – like most of the corporate governance provisions of the Dodd-Frank Act – applies to every listed company and not just to banks. The SEC was to require self-regulatory organizations to strengthen the independence standards for the members of compensation committees and their advisers.[120] Specifically, Section 952 of the Dodd-Frank requires that all members of the compensation committee be members of the board of directors and that they be independent. However, the law does not provide an explicit definition of independence. Instead, it sets standards for the exchanges to define the independence of compensation committees. In testing for independence, the exchanges are required to pay particular attention to the following factors: (a) the "Fee Factor" being any source of compensation of a member of the board of directors of the issuer; (b) any consulting, advisory, or other compensatory fee paid by the issuer to such a member of the board of directors; and (c) the "Affiliation Factor" referring to any affiliation of a member of the board of directors with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.[121]

In furtherance of the outlined Section 952 of the Dodd-Frank Act, the SEC adopted the final version of Rule 10C-1 under the Securities Exchange Act of 1934 on 20 June 2012.[122] In the document releasing the final version of Rule 10C-1, the SEC states, *inter alia*, that the new rule directs national securities exchanges and national securities associations to

> establish listings standards that, among other things, require each member of a listed issuer's compensation committee to be a member of the board of directors and to be "independent," as defined in the listing standards of the national securities exchanges adopted in accordance with the final rule.[123]

In compliance with Rule C10-1, the NASDAQ and the NYSE filed with the SEC a request for amendment of their respective listing rules relating to the independence of compensation committees.[124] After a public consultation, these proposals have been amended and the SEC has approved them.[125]

According to the SEC, the notion of compensation committee includes "the members of the board of directors who oversee executive compensation matters on behalf of the board of directors in the absence of a formal committee".[126] Exchanges are therefore required to adopt independence standards that apply to any committee of the board that performs functions typically assigned to a compensation committee "including the oversight of executive compensation, whether or not such committee also performs other functions or is formally designated as a compensation committee".[127] As an example, the

115. The Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
116. COM(2011) 453 final.
117. For an outline of different definitions of independence in the context of board of directors, see Van Zijl 2012, pp. 26-36.
118. See Van Zijl 2012, p. 30.
119. § 952(a) Dodd-Frank Act.
120. For a brief overview of the corporate governance provisions of the Dodd-Frank Act, see Bainbridge 2010b.
121. See § 952(a) the Dodd Frank Act and, for example, SEC Release No. 34-68639; File No. SR-NYSE-2012-49, p. 4.
122. SEC Release Nos. 33-9330; 34-67220; File No. S7-13-11.
123. *Ibid*.
124. See Securities Exchange Act Release No. 68013 (9 October, 2012), 77 FR 62563 for NASDAQ's proposal of change in listing rules and Securities Exchange Act Release No. 68011 (9 October 2012), 77 FR 62541 for NYSE change in listing rules.
125. Securities and Exchange Commission (SEC), "Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Amendment No. 3, and Order Granting Accelerated Approval for Proposed Rule Change, as Modified by Amendment Nos. 1 and 3, to Amend the Listing Rules for Compensation Committees to Comply with Securities Exchange Act Rule 10C-1 and Make Other Related Changes", SEC Release No. 34-68640; File No. SR-NASDAQ-2012-109. Available at: <www.sec.gov/rules/sro/nyse/2013/34-68639.pdf> accessed 16 February 2013.
126. SEC Release Nos. 33-9330; 34-67220; File No. S7-13-11, p. 13. In this document, the SEC explains the term of "compensation committee" as including "any committee of the board that conducts activities which are typical for a compensation committee". Such activities are understood to include monitoring of executive compensation.
127. Release Nos. 33-9330; 34-67220; File No. S7-13-11, p. 11.

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SEC mentions corporate governance committees or human resources committees in which the oversight of executive compensation may be vested. In such cases, the independence requirements should be applicable to these committees.[128]

This may imply that having a standing compensation committee is not strictly mandatory according to the US law. The question whether Section 952 of the Dodd-Frank Act actually mandates a standing compensation committee was raised by legal scholars. According to Professor Bainbridge, Section 952 does not require that a standing remuneration committee be established although it does require that the existing remuneration committees comply with the statutory requirements of independence.[129] This interpretation was relevant in the context of the NASDAQ listing standard 5605(d) which, prior to the Dodd-Frank reform, allowed for an alternative to a standing compensation committee. Particularly, it was recognized that a majority of independent directors could act and determine the executive remuneration policy. This exception, however, is no longer relevant after the NASDAQ has amended its listing standards. Today also the NASDAQ prescribes the establishment of a standing compensation committee, to which the full set of independence requirements – strengthened according to Section 952 of the Dodd-Frank Act – apply.[130] As a result, although a standing remuneration committee is not strictly mandated by the Dodd-Frank Act, the two major exchanges in the US – the NYSE and the NASDAQ – require listed companies to have one.

The SEC Rule 10C-1 also extends the independence requirements to compensation advisers.[131] Compensation committees may select the latter only after considering six independence factors. Five of them are enumerated in Section 10C(b)(2) of the Securities Exchange Act of 1934.[132] The sixth one was added by the SEC in its document releasing Rule 10C-1. This item obliges compensation committees to consider the relationships between executive officers of a listed company and the compensation adviser or the person employing the adviser.[133] The SEC provides as example situations where the chief executive officer of a listed company and the compensation adviser are business partners or are involved in a familial relationship; in this case, the compensation adviser cannot be selected.[134]

We compare the above-mentioned set of rules governing the independence of compensation committees in the US listed companies with analogous requirements that are going to be established in the EU, albeit only with respect to the boards of banks – whether listed or not. In this regard, the provisions of interest are contained in Article 91 and the related articles of Section 3 of the European Commission's CRD IV Proposal.[135]

Currently, in Europe, the issue of executive remuneration, both in banks and in other listed companies, is very loosely regulated.[136] Corporate governance codes typically require that boards establish a compensation committee in charge of determining the policy on executive remuneration and specific compensation packages for executive directors.[137] However, such a requirement can be avoided, provided that the company explains the reasons for doing so. As often in the case of provisions governed by the comply-or-explain standard, compliance may be more in form than in substance.[138] In any event, the empirical research on the compliance with European corporate governance codes has shown that explanations for non-compliance are either insufficient or missing altogether.[139]

The detailed individuation of tasks and responsibilities of compensation committees differs across codes and across companies' practices, but the core function remains related to the responsibility for setting up the executive remuneration and monitoring its implementa-

128. *Ibid*.
129. Bainbridge 2010b. Available at: <www.professorbainbridge.com/professorbainbridgecom/2010/09/a-question-re-compensation-committees-under-dodd-frank-952.html> accessed 16 February 2013.
130. See Release No. 34-68640; File No. SR-NASDAQ-2012-109.
131. Following the wording of the US reforms, we refer to a compensation consultant, legal counsel, or other adviser to a compensation committee of an issuer as advisers to compensation committees or a compensation adviser.
132. The following factors are to be considered in the assessment of the adviser's independence:
   - provision of other services to the listed company by the person that employs the compensation adviser;
   - the amount of fees received from the issuer by the person that employs the compensation adviser, as a percentage of the total revenue of the person that employs the compensation adviser;
   - policies and procedures regarding prevention of conflicts of interest as adopted by the person that employs the compensation adviser;
   - any business or personal relationship of the compensation adviser with a member of the compensation committee;
   - any stock of the issuer owned by the compensation adviser.

   See Section 10C(b)(2) of the Securities Exchange Act of 1934.
133. See SEC Release Nos. 33-9330; 34-67220; File No. S7-13-11 p. 39.
134. SEC Release No. 33-9330.
135. Also the following EU regulatory measures are of importance: European Commission, *Recommendation on the Role of Non-executive or Supervisory Directors of Listed Companies and on the Committees of the (Supervisory) Board*. 2005/162/EC, OJ L 52/51; European Commission, *Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies*, COM (2010) 284 final; European Commission, *Staff Working Document on Corporate Governance in Financial Institutions: Lessons to be Drawn from the Current Financial Crisis, Best Practices. Accompanying Document to the Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies*, SEC (2010) 669; European Commission, *Green Paper on the EU Corporate Governance Framework,* COM (2011) 164 final, European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions. Action Plan: European Company Law and Corporate Governance – A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies*, COM (2012) 740/2.
136. Currently the matter is only subject to Recommendations by the European Commission. See European Commission, *Report on the Application by Member States of the EU of the Commission 2009/384/EC Recommendation on Remuneration Policies in the Financial Services Sector*, COM (2010) 286 final; and European Commission, *Report on the Application by Member States of the EU of the Commission 2009/385/EC Recommendation Complementing Recommendations 2004/913/EC and 2005/162/EC as Regards the Regime for the Remuneration of Directors of Listed Companies*, COM (2010) 285 final.
137. See Chambers 2005, p. 941.
138. Arcot & Bruno 2006. Available at: <www.lse.ac.uk/FMGPersonalPages/sridharArcot/CGPaper1.pdf> accessed 16 February 2013.
139. Arcot *et al.* 2010.

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tion. For example, the UK Financial Reporting Council describes this function in terms of delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management.[140]

Similarly to the audit and nomination committees, on whose experience they build, remuneration committees are meant to prevent potential conflicts of interest within the board because the codes require their members to be independent. Some commentators believe that mandatory standing committees can be effective in policing conflicts of interest.[141] It is for this reason that the EU legislator has decided to depart from the previous "soft" approach to the structure, level, and governance of executive compensation and to introduce mandatory rules instead of recommendations. Article 91 of the CRD IV Proposal makes the establishment of a standing remuneration committee mandatory. Differently from the US regulation, however, the EU approach is focusing exclusively on banks. Executive remuneration is a more delicate issue in banks because of its implications on risk-taking and, thereby, on the externalities of banking. Pursuant to the provisions of Article 91.2 of the CRD IV Proposal, the remuneration committee in a bank must be part of the management body without executive powers. The wording of the Directive is as follows: "The Chair and the members of the remuneration committee shall be members of the management body who do not perform any executive functions in the credit institution concerned."[142] Although the CRD IV Proposal does not explicitly refer to any independence criteria, the requirement that the remuneration committee be entirely made of non-executives already suggests a step in this direction. In addition, the remuneration committee is explicitly assigned the task to monitor the implications of executive remuneration for risk-taking and the interest of shareholders, investors and other stakeholders. It can be expected that, in implementing Article 91 of the CRD IV Proposal, more precise independence requirements will be specified by the European Banking Authority and/or the national supervisory authorities.

The role of the remuneration committee, as defined in Article 88.2 (f) of the CRD IV Proposal, refers particularly to the direct oversight of the remuneration of senior officers in the risk management and compliance functions. Article 88.2 of the CRD IV Proposal provides the foundation for the decisions to be made by the remuneration committee. When acting in their capacity as members of the remuneration committee, directors will have to make sure that the remuneration policy they endorse is consistent with effective risk management[143] as well as with the business strategy, objectives, values and long-term interests of the institution.[144]

Since the compensation committee is a part of the management body, namely of the board of directors, it has to reflect in its functioning the corporate governance principles established by the CRD IV Proposal with respect to the whole board. According to Article 86.1 of the Proposed Directive, the following norm should apply to all committees. All board committees and committee members are expected to define and oversee "the implementation of the governance arrangements that ensure effective and prudent management of an institution".[145] The focus of this norm is again risk management, which is the mantra of the corporate governance provisions included in the CRD IV Proposal. The mandatory remuneration committee, with its characteristics and mission to oversee the incentives generated by executive compensation, is a key element of the EU regulatory policy towards risk management in banking.[146]

To summarize, the post-crisis reforms of boards (of banks) on the two sides of the Atlantic converge towards a similar outcome. Namely, the listed companies in the US and, after the implementation of the proposed directive, all banks in the EU will have to include a standing compensation committee with the task to monitor the remuneration of executives. The goal is to prevent executives from engaging in excessive risk-taking because of the incentives created by performance pay.

5. A Step Forward

Corporate governance reforms seeking to enhance the independence of boards of banks, particularly with regard to the remuneration committees, are obviously intended to reduce managerial incentives to take risks. The idea underlying the setting of remuneration by independent directors is that the latter should curb the tendency of management to establish performance pay schemes that reward high-risk strategies in the short run. These strategies are obviously beneficial for bank managers because their compensation increases in the presence of short-term profits, but does not decrease in case of losses or bankruptcy. As we have seen in Section 2, bank managers pursuing such strategies are effectively creating an externality to society in the form of financial instability and the taxpayers' money necessary for bailing out systemically relevant financial institutions.

Regulatory intervention in the design of bankers' remuneration is economically justified by the failure of markets to discipline banks effectively. However, it is doubtful that assigning independent directors the task to

140. See Financial Reporting Council, "The UK Corporate Governance", 2010. Available at: <www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx> accessed 16 February 2013.
141. See Chambers 2005.
142. Art. 91.2 Directive COM (2011) 453 final.
143. Art. 88.2 (a) Directive COM (2011) 453 final.
144. Art. 88.2 (b) Directive COM (2011) 453 final.
145. Art. 86.1 Directive COM (2011) 453 final.
146. In the EU, an important complement of this policy is the direct regulation of variable remuneration. See Art. 90 of the CRD IV Proposal.

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discipline the bank management, both via setting their compensation and otherwise,[147] can solve the problem. Independent directors, no matter how knowledgeable, reputable and effectively independent from the management they are, are ultimately accountable to the constituency that appoints them. Both in the United States and in most of the European countries, this constituency is the shareholders. As some of the board theories reviewed in Section 3 show, the interest of shareholders does not always correspond with that of the managers. In banking, however, both shareholders and managers share an interest in taking advantage of the governmental subsidy originating from the safety net. In other words, both bank managers and bank shareholders have an incentive to engage in moral hazard.

To be sure, regulation tries to cope with this problem by imposing minimum capital adequacy requirements on companies operating in the banking industry.[148] But the fact remains that banks are enormously more leveraged than non-financial firms, and a great deal of their liabilities – particularly those that are liquid – are explicitly or implicitly insured by the government. The holders of these liabilities are not going to discipline shareholders for excessive risk-taking inasmuch as they can expect a bailout. Bank shareholders have thus an incentive to take more risk than it is socially optimal. Consequently, they will be inclined to reward management for taking such risks. Only in the absence of a safety net nurturing moral hazard or in the presence of a tight public supervision of risk-taking, bank shareholders could be credited to prevent the management from taking excessive risks – or at least, to have the right incentives to do so. However, as also the experience of the global financial crisis has shown, removing the safety net is not really an option and would not be credible. On the other hand, banking regulation and supervision has been historically unable to monitor risk-taking by banks, also because of a structural inability to keep up with financial innovation. Under these conditions, it is illusory to believe that a more independent remuneration committee can effectively curb risk-taking by bank managers, as long as independent directors are appointed by the shareholders.

This is indeed a general point that applies to the corporate governance of banks. If the goal of regulating such governance is to police the externalities of banking, then putting the shareholders on the drivers' seat is not a good idea. Initiatives aimed at increasing shareholder powers, which have been particularly popular in the United States,[149] are going in the wrong direction. As discussed earlier, the first empirical analyses of the global financial crisis provide mixed evidence regarding the role of corporate governance. However, it is clear that institutional shareholders have not opposed risk-taking by bank managers even in the UK, where they had the power to do so.[150] As far as the US is concerned, the literature has recently shown that banks whose management was more exposed to shareholders influence were more likely to need a bailout.[151] Therefore, both theory and empirical evidence suggest that shareholders involvement in the governance of banks is part of the problem, not part of the solution.

The idea of having the boards checking on banks executives' remuneration could be, however, carried further. The first step in the direction of making a board remuneration committee effective in curbing risk-taking by bank managers is to insulate that committee from the influence of shareholders. This approach should be combined with special rules for the appointment of the directors to sit in the committee: it is of course unthinkable to have a remuneration committee independent of shareholders if the latter have still the last word on the appointment and the removal of the directors involved. Insulating a part of the board from the influence of shareholders is relatively easy to implement in practice. It is more difficult to identify the constituency that should replace the shareholders in the appointment of the directors who are assigned special tasks concerning the monitoring of risk-taking in banks (including setting the right remuneration scheme for bank executives).[152]

The circumstance that banks are highly leveraged firms suggests that the constituency more in need of protection should be the debt-holders. This observation parallels the proposal, authoritatively advanced in the literature, to directly link the remuneration of bank managers to debt instruments in order to make them more concerned about the risks they are taking.[153] Conferring upon debt-holders the right to indirectly determine – through the appointment of the members of the remuneration committee – the structure of executive compensation has one advantage and one disadvantage relative to the direct regulation of the pay structure. The advantage is that debt-holders, through the directors they appoint to the board, are in a better position to identify the right pay structure and the risk-management policies to protect their investment. Debt-holders and their representatives may have stronger incentives than the employees of a banking authority. This proposition holds true, however, only if debt-holders are credibly committed not to ever benefit from a bailout. The fact that this condition is difficult to fulfil due to the moral hazard generated by the governments' safety

147. Another setting in which the independence of board members is relevant is the nomination committee. See Art. 86.2 of the CRD IV Proposal (requiring that the members of nomination committee be non-executives).
148. Heremans & Pacces 2011.
149. But they are increasingly popular on this side of the Atlantic as well. See *e.g.* European Commission, *Action Plan: European Company Law and Corporate Governance – A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies*, COM (2012) 740/2 final.
150. Becht, Bolton & Röell 2012, pp. 451-453.
151. Ferreira *et al.* Available at: <http://ssrn.com/abstract=2170392> accessed 16 February 2013.
152. Another important example is the risk management function (including the Chief Risk Officer) within a bank. This function was not taken seriously enough by the bank managers during the years preceding the global financial crisis. See Becht, Bolton & Röell 2012, pp. 455-456.
153. See, for two different approaches, Bolton, Mehran & Shapiro 2010 and Bebchuk & Spamann 2010.

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net is the disadvantage of the governance solution that we advocate relative to a direct regulation of the bankers' pay.

Conferring upon debt-holders the right to appoint the members of the remuneration committee could be, however, corrected for moral hazard. For instance, the appointment rights could be made conditional on the subscription of bail-in instruments by debt-holders. Bail-in instruments are hybrid forms of debt that convert to equity in the presence of certain contingencies signalling that the bank is in trouble. If properly designed, bail-ins are an effective substitute for bail-outs.[154] We leave for another day the discussion of how to practically combine the subscription of contingent capital with the right to appoint the members of the remuneration committee (and perhaps of the risk committee as well). The point we want to make here is that trying to curb the incentives of bank management to engage in excessive risk-taking requires a straight departure from the traditional approach to corporate governance. Particularly in the context of remuneration, it is necessary that the company organs responsible for setting the bankers' pay are not accountable to shareholders, but rather to the constituency that would bear the consequences of a bank failure without benefiting from risk-taking by bankers. This constituency is well represented by the uninsured creditors of a bank.

6. Conclusion

In this article, we have discussed whether the enhancement of the independent requirements of compensation committees, fostered by the regulatory reaction to the global financial crisis, is likely to lead to less risk-taking by bank mangers. Our conclusion is that this is unlikely to be the case. This is because the board independence requirements are set with respect to the management, not to the shareholders. While this may make sense in the general case of non-financial listed companies, it does not work well in the context of a banking enterprise. Due to moral hazard in banking, bank shareholders have even stronger incentives than bank managers to engage in risky strategies that pay off in the short run while imposing broader externalities on the society in the long run. Because the need to protect banking from systemic crises unavoidably creates a scope for moral hazard, the only solution to discipline bank managers is to make them accountable to other stakeholders that, differently from shareholders, have no incentive to take socially excessive amounts of risk. We have identified such stakeholders in the uninsured creditors of a bank, particularly those that are exposed towards the bank via contingent capital – the so-called bail-in instruments.

154. Coffee 2011.

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