Better Governance of Financial Institutions

Law Working Paper N°. 207/2013
April 2013

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ECGI Working Paper Series in Law

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Abstract

Corporate governance of banks and other financial institutions differs considerably from general corporate governance. For financial institutions the scope of corporate governance goes beyond the shareholders (equity governance) to include debtholders, insurance policy holders and other creditors (debt governance). From the perspective of the supervision of financial institutions debt governance is the primary governance concern. Equity governance and debt governance face partly parallel and partly divergent interests of management, shareholders, debtholders and other creditors, and supervisors. Failures in the corporate governance of banks and other financial institutions contributed to the financial crisis. Corporate law reforms are less suited to achieve better governance of financial institutions, strengthening supervisory law requirements is more promising. Prominent proposals include clearer separation of the management and control function, possibly by a two-tier board as for Swiss and Belgian banks; establishment of a separate risk committee of the board or an independent chief risk officer; dealing with the problem of complex or opaque structure and organization; and group-wide corporate governance in single entities as well as in the group. Appropriate supervisory law requirements are needed for the internal procedures of banks and other financial institutions, specifically for risk management, internal control and compliance, and internal and external auditing. Supervisory fit and proper tests for the board, the management and major shareholders are useful. Qualification and experience of board members of banks and other financial institutions is more important than independence, though having a number of independent directors is useful. These and other requirements of the regulation and supervision of banks and other financial institutions concerning better governance are demanding and even severe, but necessary for regulated industries such as financial institutions. But the temptation to let them spill over indiscriminately to the corporate governance of the firm must be strictly resisted. This article analyses the economic, legal and comparative research and covers the reforms by the European Commission, the European Banking Authority, CDR IV and Solvency II up to the end of 2012.

Keywords: corporate governance of banks, debt governance, financial crisis, bank reform, bank supervision, bank two-tier board, governance of financial groups, bank risk management, fit and proper test, major shareholders of banks, independent directors, experience of directors

JEL Classifications: G3, G21, G28, K22

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Better Governance of Financial Institutions[#]

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Abstract

Corporate governance of banks and other financial institutions differs considerably from general corporate governance. For financial institutions the scope of corporate governance goes beyond the shareholders (equity governance) to include debtholders, insurance policy holders and other creditors (debt governance). From the perspective of the supervision of financial institutions debt governance is the primary governance concern. Equity governance and debt governance face partly parallel and partly divergent interests of management, shareholders, debtholders and other creditors, and supervisors. Failures in the corporate governance of banks and other financial institutions contributed to the financial crisis. Corporate law reforms are less suited to achieve better governance of financial institutions, strengthening supervisory law requirements is more promising. Prominent proposals include clearer separation of the management and control function, possibly by a two-tier board as for Swiss and Belgian banks; establishment of a separate risk committee of the board or an independent chief risk officer; dealing with the problem of complex or opaque structure and organization; and group-wide corporate governance in single entities as well as in the group. Appropriate supervisory law requirements are needed for the internal procedures of banks and other financial institutions, specifically for risk management, internal control and compliance, and internal and external auditing. Supervisory fit and proper tests for the board, the management and major shareholders are useful. Qualification and experience of board members of banks and other financial institutions is more important than independence, though having a number of independent directors is useful. These and other requirements of the regulation and supervision of banks and other financial institutions concerning better governance are demanding and even severe, but necessary for regulated industries such as financial institutions. But the temptation to let them spill over indiscriminately to the corporate governance of the firm must be strictly resisted. This article analyses the economic, legal and comparative research and covers the reforms by the European Commission, the European Banking Authority, CDR IV and Solvency II up to the end of 2012.

Keywords

Corporate governance of banks and other financial institutions, equity governance vs. debt governance, financial crisis and bank reform proposals, supervisory requirements as to bank governance, separation of management and control by a bank two-tier board, group-wide corporate governance of financial institutions, bank risk management, fit and proper test for the board, the management and major shareholders of banks and other financial institutions, experience vs. independence of board members, the danger of spillover of bank governance reforms to the corporate governance of the firms.

[#] Part A has been published with some changes in 2012: K. J. Hopt, "Corporate Governance of Banks after the Financial Crisis", in: E. Wymeersch, K. J. Hopt, G. Ferrarini, eds., *Financial Regulation and Supervision,* Oxford University Press 2012, p. 337-367. Part B goes back to a lecture in Cambridge, UK on 30 November 2012 and will be published in an updated version in: The Journal of Corporate Law Studies 2013, winter issue.

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<u>I. Corporate governance of firms and its relevance for banks</u>

1. Corporate governance and bank governance:[1] An emerging discussion

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[1] Instead of bank governance, the term "corporate governance of banks" is used in this paper because it more clearly marks the connection with the general corporate governance discussion. The most recent and, at least in Germany, the first specialized book on this topic is K.J. Hopt/G. Wohlmannstetter (eds.) *Handbuch Corporate Governance von Banken* (Vahlen, C.H. Beck Munich 2011). For example, see therein G. Wohlmannstetter, "Corporate Governance von Banken," 31; S. Emmenegger, "Grundsätze guter Unternehmensführung von Banken aus der Sicht des Basler Ausschusses und der FINMA," 405; and D. Weber-Rey/C. Baltzer, "Verlautbarungen der EU und der BaFin zur internen Governance von Banken," 431. More generally, K. J.

a) What is special about banks and bank governance?[2]

Corporate governance is “the system by which companies are directed and controlled.”[3] This is the classical succinct definition for the corporate governance of companies as developed by the Cadbury Report in the UK in 1992 for the sake of company and code reform. A more economic and widely used definition holds that corporate governance “deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”[4] In corporate law and in the legal discussion about corporate governance, the focus is on the shareholders as members of the company. The interests of other stakeholders – such as creditors/debtholders, the general public, and the government with its different social, environmental, and other policies – are either left to other parts of the law (classical shareholder orientation) or only very generally included in the orientation for the board when directing and controlling the company (enlightened shareholder orientation). In contrast, many economists use a broader definition of corporate governance that includes the stakeholders (stakeholder orientation).[5]

What is special about banks and bank governance? The first question was answered long ago in bank supervisory law and bank practice, and there is no need here to summarize the special functions and risks of banking. There is vast practical experience and economic literature describing the special case of banks and the consequences for the regulation and supervision of banks as a regulated sector in contrast to normal firms. In a nutshell: What is unique for banks is the liquidity risk since they are involved in borrowing short and lending long (maturity transformation), combined with other risks arising from this, such as reputational risk and, finally, systemic risk.[6] Public trust and confidence are the very essence of banking.

Hopt, “Comparative Corporate Governance: The State of the Art and International Regulation,” American Journal of Comparative Law LIX (2011) 1.

[2] The title is adapted from one of the earliest contributions to the topic by E. F. Fama, “What’s different about banks?”, Journal of Monetary Economics 15 (1985) issue 1, 29. See also later the Federal Reserve Bank of New York (FRBNY) Economic Policy Review 9 (2003) no. 1 (April), Special Issue “Corporate Governance: What Do We Know, and What is Different about Banks?”

[3] A. Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance,* London, December 1992.

[4] A. Shleifer & R. W. Vishny, “A Survey of Corporate Governance,” 52 Journal of Finance 737 (1997) 737.

[5] Cf. Wohlmannstetter (n. 1) 31, 33; A. v. Werder, “Ökonomische Grundfragen der Corporate Governance,” in P. Hommelhoff/K. J. Hopt/A. v. Werder, eds., *Handbuch Corporate Governance* (Schäffer-Poeschel Stuttgart/Dr Otto Schmidt KG Cologne 2d ed 2009) 3 ff, 9; K. J. Hopt (n. 1) American Journal of Comparative Law (A. J. C. L.) LIX (2011) 1, 28 f.

[6] OECD 2009 (n. 16), 9, 32; Devriese et al. (n. 27) 98 sees three special factors of corporate governance of banks: systemic risk, high leverage, and dispersed non-experts as claim holders; P. O. Mülbert, “Corporate

But what is special about the corporate governance of banks? There is a very different focus. According to some, "banks are not fundamentally different from other companies in respect to corporate governance, even though there are important differences of degree and failures will have economy-wide ramifications."[7] It then follows that "[t]he general policy needs are similar for financial and non-financial companies."[8] This was the implicit majority view before the financial crisis, but the special case for the corporate governance of banks was not made until more recently.[9] Since the financial crisis, the insight that banks have special corporate governance problems has gained momentum rather quickly. For the bank supervisory authorities, it has long been obvious that they should consider corporate governance as part of depositor protection (internal governance).[10]

b) The discussion on bank governance before and after the financial crisis

One of the first institutions to codify minimum requirements for bank governance under the heading "corporate governance" was the Basel Committee on Banking Supervision at the Bank for International Settlements (BIS) in 1999.[11] A newer version was published in 2006 and received wide attention.[12] It set up eight principles of good corporate governance of banks and six recommendations for bank supervision: seven of the principles concerned the board (two of these focused on the board and senior management) and one the bank (governance in

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Governance of Banks," 10 European Business Organization Law Review 10 (2009) 411, 420 ff, counts seven differences between banks and ordinary firms: liquidity-producing function, leverage, opaqueness of banks' balance sheets, interbank business, quick changes in risk-profile, runs, systemic risk. In the following, the more recent version of this paper is cited: P. O. Mülbert, "Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms," ECGI Law Working Paper No. 130/2009, April 2010, still based on the 2006 version of the Basel Committee (n. 12, for the 2010 version see n 13). See also Wohlmannstetter (n. 1) 31, 38 ff, who distinguishes three major theories for the differences of the "bank" business type: its macroeconomic relevance, the specific lack of transparency of the bank business, and the regulation of banks.

[7] OECD 2009 (n. 16) 12.

[8] Ibidem.

[9] Infra I 1 b.

[10] Basel Committee 1999 (n. 11) IV: "Supervisors should consider corporate governance as one element of depositor protection." K. J. Hopt, "Corporate Governance von Banken," *Festschrift für Nobbe* (RWS Verlag Colonge 2009) 853, 864 ff. As to internal governance, cf. Committee of European Banking Supervisors (CEBS), Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised), 25.1.2006, p. 5 f and Annex 1, Internal governance.

[11] Basel Committee on Banking Supervision, Enhancing Corporate Governance for Banking Organizations, September 1999.

[12] Basel Committee on Banking Supervision, Enhancing governance for banking organisations, revised version, February 2006. See Emmenegger (n. 1); K. J. Hopt, *Festschrift für Nobbe* (n. 10); E. Wymeersch, "Corporate governance and financial stability," Financial Law Institute Gent, Working Paper 2008-11, October 2008, 7 et s.; P. Mülbert (n. 6) ZHR 173 (2009) 1.

a transparent manner). All six principles for bank supervision concerned corporate governance by the bank expressly or in substance.

After the financial crisis, vast amounts of reports and research on corporate governance of banks sprang up. One of the most important contributions is the new report of the Basel Committee of October 2010,[13] which was preceded by a Consultative Document of March 2010 and will be dealt with in detail in this paper. The 2010 report overhauled the 2006 report fundamentally. It contains 14 principles (instead of 8): 4 for board practices, 1 for senior management, 4 for risk management and internal control, 2 concerning compensation, 2 for bank structure, and 1 for disclosure and transparency. All five principles for the role of supervisors expressly address corporate governance of the bank. The recommendations provide guidance only and are not intended to establish a new regulatory framework on top of the law, regulations, and codes.[14] They are principle-based rather than rule-based and address all banks, though the implementation should be proportionate to size, complexity, structure, economic significance, and risk profile of the bank or the group.[15]

There were many other important reports, only three of which will be mentioned here: the OCED report of 2009 on "Corporate Governance and the Financial Crisis"[16] with conclusions and emerging good practices in 2010[17] and a general policy brief for boards;[18] the Walker Review on corporate governance in UK banks of 2009;[19] and, on the basis of earlier measures (directives and recommendations),[20] the European Commission's Green Paper on corporate governance in financial institutions and remuneration policies, June 2010.[21] A great many reports, law reforms, bank supervisory authorities' instructions and recommendations, and

[13] Basel Committee on Banking Supervision, Principles for enhancing corporate governance, October 2010. For details, see S. Emmenegger (n. 1). Cf. more generally N. Moloney, "EU Financial Market Regulation After the Global Financial Crisis: "More Europe" or More Risks?" Common Market Law Review 47 (2010) 1317.

[14] Basel Committee 2010 (n. 13) no. 7.

[15] Basel Committee 2010 (n. 13) nos. 7 f. Cf. Moloney (n. 13) 1376 as to a European rule book: "A focus on core principles might also reduce the risk of gaps appearing in the rule book."

[16] OECD, Corporate Governance and the Financial Crisis: Key Findings and Main Messages, Paris, June 2009.

[17] OECD, Corporate Governance and the Financial Crisis, Conclusions and emerging good practices to enhance implementation of the Principles, Paris, 24 February 2010.

[18] Though not specifically for banks, see OECD, Restoring Trust in Corporate Governance: The Six Essential Tasks of Boards of Directors and Business Leaders, Policy Brief, Paris, January 2010.

[19] Walker Review, A review of corporate governance in UK banks and other financial industry entities, Final recommendations, 26 November 2009. For general corporate governance, see also Financial Reporting Council, The UK Corporate Governance Code, June 2010.

[20] Listed in detail by D. Weber-Rey/C. Baltzer (n. 1) 431, 436 ff, 439, 448 ff.

[21] European Commission, Green Paper on Corporate governance in financial institutions and remuneration policies, 2.6.2010, COM(2010) 284 final. See also 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, 2.6.2010, SEC(2010) 669.

codes regarding the corporate governance of banks spread all over the EU member states and beyond, including the UK with the just-mentioned Walker Review as well as Germany[22] and Switzerland[23], for example. This is not surprising: the Basel recommendations, which are drawn up by delegates from many countries, are usually the international forerunners and are taken up by the European Union. They are implemented in the member states either directly or via EU directives and recommendations.

In economic research, the first contributions sprang up in the 1980s with a contribution by Fama,[24] followed in 2000 by Ciancanelli and Reyes Gonzales[25] and in 2003 by Macey and O'Hara.[26] Many others followed, in particular around the financial market crises.[27] Since 2004 the literature in Europe arose especially in Germany, Switzerland, and Austria.[28] But only after the Green Paper on corporate governance of banks in 2010 and the responses to it – some of them very critical – did other contributions start to abound. In the same year, the first separate volume on the corporate governance of banks in Germany was published.[29]

2. Internal and external corporate governance: Different relevance for banks

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[22] For Germany, see D. Weber-Rey/C. Baltzer (n. 1) 431, 455 ff.
[23] For Switzerland, see S. Emmenegger (n. 1) 405, 406 ff, 414 ff.
[24] E. F. Fama (n. 2).
[25] P. Ciancanelli/J. A Reyes-Gonzales, "Corporate Governance in Banking: A Conceptual Framework," December 2000, http://papers.ssrn.com/ abstract=253714.
[26] J. R. Macey/M. O'Hara, "The Corporate Governance of Banks," FRBNY Economic Policy Review, Vol. 9, No. 1, April 2003, 91; also http:/ssrn.com/ abstract=795548.
[27] For example, P. Hamalainen, "Mandatory Subordinated Debt and the Corporate Governance of Banks," Corporate Governance: An International Review 12 (2004) issue 1, 93; A. Mullineux, "The corporate governance of banks," Journal of Financial Regulation and Compliance 14 (2006) 375; J. Devriese/M. Dewatripont/D. Heremans/G. Nguyen, "Corporate governance, regulation and supervision of banks," National Bank of Belgium, Financial Stability Review 2004, 95; D. Heremans, "Corporate Governance Issues for Banks: A Financial Stability Perspective," February 2007, http://ssrn.com/abstract=1024693; A. Polo, "Corporate Governance of Banks: The Current State of Debate," January 2007, http://ssrn.com/abstract =958796; G. Nini/ A. Sufi/D. C. Smith, "Creditor Control Rights, Corporate Governance, and Firm Value," Nov. 19, 2010, http:/ssrn.com/abstract=1344302; L. Laeven/R. Levine, "Bank governance, regulation and risk taking," Journal of Financial Economics 2009, vol. 93(2) 259; R. Levine, "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence," September 2004, World Bank Policy Research Working Paper No. 3404, http://ssrn.com/abstract=625281; M. C. Ungureanu, "Banks: Regulation and Corporate Governance Framework," Corporate Ownership & Control 5 (2008) issue 2, 449, http://ssrn.com/abstract=1084042; idem, "Effective Systemic Players in the Corporate Governance of Banks: A Closer Look at Supervision," November 1, 2008, FSR Forum Journal, Erasmus University Rotterdam, No. 1, November 2008, http://ssrn.com/abstract=1307644; M. Becht, "The Governance of Financial Institutions in Crisis," in S. Grundmann et al. (eds.), *Festschrift für Klaus J. Hopt* (Berlin, De Gruyter 2010) vol. 2, 1615.
[28] See the list in K. J. Hopt, *Festschrift für Nobbe* (n. 10) 853, 856; A. Wittig, "Reform der Corporate Governance von Finanzinstituten als Reaktion auf die Finanzmarktkrise," Zeitschrift für Wirtschafts- und Bankrecht (WM) 2010, 2337.
[29] See n. 1. Earlier volumes in English include R. Levine, *The Corporate Governance of Banks* (Global Corporate Governance Forum, World Bank, Washington D. C. 2003); A. Kern/R. Dhumale/J. Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (Oxford University Press, Oxford 2006) in particular ch. 10; E. Gup (ed.), *Corporate Governance in Banking, A Global Perspective* (Elgar, Cheltenham et al. 2007).

a) Control within the corporation

The two major principal-agent conflicts in the corporation are between the shareholders and the directors in the case of dispersed ownership and between the minority and majority viz. the controlling shareholder in groups of companies or family enterprises. In principle, this is the same for firms and for banks.

But differences may arise if there is a mandatory different orientation for the board of directors of a bank – namely, to manage the bank not only or primarily in the interest of the bank's shareholders, but evenly or even primarily in the interest of the debtholders. This is particularly true if the stakeholder/debtholder orientation is not a matter for the board to decide (as is usually the case under those corporate laws that follow the enlightened shareholder approach), but if bank regulation and supervision interfere in the internal life of the bank corporation by establishing mandatory standards for the quality of the board and the management, setting up requirements for the organization of the bank, and prescribing certain internal procedures.

b) Control from the outside

Besides internal corporate governance, there is external corporate governance – i.e., control from the outside, for example, by disclosure to the market and control by the auditors, rating agencies, the market of corporate control, et al. While these forces are principally the same for all firms, there area again differences for banks.[30]

There are many special disclosure requirements and balance sheet regimes for banks that differ considerably from those for general firms.[31]

There are special auditors for banks with particular information duties toward the bank supervisory authority. The bank supervisory authority may ask for special inquiries and have them undertaken by special bank auditors.[32]

[30] Cf. H. Merkt, "Transparenz der Banken und des Bankgeschäfts als Element der Corporate Governance von Banken," in K. J. Hopt/G. Wohlmannstetter (n. 1) 117.
[31] Cf. E. Löw, "Bilanzierung und Offenlegung," in K. J. Hopt/G. Wohlmannstetter (n. 1) 139.
[32] Cf. G. Wohlmannstetter, "Die Rolle des Jahresabschlussprüfers bei der Corporate Governance von Banken," in K. J. Hopt/G. Wohlmannstetter (n. 1) 199.

The influence of the rating agencies on banks became a source of concern during the financial crisis, especially the legal rules in various national laws which prescribed that the ratings of the rating agencies had to be taken into consideration or could even be relied on more or less automatically. Reforms are under way.[33]

In a market economy, control on the firm from the outside is exercised by the markets, in particular the market for corporate control, but also other markets like the market for managers and indirectly also the product market. In theory, the market for corporate control is the most important external control mechanism that disciplines management. Bad performance will result in lower share price and make takeovers cheaper and more probable, with the result that the old management risks being replaced if the takeover is successful. Yet the takeover markets are not well developed in many European countries. The takeover market for banks is especially week and cannot be trusted to be a major disciplining force in bank corporate governance.[34]

c) Regulation and supervision of banks

The most obvious difference between firms and banks is that banking is a regulated sector with a vast number of legal, supervisory, and informal rules that cannot be treated here in any detail. According to some voices, regulators and supervisors are also stakeholders and their role should be analyzed in principal-agent terms. However, it will be argued here that regulation and supervision of banks should not be considered as external corporate governance, but as regulatory intervention into the corporate governance of the bank.[35]

d) One size does not fit all: Sector-specific corporate governance and governance codes

The conclusion of these introductory remarks is that banks and their corporate governance are special compared with general corporate governance of firms. This is in line with the development corporate governance has taken in recent years. There is a clear trend toward

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[33] Cf. B. Haar, “Die Rolle der Ratingagenturen bei der Corporate Governance von Banken,” in K. J. Hopt/G. Wohlmannstetter (n. 1) 223.
[34] Wohlmannstetter (n. 1) 31, 51 f; M. Köhler, “Der Markt für Unternehmenskontrolle,” in K. J. Hopt/G. Wohlmannstetter (n. 1) 245, 246.
[35] Infra II 2 d; see also Wohlmannstetter (n. 1) 31, 52 ff.

sector-specific corporate governance and governance codes. Examples are special corporate governances for non-listed companies,[36] close corporations and partnerships,[37] family enterprises,[38] state-owned enterprises,[39] and nonprofit organizations.[40] For some of these sectors, special corporate governance codes exist. Such a code would also be appropriate for banks.[41] The corporate governance principles should basically be the same for all banks,[42] though modifications in the details may be appropriate for different kinds of banks (for example, investment banks, deposit banks, universal banks, state-owned banks, and unlisted banks).

II. Corporate governance of banks

1. Corporate governance of banks and the financial crisis

a) Corporate governance failures in banks as evidenced by the financial crisis

A controversial discussion has concerned whether the deficits in the corporate governance of banks were (co-)responsible for the financial crisis, or whether they have instead been irrelevant. Before going into this, it would be helpful to have a quick look at the major deficits of corporate governance of banks as they are evidenced by the financial crisis. It may be that this perspective will help to dissipate the controversy. The corporate governance failures in

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[36] J. A. McCahery/E. P. M. Vermeulen (eds.), *Corporate Governance of Non-listed Companies* (Oxford University Press, Oxford 2008).

[37] J. A. McCahery/T. Raaijmakers/E. P. M. Vermeulen (eds.), *The Governance of Close Corporations and Partnerships* (Oxford University Press, Oxford 2004).

[38] A. Cadbury, *Family Firms and their Governance: Creating Tomorrow's Company from Today's* (Egon Zehnder International Publication, London 2000), http://www.egonzehnder.com/global/download/cadburyfamilyfirmsbrochure.pdf.

[39] OECD, Guidelines on Corporate Governance of State-owned Enterprises, Paris, September 2005; The Independent Commission for Good Governance in Public Services, The Good Governance Standard for Public Services, London 2004; M. J. Whincop, *Corporate Governance in Government Corporations* (Ashgate, Aldershot 2005).

[40] K. J. Hopt/T. von Hippel (eds.), *Comparative Corporate Governance of Non-Profit Organizations* (Oxford University Press, 2010).

[41] The German Lawyers Association recommended drawing up a special corporate governance code for banks in 2010; cf. K. J. Hopt/P. C. Leyens, "68. Deutscher Juristentag 2010 in Berlin: Abteilung öffentliches und privates Wirtschaftsrecht," Schweizerische Zeitschrift für Wirtschaftsrecht 2011, 198, 202 f.

[42] Basel Committee 2010 (n. 13) no. 19; K. J. Hopt, *Festschrift für Nobbe* (n. 10) 853, 863. A number of major international banks have their own corporate governance codes, for example, the European Investment Bank, the International Monetary Fund, the Bank for International Settlements, the World Bank, the European Central Bank, and the Deutsche Bundesbank; see the references ibidem, 856.

banks can be pinpointed in five main areas.[43] Some of these failures appeared fully only during the financial crisis that began in mid-2007.[44]

(1) Risk management and internal control failures

Banking is an inherently risky business, and the risks both credit banks and investment banks face are many and multi-faceted. Traditional banking lives from the so-called transformation of risks (short-term into long-term), and investment banking is about finding and financing investments in enterprises and products. Key risks include credit, market, operational, compliance, and reputational, among others.[45] This is a truism and has been the cause for bank regulation and supervision for more than a century. Yet during the financial crisis it came to light that many of these risks had been neglected, underestimated, or – particularly in the case of systemic risks – not understood and taken into consideration. It is telling that in the Basel Committee's eight principles for good corporate governance of banks in 2006, the word "risk" does not appear at all, while in its fourteen principles of 2010 it appears in nine of the fourteen principles – in fact, in principle 11 it even appears five times.[46] In addition, terms such as risk strategy, risk tolerance, and risk appetite also became popular.[47] According to the Nestor study,[48] in the years before the financial crisis three key board failings concerning risk were found: the focus on the risk measurement at the expense of risk identification, the failure to check excessive leverage, and the gross underestimation of liquidity risks. The OECD holds that perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management.[49] The lesson to be learned is not that risk should be eliminated – it never can. Nor should it be eliminated as far as possible – risk is the very business of banking. Instead, the lesson is this: The risk(s) must be known, understood, managed, and – when appropriate – communicated.

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[43] Cf. to this Basel Committee 2010 (n. 13) no. 20 ff: III A – F. In the above text, risk management and internal control failures are considered to be the first and most important issue. In the Basel Committee report they are also mentioned under III C, while the board and the management are mentioned first under III A and B. Yet for the Basel Committee this may be just a matter of presentation, since the risk management is up to the management and the board. See also the findings of Nestor Advisors Ltd, Bank Boards and the Financial Crisis, A corporate governance study of the 25 largest European banks, May 2009.
[44] Basel Committee 2010 (n. 13) no. 6. For this reason the Basel Committe decided to revisit its 2006 guidance and enlarged the number of sound corporate governance principles from eight in 2006 to fourteen and modified the previous eight to a very large degree. Risk in particular got prime attention.
[45] Basel Committee 2010 (n. 13) no. 52 and nos 6 and 69 ff.
[46] Emmenegger (n. 1) 405, 409.
[47] Basel Committee 2010 (n. 13) no. 6 note 7.
[48] Nestor (n. 43) 11 ff.
[49] OECD 2009 (n. 16) 8.

(2) Deficiencies in the profile and practice of directors and senior management

During the financial crisis, many deficiencies concerning boards in general and the bank board in particular appeared in a new light, though most of them had been observed and criticized long before. During the years before the crisis, the academic and reform discussion concentrated primarily on the conflict of interest of the board and board members, and on independent directors as the remedy or, according to many at that time, even a panacea. While this has also remained a topic after the crisis, the attention has rightly shifted to qualification. Many bank board members were just not qualified enough to know, understand, and deal with the complexities and risks of modern banking. This led to failures, even in firms and banks where the board was composed according to all good corporate governance standards that were valid at the time. Most dramatic was the failure of the boards of public banks as shown by a recent empirical study by Harald Hau and Marcel P. Thum.[50] In their profile of the 29 largest German banks during the financial crisis, they found that the public banks – in particular the banks of the German *Länder* (states) – had losses between the first quarter of 2007 until the third quarter of 2008 that were three times as high as other privately owned banks. In addition, Hau and Thum analyzed the biographies of 593 supervisory board members of these public banks and found that the management and finance experience of the board members in the other banks was systematically higher than that in the public banks. The correlation between the losses of the banks and the qualification and experience of the bank directors was statistically highly significant and indicated causality between the two.

(3) Complex and opaque corporate and bank structures

Such structures have been shown to be a major impediment to good corporate governance of banks. Banks have failed to create clear responsibility lines throughout the whole bank, and in particular throughout the bank group. Banks belonging to non-bank groups failed to act in the market as far as possible as stand-alone unities and therefore shared the fate of the group as a whole. In bank groups, the contradiction between the interest and the group policy of the parent and the individual interest of the subsidiaries was aggravated by the separate entity principle prescribed by the law. As a consequence, a general corporate governance policy throughout the group was difficult to achieve, since under group law there is no direct order

[50] H. Hau/M. Thum, Subprime Crisis and Board (In)Competence: Private vs. Public Banks in Germany, June 21, 2010, INSEAD Working Paper No. 2010/45/FIN, http://ssrn.com/abstract=1627921. See also the harsh critique by Wohlmannstetter (n. 1) 31, 47 f, 61 f.

line between the parent and the subsidiary. But there is also the flip-side. While the subsidiary bank must follow its own interest for the sake of its own shareholders and creditors, there is always the danger that the parent will impose measures, transactions, or systems of organization that are not in the interest of the subsidiary or, particularly in multinational banks, that are even illegal. These problems arise not only in normal bank group structures, but in a particular way in banks in which matrix and business line organizations are practiced, and if important functions like IT are outsourced either within the group or fully outside.[51] Both concerns – the effectuation of an appropriate group-wide risk policy and bank governance and the avoidance of conflicts of interest and inappropriate and even illegal interventions of major shareholders, especially if this is the state or even a foreign state – are intensified if the structure of the bank is complex or opaque.

(4) Perverse incentives

Bankers' remuneration has become a major concern during the last years. While this was also the case with excessive directors' remuneration in general firms, the case of bankers' remuneration was special insofar as the equity-based remuneration systems there led to very concrete wrong incentives. In particular, investment banking remuneration structures provided an inherent temptation for directors and senior management to generate short-term revenues while taking on high long-term risk. This perverse incentive was even stronger for senior investment bank managers who often earned much more than even the CEO, and it was aggravated by the fact that whole teams competed with each other and the board feared to lose them when tackling the remuneration system. The latter danger was appreciated relatively late, since the discussion on "pay without performance" concentrated for a long time on directors' pay only.

(5) Failures in disclosure and transparency

Disclosure and transparency is an overall goal, but it is seldom achieved in a fully satisfactory way unless enforced by law. Particularly if the bank structures are complex or opaque, the market discipline does not function. In multinational banking groups, the information flow between the bank that is seated in one country and the subsidiary with its seat in another country and vice versa may be impeded not only in practice, but also by national laws that

[51] See Basel Committee 2006 (n. 12) no. 35, 36; K. J. Hopt, *Festschrift für Nobbe* (n. 10) 853, 879.

prohibit information sharing or make it difficult or slow. This not only affects the parent of the group, but also the supervisory agencies of the parent and of the subsidiary. But disclosure and transparency is not only dampened in multinational settings. If new risks are not even adequately seen and understood by the bank board itself, it is difficult for the supervisory agency to grasp them and practically impossible for the shareholders and the debtholders to react to them. In sum, adequate disclosure and transparency was badly lacking, in the first instance for the board itself within the bank and bank group, then for the supervisory agency/agencies, and in the end for the shareholders and the public.

b) The irrelevance theory and the major cause theory in view of these failures

In the discussion of the financial crisis, opinions differ sharply on the contribution of failures in the corporate governance of banks. According to some, the undisputed failures of corporate governance of banks is of minor relevance or even irrelevant for the crisis.[52] According to others, corporate governance in banks – and in particular ill-designed incentive structures – played a "significant role in the genesis of the current financial crisis."[53] This is also a widely held conviction among politicians[54] and the general public. The Walker Review states that "the need is now to bring corporate governance issues close to centre stage."[55]

But in view of the obvious failures in the corporate governance of banks as evidenced in the financial crisis, this is a rather futile discussion. The failures must be corrected, though they seem to have been just one piece in the puzzle. Many other more important causes for the crisis are evident. This is the reason why the regulatory and supervisory reforms, which have

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[52] For example, R. Adams, "Governance and the Financial Crisis," Finance Working Paper No. 248/2009, April 2009, 15 f; J. C. Coates, "Corporate Governance and the Financial Crisis," February 26, 2010 (lecture at Columbia Law School); see also the evaluation by P. Mülbert (n. 6) ZHR 173 (2009) 1, 2: since the outbreak of the financial crisis, the corporate governance of banks has hardly been mentioned, leading to the so-called irrelevancy thesis.

[53] Cf. Nestor (n. 43) 15 regarding "many informed commentators."

[54] For example, the OECD 2010 (n. 17) and the European Commission in its Green Paper (n. 21); but also in academia, cf., e.g., A. Beltratti/R. M. Stulz, "Why Did Some Banks Perform Better During the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation," July 2009, http://ssrn.com/abstract=1433502; R. Fahlenbrach/R. M. Stulz, "Bank CEO Incentives and the Credit Crisis," ECGI Finance Working Paper No. 256/2009.

[55] Walker Review (n. 19) 9. See also P. Mülbert, "Corporate Governance in der Krise," Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR) 174 (2010) 375 ff with a surprisingly different evaluation compared to 2009 (n. 52), and later P. Mülbert (n. 6) 5 f, 7ff with an attempt to delineate time phases in the discussion.

already been enacted or are under way on the national, European, and international levels,[56] rightly extend far beyond corporate governance to capital, liquidity, systemic risk, more competences for the banking supervisory agencies, restrictions on certain transactions and products, and last but not least rescue and insolvency, among others.[57] In this paper, the focus is on the corporate governance of banks insofar as it goes beyond the general corporate governance of firms.

2. Equity governance and debt governance: Parallel and divergent interests of management/board, shareholders, debtholders, and regulators/supervisors

Instead of trying to explain why banks and bank governance are special based on the three general theories mentioned above (i.e., macro-economics, lack of transparency of the bank business, and regulation),[58] the special case of banks and bank governance is best shown by looking at the interests and incentives of the actors (i.e., of the management and the board, the shareholders, the debtholders, and the supervisors) to undertake risks.[59]

a) The directors

The key actors in firms and banks are the directors. This is particularly true in corporations with dispersed shareholdings, though it is less true if there is a controlling shareholder who can have his or her way, at least in the end. The directors – i.e., the board members, or in the two-tier system, primarily the members of the management board – are the ones who run the bank and undertake risks.[60] The interests and incentives of directors in undertaking risk are mixed depending on the circumstances. In theory, directors are less prone to undertaking high risks since they are not diversified like shareholders. But this is true only for such high risks that would endanger their position as directors and only if they understand and evaluate these

[56] See the surveys by A. Guericke, "Regulierungsinitiativen des Basler Ausschusses für Bankenaufsicht in Reaktion auf die Subprime-Kriese und die Finanzmarktkrise – Basel III," in K. J. Hopt/G. Wohlmannstetter (n. 1) 281.
[57] B. Wolfers/T. Voland, "Sanierung und Insolvenz von Banken unter besonderer Berücksichtigung der Vorgaben des Verfassungs- und Europarechts," in K. J. Hopt/G. Wohlmannstetter (n. 1) 315.
[58] Supra I 1 a n. 6.
[59] See in more detail L. Laeven/R. Levine, "Bank governance, regulation, and risk taking," Journal of Financial Economics 93 (2009) 259, http://ssrn.com/abstract=1142967; M. Becht (n. 27) 1615, 1619 ff; Wohlmannstetter (n. 1) 44 ff with a behavioral focus; Mülbert (n. 6) 14 ff, 19 f with a classical principal-agent analysis.
[60] This must be qualified since in large companies it is the executives or senior officers rather than the board who are in charge. In the corporate governance discussion this is usually underemphasized since the focus is on the board and not on the senior executives; an exception is the remuneration discussion that includes senior executives. Cf. infra III 3 d.

risks as such. Normally, undertaking risks opens chances of profit, growth, and reputation, both for the bank and the director. The financial crisis has shown how underdeveloped risk analysis and risk management were and how difficult it is to recognize systemic risks in advance. From behavioral economics we also understand the factor of over-optimism, which is particularly relevant for managers. Equity-based remuneration is a factor that adds to such over-optimism since the pay may be short term while the risk may materialize only in the long term. The prospect of certain short-term revenue may then lead to undertaking much higher risk in the longer term.[61] There are also situations in which directors may be tempted to undertake high risks even if they recognize them fully. This is so in end games, for example – i.e., when the director knows that he or she will have left the bank, either by retirement or by taking a new position elsewhere, before the risk materializes. The financial crisis provided many examples of this type of exaggerated risk-taking by bank directors, sometimes with disastrous results.

b) The shareholders

In terms of the principal-agent analysis, the shareholders should be expected to check director risk-taking since they are the ultimate risk-bearers. Yet the situation is very different depending on the shareholder structure. In a dispersed shareholding structure, the normal shareholders are interested in the share price and the dividends (rational apathy); they do not understand the risks in play and cannot be a counterbalance to the risk-taking of the directors. Quite the contrary, they will push for more bank profit and higher dividends. This is even more the case if they are diversified. So these shareholders cannot be expected to take into consideration the interests of debtholders; in reality, they may actually be risk-prone in the hope that if the risk materializes they will lose only their share while the real losses will be borne by the debtholders.

The rise of institutional shareholders does not change this picture. Usually these shareholders hold only relatively small stakes in the bank and are not interested in internal corporate governance. If they do not like the management, they sell (the Wall Street rule). It is true that more recently much hope has been placed on them as possibly active shareholders, and

[61] This is true as well for senior bank officers who receive equity-based remuneration and other bonuses depending on transactions and short-time profit; cf. infra III 3 d. Particularly in investment banking, their revenue is often higher than that of the CEO.

regulators and legislators have pushed them to engage themselves more actively in the internal corporate governance of the firm and the bank.[62] But there is justified skepticism.[63]

If there is a controlling shareholder or a major blockholder in the bank, the interest and incentives differ. These shareholders may be better qualified to understand the risk and motivated to oppose excessive risk-taking since they have a clear stake in the firm or bank. Yet this is not necessarily the case. Controlling shareholders have their own agenda, in particular in the case of bank groups and multinational groups. Risks taken and borne by one member of the group may benefit the parent or another member of the group. In addition, controlling shareholders are subject to over-optimism and the temptation of empire-building.

c) The debtholders

For the corporate governance of banks, it follows that equity governance is insufficient, even if the model of shareholder profit maximization is discarded in favor of the enlightened shareholder approach.[64] It must be complemented by some sort of debt governance that is more geared toward avoiding excessive risk-taking by the bank. The debtholders are interested not in the profit of the bank as such – which stays in the bank or goes to the shareholders – but in being paid. They are therefore risk-averse, especially to ex post risk extension. Yet as in the case of shareholders, the interest and incentives of the debtholders differ widely. The employees of the bank are usually interested only in their pay and are not in a position to understand and evaluate risks taken, which, if they were to materialize, might endanger their job. Labor codetermination in the board does not change this diagnosis substantially.[65] The same is true for small bondholders and other creditors. They are usually diversified and, in any case, they are not in a position to understand and evaluate excessive risk-taking, quite apart from lacking the legal standing and rights to oppose this.

These interests and incentives are different for large debtholders.[66] Like major shareholders, they may be better qualified to understand the risk and motivated to oppose excessive risk-taking. Yet again, they may not be the ones to whom debt governance could be entrusted.

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[62] See, for example, the UK Stewardship Code and the Green Paper of the European Commission (n. 21) no. 5.5.
[63] As to the sobering international experiences in this respect, see K. J. Hopt, American Journal of Comparative Law LIX (2011) 1, 48 ff.
[64] Cf. K. J. Hopt, American Journal of Comparative Law LIX (2011) 1, 28 f.
[65] See infra III 1 a.
[66] Wohlmannstetter (n. 1) 49 f.

Large creditors such as banks are usually secured creditors. As such, excessive risk-taking does not affect them directly as long as the secured credit is not affected. Therefore, the final losses are often borne by the dispersed and other non-secured creditors. Indeed, they may even be tempted to extend new secured credit for higher risk-taking by the bank at the expense of the non-secured creditors who may not even know about this dangerous prolongation of the crisis until it is too late for rescue.[67] Nevertheless, it is true that if the bank gets into financial difficulties, the banks and other large debtholders become more active and try to influence the management. Yet this may come at too late a stage or, if the bank gets too involved in the management, there is even the risk that the bank could be treated by law as a de facto director and/or shareholder and as such held liable for the losses.[68]

d) The regulators and supervisors

From the foregoing analysis, it has become clear that the actors mentioned above – directors, shareholders, and debtholders – are not solely in a position or cannot be expected to look after an appropriate level of the special corporate governance needed in banking. Regulation and supervision must step in also in the corporate governance of banks. Sometimes the supervisors and even governments are counted among the protected stakeholders.[69] This is in line with a very broad concept of stakeholders and stakeholder orientation for the board in some countries. Yet the experience with the latter is mixed. As long as the stakeholders do not have their own standing to enforce this orientation, such an orientation leaves the balancing of the interests and the final decision-making to the board – and rightly so, since this is necessary for acting and reacting in a competitive market.

For the regulators and supervisors this is different. Their very task is to intervene, but to intervene only on the basis of legitimization by law and only insofar as interference in the play of the market is necessary. Therefore, it is not a question of interests and incentives of the supervisors, but rather of the maintenance of financial stability of the banking system (not by maintaining individual banks) and, more specifically, of corporate governance of banks insofar as this contributes, though only indirectly, to such stability.[70] As far as corporate governance and debt governance are concerned, the intervention of regulation and supervision

[67] For the worst cases, there are legal remedies in tort law (lender liability) and in insolvency law.
[68] There are various and rather different national doctrines on this in corporate law, tort law, and insolvency law.
[69] Basel Committee 2010 (n. 13) no. 13 note 11.
[70] Cf. E. Wymeersch (n. 12); Mülbert (n. 6) 21 ff develops the “supervisors’ perspective” by looking at the Basel Committee 2006 (n. 12; but further developed and in part overtaken by Basel Committee 2010, n. 13).

can therefore be considered as the necessary reaction to the failure of shareholders and debtholders to achieve appropriate corporate governance of the bank. As far as the functional relationship between corporate governance of the bank and banking regulation and supervision is concerned,[71] it is a rather obvious insight that bank regulation and supervision are more on the side of the debtholders than of the shareholders.

3. The ambiguous role of deposit insurance and bail-out

The financial crisis has given new impetus to the old discussion on deposit insurance and bail-out systems. The pros and cons of these instruments are well known in theory and practice and need not be taken up here again. While both seem unavoidable in real life – the first for consumer protection reasons and the second under the slogan "too big to fail" – it is undisputable that they have severe drawbacks for the interests and incentives of the debtholders. The negative side effect of deposit insurance is the danger of increasing risk-taking on the side of the bank directors and of less prudence and free-riding on the side of the depositors.[72] Similarly, the negative side effect of bail-out is the temptation of undertaking higher risks for more profit at the expense of the taxpayer, of less care of the bank creditors, and of falsifying competition.[73] The point in the context of this paper is that these two instruments reduce the interests and incentives of the above-mentioned actors in the corporate governance of the banks even more. The task of the regulators and supervisors is then to try to make up for these negative effects by a reform of the deposit insurance system[74] and by bank insolvency regulation,[75] both preferably not only in disparate ways at the national level but harmonized to the necessary degree on a European or even international level.

III. Internal corporate governance of banks: Corporate and supervisory law reform measures under discussion

We have seen in the first two parts of this paper that banks are special and that the corporate governance problems of banks differ from those of general firms. Corporate governance of

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[71] As to this in detail, Mülbert (n. 6) 25 ff.
[72] M. Weber/S. Steffen, "Thesen zur Reform des Einlagensicherungssystems," in K. J. Hopt/G. Wohlmannstetter (n. 1) 303.
[73] Mülbert (n. 6) 17 f; M. Weber/S. Steffen (n. 72), Wohlmannstetter (n. 1) 49.
[74] M. Weber/S. Steffen (n. 72).
[75] Most recently B. Wolfers/T. Voland (n. 57).

banks cannot be restrained to equity governance but must be broadened to debt governance. The analysis of the interests and incentives of the actors in the corporate governance of banks has shown that debt governance cannot be entrusted to debtholders alone, but that supervisory and regulatory intervention is needed. The legal and regulatory problem is then the measure by which an appropriate level of debt governance can be reached. The proposals in academia as well as the reforms and reform agendas in practice show a bewildering multitude of interventions into the free play of banking business. The object of the third part of this paper is to take stock of this armory and to evaluate it. The focus is on internal corporate governance of banks – i.e., on corporate and supervisory law reform measures – rather than general bank regulation such as stiffer requirements on banks regarding equity, structure, products, and transactions. A number of less suited corporate law reforms will first be dealt with rather succinctly (III 1), since mere corporate law intervention without being bolstered by supervision is less promising. Then internal corporate governance requirements under the shadow of bank supervision will be analyzed in some detail and divided into supervisory law requirements for board and bank structure and internal procedures (III 2) and for people (board, management, major shareholders, III 3).

1. Less suited corporate law reforms (stakeholder governance, stakeholder goal, duties and liabilities, hybrid capital)

a) Stakeholder governance for banks?

The debtors who are nearest to the corporation are the workforce. Under most countries' corporate law, labor does not participate in the corporation like the shareholders but is a special group of debtor, though as such it is privileged in many ways. This privilege is usually granted by labor law, like collective bargaining and codetermination by a work council, but in EU member states often also by up to one-third labor codetermination on the board, and in Germany even by a quasi-paritary codetermination. Since the workers have an interest in stable work places while debtors in general are only interested in getting paid, one might expect that labor codetermination in banks would serve as an ideal means of debtor governance. Unfortunately, practice shows that this is not the case. The workforce is very often interested only in maintaining and improving their salaries and working conditions, and the trade union representatives may pursue general, sometimes ideological working class purposes. A real interest in and control of risk-taking in the firm or in the bank at the expense of profit and better wages is not recognizable. [76]

Another proposal is to have the debtors represented in the board of the bank by one or more representatives of the deposit insurer[77] or of the bank supervisor.[78] The former would be expected to caution against risk-taking, which might affect the deposit insurer. The latter should bring the concerns of bank supervision right into the decision-making of the supervisory board. But quite apart from the concern of the already too big German supervisory boards (for larger enterprises usually 20 members), this would fractionize the supervisory board even more. The bank supervisory agency already has the right to participate in board meetings if it deems it necessary. Having permanent representation there would mingle supervision and decision-making too much and risk making supervision co-responsible for bad decisions. Furthermore, the experience with state representatives is bad, indeed, as shown in cases of state-owned or state-controlled banks, especially the German *Landesbanken* and their disastrous involvement in the financial crisis.[79] Political appointees and political influence have been and are costly for the banks and debtholders.[80]

b) Stakeholder goal for banks?

Constituency clauses for labor can be found in many countries. They impose on the board the duty to act in the interest of labor as well, i.e., to find an adequate balance of shareholder and labor interests in the firm. The proposal of also having a constituency clause for the debtholders is not new. In German corporate law, for example, the management board has to act in the interests of the firm, including the interest of the debtholders. Yet this proved not to make a difference for the risk-taking of the banks before the financial crisis. Constituency clauses leave it to the discretion of the board how to weigh the interests and let the board act under the business judgment rule. Some cynics have observed that such clauses serve labor

[76] Wohlmannstetter (n. 1) 58 f.
[77] Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie, Reform von Bankenregulierung und Bankenaufsicht nach der Finanzkrise, Gutachten Nr 3/10, April 2010. For more nuance, see M. Becht (n. 27) 1615, 1625 f.
[78] G. Wohlmannstetter, "Corporate Governance von Banken" in P. Hommelhoff/K. J. Hopt/A v Werder (n. 5) 905, 921. In order not to hamper labor codetermination in the board, the suggestion is to have two representatives, one in place of one member of the shareholder side and the other in place of a labor representative.
[79] Infra III 3 a.
[80] Cf. also Basel Committee (n. 13) no. 59.

(and the debtholders) only if and as far as their interest coincides with the interest of the management.[81]

c) Strengthening legal duties?

In the United States, an early proposal to foster debtholder interest extends the fiduciary duties of the directors toward the debtholders.[82] This proposal refers explicitly to the constituency clause of the Franco-German corporate governance model. It is submitted that it would be more successful in the United States because of the well-developed private enforcement system there. The proposal is coupled with the right of creditors, including the Federal Deposit Insurance Corporation, to sue bank directors for damages, and with other measures tightening up bank directors' liability. Since the financial crisis, similar ideas have spread to other countries; one of the proponents of tight liability for bank directors in Germany is Marcus Lutter.[83] Yet a special liability regime for bank directors is problematic, and unless the concept and requirement of civil (or even criminal) liability is curbed (such as fault, business judgment rule,[84] causation), there is little hope to make real progress.[85] Imitating the American private enforcement system with its blatant abuse possibilities would hardly be welcome under the European tradition. On the other hand, the remark that "even nominal liability" might be useful[86] is rather cynical. This is not to say that directors should not be held liable if the legal requirements are fulfilled. Indeed, directors' liability cases have sharply increased since the financial crisis, and the former under-enforcement status quo seems to be changing.[87]

d) (Financial) liability?

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[81] K. J. Hopt, American Journal of Comparative Law LIX (2011) 1, 29.
[82] J. R. Macey/M. O'Hara (n. 26) 102 f; A. Mullineux, "The corporate governance of banks," Journal of Financial Regulation and Compliance 14 issue 4 (2006) 375; A. Mullineux (n. 27) 375, 377; also OECD 2009 (n. 16) 46: "There might be a need to strengthen the legal duties of board members and to improve enforcement possibilities." More generally as to the duty of care of bank directors, Basel Committee 2010 (n. 13) no. 24.
[83] His views are articulated in many articles, but they are considered too extreme by the vast majority of other opinions.
[84] Cf. Basel Committee 2010 (n. 13) no. 22 n 15.
[85] In the end also OECD 2010 (n. 17) no. 62 f; G. Bachmann, "Corporate Governance nach der Finanzkrise," Die Aktiengesellschaft 2011, 181, 186 concerning the obligatory deductible and the extension of the statute of limitation for directors in Germany; P. Mülbert (n. 6) 38: "[B]anks are entrepreneurial risk-takers just like any generic corporation."
[86] OECD 2010 (n. 17) no. 64.
[87] One must not look just at court decisions but more for settlements with D&O insurers and in arbitrations.

Looking back at the history of Wall Street, it's interesting to remember that in earlier times bankers used to be partners who were personally liable for losses. One might even consider forcing banks into a legal form of partnership that would make the directors personally liable. Yet limited liability has been a response to the needs of industrialization and modern risk-taking, and it would be utterly ahistorical to deny it to a special class of business.[88] Another still rather sketchy idea is to look for a kind of product liability for risky financial products together with the general far-reaching personal liability of directors in case of damages by financial products. This would go far beyond the traditional liability of banks for wrong or inappropriate advice and omission of warning, a liability with which the courts have long and good experience and which they have considerably stiffened after the financial crisis.[89]

e) Hybrid capital

One short note on hybrid capital must suffice here. The idea of a mandatory subordinated debt policy and of contingent convertible bonds is an interesting contribution to solve the bank insolvency problem and may indeed help to broaden the financial base of banks in case of financial difficulties. The side effect of this measure – i.e., broadening the debtholder group and expecting better risk control from them – would be welcome, but in practice it may be overestimated, quite apart from political and practical difficulties of implementation.[90]

2. Supervisory law requirements for board and bank structure and internal procedures

The board is the key organ of the firm and the bank and has the overall responsibility. According to the Basel Committee, this is the very first principle; in the case of banks in particular, it includes the responsibility for "approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values" and includes oversight of senior management.[91] The overall most important responsibility

[88] C. A. E. Goodhart, "The financial crisis and the structure of contracts," policy comment, 17 December 2009.
[89] For Germany, see A. Baumbach/K. J. Hopt (eds.), Handelsgesetzbuch (35th ed., C. H. Beck, Munich 2011) comments to § 347 including the spectacular Deutsche Bank decision of the Bundesgerichtshof.
[90] Cf. Wohlmannstetter (n. 1) 51. See already Board of Governors of the Federal Reserve System/U.S. Department of the Treasury, The Feasibility and Desirability of Mandatory Subordinated Debt, December 2000.
[91] Basel Committee 2010 (n. 13), Principle 1 (before no. 21). Cf. the study of D. Ferreira/T. Kirchmaier/ D. Metzger, "Boards of Banks Around the World," ECGI papers.ssrn.com/sol 3/papers.cfm?abstract_id=1620551. On the role of the board in corporate governance, cf. K. J. Hopt, American Journal of Comparative Law LIX (2011) 1, 19 ff.

concerns the strategic objectives and the risk strategy.[92] The special responsibilities for corporate governance[93] and oversight of senior management[94] are spelled out by the Basel Committee in special principles. Therefore, the focus must be in the following on the board, and in particular on board and bank structure and internal procedures (III 2) and on the board profile (III 3 a).[95]

a) Two-tier board for banks

The most far-reaching requirement for the structure of the bank board is the mandatory separation of the board into a management board and a supervisory board. While this is the normal structure in all corporations in the two-tier board countries such as Germany and Austria, this is required specifically for banks even in some one-tier board countries such as Switzerland and Belgium.[96] These countries have had good experiences with this separation, especially in risky businesses such as banks. But it must be recognized that in many other one-tier board countries, the risk and control problems of banks can also be dealt with without such a mandatory separation, since the one-tier board is flexible by nature and can be adapted to various demands.[97]

b) Group-wide corporate governance for banks

Today most banks belong in some way or another to a group, very often an international group. While legal theory upholds the principle of separate entities, the risks undertaken within the group – either by the parent bank or by the subsidiary bank – may affect the whole group. While this is also the case for general groups, it is even more so for financial groups since they depend much more on confidence and reputation. Therefore, the board of the parent company has the overall responsibility for adequate corporate governance across the

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[92] Emmenegger (n. 1) 414 ff, referring to the Basel Committee and to the Swiss FINMA: the bank management's responsibility is primarily the responsibility for risk.
[93] Basel Committee 2010 (n. 13) Principle 3 (before no. 40).
[94] Basel Committee 2010 (n. 13) Principles 5 (before no. 65).
[95] This sequence more or less follows the Basel Committee 2010 (n. 13) nos. 20 ff: III A-F and in description of it Emmenegger (n. 1) 414 ff: keypoints I-VII. Other sequences are possible, e.g., Mülbert (n. 6) 34 ff..
[96] Article 3 section 2 lit a of the Swiss Banking Law; J.-B. Zufferey, "Private Banking Governance," Zeitschrift für Schweizerisches Recht 2007, 235, 252 ff; J. Devriese et al. (n. 27) 95, 114; K. J. Hopt, *Festschrift für Nobbe* (n. 10) 853, 869. The principles of the Basel Committee apply to the one-tier as well as the two-tier board systems; cf. Basel Committee 2010 (n. 13) no. 10. In many reports and contributions, the distinction between both systems is neglected, sometimes with unanticipated side effects; K. J. Hopt, *Festschrift für Nobbe* (n. 10) 853, 869 f.
[97] Cf. generally K. J. Hopt (n. 1) American Journal of Comparative Law LIX (2011) 1, 20 ff.

group.[98] This group-wide responsibility of the board for corporate governance is complemented by a group-wide responsibility for risk management.[99] Yet it must be seen that this postulate, as sound and indispensible as it is, is faced with many technical legal problems due to the entity principle, which separates the rights and duties of each legally independent entity. The Basel Committee acknowledges this by this prudent formulation: "[T]he board of the parent company should: ... have appropriate means to monitor that each subsidiary complies with all applicable governance requirements."[100] These difficulties concern the realization of a group-wide internal corporate governance[101] as well as the group-wide audit[102] and the group-wide supervision.[103] These difficulties are mirrored by the responsibility of the board of a bank subsidiary. While this board should follow the group-wide corporate governance standards, it has its own responsibility to the subsidiary for the legality of the measures and the management and financial health of the subsidiary.

c) Less opaque and, if possible, less complex bank structure

The monitoring task of the board is made more difficult if the bank structure is complex and opaque. This concern is very acute as quite a number of bank failures before and during the financial crisis have evidenced. While it seems to be a truism to require the board to know the bank structure, there is unfortunately good reason for the Basel Committee to lay this down in a separate principle: "Know your structure."[104] Streamlining the structure of the bank would certainly be better, but as the Basel Committee acknowledges, in multinational banking in particular there are many legal, tax, economic, and political reasons for complex structures, such as special purpose vehicles, for example. The Basel Committee therefore requires only that the board be aware of all the complexity: "Understand your structure."[105] This should go together with disclosure and transparency.[106]

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[98] Basel Committee 2010 (n. 13) Principle 4 (before no. 61); K. J. Hopt, *Festschrift für Nobbe* (n. 10) 878 f; OECD 2009 (n. 16) 40.
[99] Basel Committee 2010 (n. 13) Principle 7 (before no. 80); see infra III 3 a.
[100] Basel Committee (n. 13) no. 62 at the end.
[101] See the detailed study by J.-H. Binder, "Interne Corporate Governance im Bankkonzern," in K. J. Hopt/G. Wohlmannstetter (n. 1) 685; A. Erdland/A. Neuburger, "Corporate Governance von Finanzkonglomeraten," in K. J. Hopt/G. Wohlmannstetter (n. 1) 717.
[102] E. Andriowsky, "Herausforderungen bei der Prüfung eines Bankkonzerns," in K. J. Hopt/G. Wohlmannstetter (n. 1) 735.
[103] S. Lautenschläger/A. Ketessidis, "Führung von gruppenangehörigen Banken und ihre Beaufsichtigung," in K. J. Hopt/G. Wohlmannstetter (n. 1) 759.
[104] Basel Committee (n. 13) Principle 12 (before no. 114).
[105] Basel Committee (n. 13) Principle 13 (before no. 120); S. Emmenegger (n. 1) 419.
[106] Cf. H. Merkt, "Transparenz der Banken und des Bankgeschäts als Element der Corporate Governance von Banken," in K. J. Hopt/G. Wohlmannstetter (n. 1) 117.

d) Risk management and internal control

Risk responsibility is the board's main task, and it implies risk management and internal control.[107] This has consequences for the organization of the board, the organization of management, and the risk management and internal control as such.

For the board, the question is whether – apart from the normal three committees – a special risk committee should be created. By the end of 2008, 52% of the 25 largest European banks possessed a stand-alone risk committee – i.e., not just a combined audit and risk committee – but no correlation was found between such a committee and crisis avoidance.[108] Sometimes in addition to the board risk committee, a separate risk management committee is created with members from across the firm.[109] The Walker Review holds that the FTSE 100 listed bank or life insurance companies should establish a board risk committee that is separate from the audit committee.[110] The Basel Committee is more careful, stating that for many banks, especially those that are large and internationally active, a board risk committee is "appropriate."[111]

In addition, there seems to be a consensus that an independent risk management function should be created within the management of banks.[112] The best solution is a chief risk officer/CRO,[113] i.e., a central risk management function that is responsible for all the bank's principal risks. As late as 2007, a CRO was on the board of only one of the 25 largest

[107] Cf. Emmenegger (n. 1) 422 ff; S. Emmenegger/R. Kurzbein, "Finanzmarktkrise und neue Corporate Governance von Banken," Schweizerische Zeitschrift für Gesellschafts- und Kapitalmarktrecht sowie Umstrukturierungen (GesKR) 2010, 462, 463 f; P. Gann/B. Rudolph, "Anforderungen an das Risikomanagement," in K. J. Hopt/G. Wohlmannstetter (n. 1) 601; Mülbert (n. 6) 28; Roggenbuck, "Die Bedeutung der Internen Revision in der Corporate Governance von Banken," in K. J. Hopt/G. Wohlmannstetter (n. 1) 627. The controversy found in academia and in practice on separate functions and responsibilities of risk management, internal control, internal audit, and compliance (cf. CEBS (n. 10) 16: Internal control comprises risk control, compliance and internal audit) is less relevant for the purposes of this paper. Regarding compliance, see D. Auerbach/O. Jost, "Bedeutung und Aufgaben der Compliance-Funktion," in K. J. Hopt/G. Wohlmannstetter (n. 1) 651.

[108] Nestor (n. 43) 10.

[109] Basel Committee 2010 (n. 13) no. 98.

[110] Walker Review (n. 19) Recommendation 23; OECD 2009 (n. 16) 9.

[111] Basel Committee 2010 (n. 13) no. 52.

[112] Basel Committee 2010 (n. 13) Principle 6 (before no. 69); Walker Review (n. 19) Recommendation 24; Nestor (n. 43) 12 f; and many others.

[113] S. Schmittmann, "Die Rolle des Chief Risk Officer unter Corporate-Governance-Gesichtspunkten," in K. J. Hopt/G. Wohlmannstetter (n. 1) 481. A separate CRO may be too burdensome for smaller banks, but even in very small banks at least the "four eyes principle" should be implemented as is already prescribed by the bank supervisory law of various countries; Basel Committee (n. 13) no. 70.

European banks.[114] Independence of the CRO is key. This means that the CRO should be an executive officer who is embedded but independent of the line businesses, specifically the profit centers; therefore, the CRO is to a considerable extent also independent of the CEO.[115] In principle, there should not be dual-hatting, i.e., the COR, CFO, chief auditor, and other senior management should not simultaneously fulfill the function of the CRO.[116] There should also be special safeguards concerning the removal of the CRO, i.e., consent of the board and public disclosure in general.[117] Quick and direct information flow is essential.[118] The CRO should have a direct reporting line not only to the CEO or CFO, but also to the board or the board risk or audit committee with direct access to the chairman of the committee if needed.[119] The Basel Committee also recommends that the non-executive directors have the right to regular meetings with the CRO in the absence of senior management.[120] Since the board normally gets its information from the CEO and, with the CEO's help, from other management, in order to avoid distrust it is recommended that the contacts of the CRO with the board be documented.[121]

Regarding risk management and internal control as such, there are detailed descriptions and recommendations in the various codes, reports, and comments.[122] This is not the place to get into this here. Engaging in new risks as well as not paying attention to creeping risks is particularly dangerous. There is also the timely warning against excessive reliance on risk models without adequately questioning the assumptions and neglecting other scenarios, in particular embedded assumptions, and against the danger of credit ratings and externally purchased risk models.[123] Overconfidence in "star employees"[124] is rightly mentioned, too. New products may involve new risks, and the risk structure of the clients may also present a danger to the bank.[125] The complex or opaque structures mentioned previously also contribute

[114] Nestor (n. 43) 13.
[115] Basel Committee 2010 (n. 13) no. 72: "independence of the CRO is paramount"; OECD 2010 (n. 17) nos. 39, 40.
[116] Basel Committee 2010 (n. 13) no. 71
[117] Basel Committee 2010 (n. 13) no. 74. The practice of some banks to make use of rotation to better know the bank is also mentioned, though not specifically recommended; idem no. 80 note 27.
[118] As to whistle-blowing without reprisal as a legitimate part of the information system, see Basel Committee 2010 (n. 13) no. 31.
[119] Walker Review (n. 19), Recommendation 24; Basel Committee 2010 (n. 13) principle 8 (before no. 92).
[120] Basel Committee 2010 (n. 13) no. 72.
[121] Basel Committee 2010 (n. 13) no. 72.
[122] See, e.g., Basel Committee 2010 (n. 13) Principle 6 and no. 69 on five components of risk management and Principle 7 (before no. 80) on risk methodologies and activities. As to the principles and codes of the New York Stock Exchange, the UK Combined Code, or the French MEDEF code, see OECD 2009 (n. 16) 33 ff.
[123] Basel Committee 2010 (n. 13) nos. 84 ff, 97.
[124] Basel Committee 2010 (n. 13) no. 104.
[125] Basel Committee 2010 (n. 13) nos. 88, 121,

to this, in particular those in bank groups and multinational banks. Risks must be identified and monitored on an ongoing, firm-wide, and individual entity basis, and there must be no "organizational silos."[126]

At the end, what counts is the development of a culture of risk awareness that comprises the internal pricing of the risk, defines the risk appetite, and implements this through well-established risk management throughout the whole bank and bank group in an integrated effort of the different functions of risk management, internal control, and compliance.[127] Whether all this really works depends to a considerable degree on the "tone at the top," and this leads us back to the beginning: Risk responsibility is a main task for the board.

3. Supervisory law requirements for people

In the preceding section, supervisory law requirements for board and bank structure and internal procedures were examined. Many of them were particular to banks and financial institutions. In the following section, the supervisory law requirements for people are analyzed, primarily concerning the board (III 3 a) but also the management (III 3 b), the blockholders (III c), and, at least regarding remuneration, particular groups of employees even underneath the top management (III d). While most of these requirements are not relevant only for banks, their specific feature in the context of banks is that they do not only result from general corporate law but are taken up and implemented by bank supervisory law. Legally speaking, this gives them not only the character of public law rules with consequences for the competent courts in the case of dispute and law suits, but it adds a most important enforcement dimension that is lacking for the corporate governance of firms generally.

a) Profile and practices of the bank board

Since the board is the key organ with the overall responsibility for the bank's corporate governance,[128] the profile and practices of the bank board are paramount. While the election of the board of the firm is a matter only for the shareholders (with the exception of labor

[126] Basel Committee 2010 (n. 13) Principle 7 (before no. 80), idem no. 98 with a working definition of organization silos; see supra III 2 c.
[127] Basel Committee 2010 (n. 13) 20
[128] Supra III 2 at the beginning.

representatives in case of labor codetermination), for bank board members the banking supervisory agency has the right to approve the election or, under certain circumstances, to relieve them of office. The supervisory agency screens bank directors under a fit and proper test,[129] and it takes this much more seriously now than before the financial crisis.

Conflicts of interest and independence of board members of the firm have been considered particularly important in recent years, not only for firms but also for banks.[130] Apart from independence requirements for certain board members and for board members of the three key committees (nomination, remuneration, and audit, with at least a majority of independent directors in the latter) in many states' company law, stock exchange rules, and corporate governance codes, such principles also exist specifically for bank boards. According to the Basel Committee, the board should have a formal written conflict-of-interest policy and an objective compliance process for implementing this policy.[131] In the Green Paper of the European Commission on corporate governance of financial institutions, the question of conflicts of interest is mentioned prominently with the obvious intention of going beyond the existing European rules, such as in the MiFID and other directives.[132] The Swiss Banking Authority requires that at least one-third of the bank board members must be independent.[133] The audit committee should be composed exclusively of non-executive or supervisory directors, and at least a majority of its members should be independent.[134] Yet national and international rules differ widely on the meaning of independence.[135] There are particular differences of opinion as to whether representatives of a controlling shareholder or of labor under labor codetermination may be considered independent. With the two-tier board system, it must be kept in mind that the incompatibility of seats both in the management and the supervisory board is not the same as independence.

A special concern that first arose in the UK is the separation of the positions of CEO and chair of the board. In some countries, such as Germany, there is even a mandatory two-year waiting period before the chairman of the board or another board member may be elected to the

[129] Basel Committee 2010 (n. 13) no. 35 with n. 17; OECD 2010 (n. 17) 20 f; Mülbert (n. 6) 29 f; S. Emmenegger/R. Kurzbein (n. 106) GesKR 2010, 462, 470 ff.

[130] Basel Committee 2010 (n. 13) no. 38 note 18, nos. 55 ff; OECD 2010 (n. 17) 20 f; Emmenegger (n. 1) 405, 416; Wohlmannstetter (n. 1) 59 ff.

[131] Basel Committee 2010 (n. 13) no. 56.

[132] European Commission, Green Paper (n. 21) sub 3.1.

[133] S. Emmenegger/R. Kurzbein (n. 107) GesKR 2010, 462, 470.

[134] European Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, L 52/51 25.2.2005, Annex I 4.1.

[135] K. J. Hopt, American Journal of Comparative Law LIX (2011) 1, 35 f.

supervisory board, unless the election is on the application of more than 25 per cent of the shareholders.[136] The Basel Committee expresses a similar concern, though it is rightly more flexible than the German mandatory solution.[137] Empirical studies have found that when the former CEO held the position of board chair, performance was better.[138]

The qualification of board members, and particularly bank board members, has always been on the agenda. Yet after the financial crisis and the bad experiences with bank boards, the pendulum has swung toward more qualification. The primordial relevance of qualification is underlined by principle 2 of the Basel Committee and the following requirement: "The board should possess, both as individual board members and collectively, appropriate experience, competencies and personal qualities, including professionalism and personal integrity."[139] While there is no necessary trade-off between independence and competence,[140] it may well be that there are cases in which qualification may be more important than independence, since independent directors lack information.[141] During the financial crisis, banks receiving bailout money had boards that were more independent.[142] Particular problems arose at state-owned bank such as the German *Landesbanken*, where in general the directors were less qualified than their colleagues in non-state-owned banks. Empirical studies found a clear correlation between less qualification and more financial difficulties.[143] According to the former chairman of the Committee of European Banking Supervisors (CEBS), independent directors should not only be independent but first and foremost knowledgeable; more insiders on the board (including the former CEO) might also contribute to better performance, as empirical evidence suggests; and fully independent boards may even be dangerous.[144] At least the chair

[136] § 100 subsection 2 no. 4 of the Stock Exchange Act.
[137] Basel Committee 2010 (n. 13) no. 38 note 19: ". . . If the board deems it to be in the interest of the company to have this person serve on the board, appropriate processes to mitigate the potential conflicts of interest should be put in place, such as a waiting period and/or a description of matters on which the person should recuse himself or herself to avoid a conflict of interest."
[138] Nestor (n. 43) 9.
[139] Basel Committee 2010 (n. 13) Principle 2 (before no. 34) and no. 35.
[140] OECD 2009 (n. 16) 46; OECD 2010 (n. 17) 21. But see also J.-B. Zufferey (n. 96), 235, 255 ff: "La composition du conseil entre indépendence et compétence."
[141] R. Adams (n. 52) 16.
[142] R. Adams (n. 52) 15 f.
[143] H. Hau/M. Thum (n. 50); G. Wohlmannstetter (n. 1) 61 f describes this correlation and the ensuing watering down of qualification requirements for German state-owned banks due to the public bank lobby (bank and insurance supervisory statutes in Germany). See also OECD 2010 (n. 17) 20; Basel Committee 2010 (n. 13) no. 19.
[144] E. Wymeersch (n. 12) 10; for France, see also R. Ricol, Report on the Financial Crisis, September 2008, http://www.tresor.bercy.gouv.fr/directions_services/sircom/rap_ricol080905_ang.pdf.

should be reserved for financial industry experts since there is a clear positive relationship between the financial industry expertise of the chair and bank performance.[145]

This shows a need for better qualification[146] and more professionalization of bank non-executive directors,[147] according to some even for more full-time non-executive board members for bank boards, and for more training of directors for the job and continuing training, especially in banks.[148] More and better evaluation is needed, too. In this context, a shift from internal self-evaluation to external, independent evaluation can be observed more generally.[149] As the Basel Committee put down in its principle 2: "Board members should be and remain qualified, including through training, for their positions."[150]

b) Profile of the bank management

In the discussion, the appropriate profile and practices of the bank board are at the forefront. But it should not be overlooked that the profile of the bank management is most important as well. In the two-tier board system, this concerns the management board; in the one tier-board systems it concerns the top managers and senior management. The latter are explicitly mentioned in many of the reports. The Basel Committee, for example, holds in its principle 5 that "[u)nder the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board."[151] Accordingly, senior management should have the necessary experience, competencies, and integrity for their job.[152] Particular functions embedded in the management – such as the chief risk officer, the chief compliance officer, the head of internal control and of internal auditing, and others – have been treated above as parts of good corporate governance of banks. The board has a particular responsibility for the selection, control, and succession planning concerning bank management.[153]

c) Fit and proper test for major shareholders

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145 Nestor (n. 43) 9.
146 A survey of the ZEW Mannheim of March 2010 found that 94 per cent of 222 financial market experts hold better qualifications for the most promising bank board reform measure; ZEWnews March 2010, 2.
147 Nestor (n. 43) 11.
148 OECD 2009 (n. 16) 10; OECD 2010 (n. 17) 20.
149 Nestor (n. 43) 11; see also OECD 2010 (n. 17) 19 et s.; Basel Committee 2010 (n. 13) no. 43.
150 Basel Committee 2010 (n. 13) Principle 2 (before no. 34).
151 Basel Committee 2010 (n. 13) Principle 5 (before no. 65).
152 Basel Committee 2010 (n. 13) no. 65.
153 K. J. Hopt, *Festschrift für Nobbe* (n. 10) 872; CEIPOS, Risk Management and Other Corporate Issues, 17.7.2007.

Controlling shareholders and blockholders must not be forgotten.[154] It is already part of supervisory law in banking[155] and insurance supervision that they must be fit and proper or – in the words of the EU banking law directive – suitable; in addition, the supervisory agency has to examine their suitability and, if the case warrants, may refuse to grant authorization to the bank and block the transaction. They are important actors in the corporate governance of firms and banks.[156]

d) Appropriate incentives or at least eliminating bad incentives: The case of remuneration

Selecting the right persons as directors and imposing duties and liabilities on them is the traditional way of the law. But finding the right incentives, or at least eliminating bad incentives, may be more effective in the end. Remuneration is one example of this. Remuneration of directors has become one of the major topics of corporate governance of firms in many countries, and it is a concern and an area of its own well beyond corporate governance. This has been partly driven by a corporate governance concern, but also by more distant motivations such as envy and the (legitimate) fear that too great disparities between management and labor may endanger peaceful co-existence in modern, transparent societies.[157] There are a host of new rules on the national and European levels on remuneration in banks concerning, for example, the ratio of fixed to variable pay, deferral, potential clawback of annual bonuses, and more generally the need for risk-adjusted performance measures.[158] The Guidelines on Remuneration by the Committee of European

[154] Cf., e.g., Basel Committee 2010 (n. 13) no. 60 in the context of conflicts of interest and influence exercised on board members appointed by the controlling shareholder.
[155] Art. 12 subsection 2 and Art. 19 of the EU directive of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJEU L 177/1, 30.6.2006: "suitability" of the acquirer of a qualifying holding in a credit institution, "in view of the need to ensure sound and prudent management of the credit institution."
[156] K. J. Hopt, American Journal of Comparative Law LIX (2011) 1, 44 ff.
[157] Cf. the discussion on mandatory fixed amount caps for directors' remuneration. Such caps should be set only for banks in difficulties that receive state assistance. For example, in Germany the cap is 500.000 €. These are not about corporate governance but about saving taxpayer money.
[158] Basel Committee, Compensation Principles and Standards Assessment Methodology, January 2010; Financial Stability Board (formerly the Financial Stability Forum), Sound Compensation Practices, April 2009, and Sound Compensation Practices and Implementation Standards, January 2010; OECD 2009 (n. 16) 14 ff with tables and international comparisons, also on say on pay. Cf. with references Mülbert (n. 6) 30 ff; Bachmann (n. 85), Die Aktiengesellschaft 2011, 181, 187 ff; Emmenegger (n. 1) 405, 420 ff; Wohlmannstetter (n. 1) 31, 66 f; K. J. Hopt, American Journal of Comparative Law LIX (2011) 1, 40 ff.

Banking Supervisors of 2010 comprise 86 pages.[159] There is also important theoretical and empirical research.[160] This is not the place to get into this discussion. Instead, the point here is simply to underline that remuneration systems contribute to bank performance and risk-taking. In addition, remuneration of the board – as in the general discussion of corporate governance of the firm – but also and especially of senior bank employees and particularly in investment banking of the lower rank as well can set wrong incentives and should be aligned with risk. The Basel Committee has condensed this concern into two principles for board and employee remuneration: Remuneration must be aligned with the risk, and there must not be a remuneration incentive to generate short-term revenues while taking on high long-term risk.[161]

4. Conclusion: Co-regulation for corporate governance of banks and no general spill over of bank governance requirements to firm governance

The conclusion of this stocktaking in Part III is sobering but not outright disappointing. The hope to avoid bank crises is futile, as the ever-recurring bank failures and scandals throughout history have amply shown. But good bank governance may contribute to reducing the danger of bank crises. Unfortunately, it is not only uncertain how strong the inverse correlation of good corporate governance for banks and bank crises is; there is also no single safe way to ensure good corporate governance of banks. Instead, what we have found is a toolbox of measures from which a selection must be made. What matters is the combination. While UK-style "light touch regulation" rightly gained a negative meaning during the financial crisis, in the aftermath of the financial crisis there is a danger of applying too many of these tools. Any of these tools, applied cumulatively and too strongly, could lead to the danger of overregulation. What is needed is a careful mix of mandatory and fall-back rules and soft law under the shadow of supervisory law. The old wisdom that disclosure and transparency is the least intrusive and nevertheless often very effective regulatory measure is still true,[162] and

[159] Committee of European Banking Supervisors (CEBS), Guidelines on Remuneration, Policies and Practices, 10 December 2010. Cf. also Moloney (n. 13) 1363.
[160] E.g., L. A. Bebchuk/H. Spamann, "Regulating Bankers' Pay," 98 Georgetown L. J. 247 (2009); R. Fahlenbrach/R. M. Stulz (n. 54); G. A. Ferrarini/N. Moloney/M. C. Ungureanu, "Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis," June 9, 2009, ECGI Law Working Paper No. 126/2009, http://ssrn.com/abstract=1418463; G. A. Ferrarini/M. C. Ungureanu, "Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks, Vanderbilt L. Rev. 62, No. 2 (2011), 431, http://ssrn.com/abstract= 1707344.
[161] Basel Committee 2010 (n. 13) Principles 10 and 11 with nos 105 f, 107 ff, 110 ff.
[162] Basel Committee 2010 (n. 13) 28 principle 14 (before no. 123).

even though reregulation as compared to the status before the financial crisis is unavoidable, the best way of regulation is co-regulation.[163]

While after the financial crisis there is a certain tendency to overregulation in banking, there is another even more serious danger – namely, the spillover of banking regulation and bank governance to the general corporate governance of firms. [164] Many recent reforms and reform proposals for corporations and general corporate governance have their origin in bank and financial regulation. Examples are the requirement of risk management, the need of having at least one independent director in the supervisory board with special knowledge of accounting or auditing, increased demands for the qualification of directors, remuneration, and conflicts of interest. This is not to say that corporate law reform in these examples is ill-taken, but it must be remembered that banks (as well as insurance and other regulated industries) are special and that their corporate governance is also unique. It is dangerous if the financial crisis is taken as the basis for statements claiming that "[b]oth financial and non-financial companies face a similar range of risks . . ."[165] and for the establishment of principles, recommendations, and requirements for corporate governance reform without distinguishing clearly between the two. The UK Financial Reporting Council was fully right in not taking up all the recommendations of the Walker Review, which were developed for the financial industry entities.[166] "Invisible hands" is not a stale concept, and this remains true even after the financial crisis. The state is not better than the markets in forecasting and discovering. Its task is and should remain to set the rules of the game and to interfere only where there are market failures. Corporate governance of banks must remain part of the special rule-setting for the game on the financial markets.[167]

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[163] Eva Hüpkes, "Regulation, Self-regulation or Co-regulation", (2009) J. Bus. L. 2009, issue 5, 427.

[164] Moloney (n. 13) 1374: "unhelpful spillover effects"; D.Weber-Rey, "Ausstrahlungen des Aufsichtsrechts (insbesondere für Banken und Versicherungen) auf das Aktienrecht – oder die Infiltration von Regelungssätzen?" Zeitschrift für Unternehmens- und Gesellschaftsrecht 2010, 543.

[165] OECD 2009 (n. 16) 8. See also OECD 2010 (n. 17), dealing with remuneration, governance of risk management, board practices, and exercise of shareholders rights without a clear distinction between the financial sector and general corporate governance.

[166] Financial Reporting Council (n. 19); see also Financial Services Authority, Effective corporate governance (Significant influence controlled functions and the Walker review), January 2010.

[167] This was the generally agreed outcome of the Symposion 2010 of the Zeitschrift für Unternehmens- und Gesellschaftsrecht on 22 and 23 January 2010 in Königstein; cf. also the discussion report by S. Thomas, Zeitschrift für Unternehmens- und Gesellschaftsrecht 2010, 591.

Part B. Better Governance of Financial Institutions

- Further Developments and Insights -

"Better Governance of Financial Institutions" is a perfect topic when we look at the bank scandals and failures in all of our countries: Lehman Brothers, Bear Stearns, Citigroup and Merrill Lynch in the USA; Royal Bank of Scotland and HBOS in the United Kingdom; and on the Continent Hypo Real Estate, the German State Banks (*Landesbanken*), Dexia, Fortis and UBS, to give just some examples. Since the publication of the earlier article on "Corporate Governance of Banks after the Financial Crisis" with a cut-off date of early 2011[168] (supra Part A), in which I had looked extensively at the Basel Committee Principles for enhancing corporate governance as of October 2010,[169] there has been a rush of developments both in the regulatory area, and also in academic publications. The purpose of this second piece (Part B) is therefore to give an overview of the main regulatory developments in Europe[170] in 2010/2011 and 2012 as to governance of financial institutions (I) and to review some of these new or proposed rules and recommendations in the light of recent academic research II).[171] It will be seen whether the summary and the theses at the end (III) will have to be modified as to the theses formulated in earlier article.

At the beginning two caveats should be voiced: First, The terms "corporate governance of banks" or "bank governance" are used in different ways. Corporate governance in a wider sense comprises internal as well as external governance, external governance being the disciplining forces of markets (products and services, labour and corporate control). In the

[168] K. J. Hopt, 'Corporate Governance of Banks after the Financial Crisis', in: E. Wymeersch, K. J. Hopt, and G. Ferrarini, eds., *Financial Regulation and Supervision, A Post-Crisis Analysis*, Oxford (Oxford University Press) 2012, pp. 337-367; short survey available at <http://ssrn.com/abstract=1918851 >. See also K. J. Hopt and G. Wohlmannstetter, eds., *Handbuch Corporate Governance von Banken*, Munich (Vahlen, C. H. Beck) 2011.

[169] Basel Committee on Banking Supervision, *Principles for enhancing corporate governance*, October 2010. For details, see S. Emmenegger, 'Prudentielle Corporate Governance', in: S. Emmenegger, ed., *Corporate Governance*, Basel (Helbing Lichtenhahn) 2011, p. 1.

[170] The developments in the USA after the Dodd-Frank Act have been complicated and the evaluation of the provisions of the Act is highly controversial, cf. for example D. A. Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences,* Hoboken, N.J. (Wiley), 2011; R. Kroszner, R. J. Shiller, eds., *Reforming US Financial Markets: Reflections Before and Beyond Dodd Frank,* Cambridge, MA (MIT Press), 2011; A. Verstein/R. Romano, Assesssing Dodd-Frank, 19 July 2011, available at < http://ssrn.com/abstract=1884290 >; J. C. Coffee, Jr., 'The political economy of Dodd-Frank: Why financial reform tends to be frustrated and systemic risk perpetuated', in E. Ferran et al. (n. 177), p. 301, also in 97 *Cornell L. Rev.* 1019 (2012). Coffee reports that many of the corporate governance provisions of the Dodd-Frank Act are not being implemented, idem, p. 364 et seq.

[171] Bank regulation more generally and in particular the emerging supervision of banks by the European Central Bank are beyond the topic of this article. For economic literature on the financial crisis see n. 225.

banking sector, these markets did not do very much disciplining.[172] On the contrary: the demand for new financial products and for the most aggressive investment bankers and their teams were well-known phenomena in the years before the financial crisis. The takeover market in banking, in particular its international side, was never really subject to up to the general market for corporate control.[173] Why this is so is not fully clear, but the reasons might include the often-described opaqueness of banking structures and business, the different regulatory environments and national protectionism.[174] The term *bank governance* will be used here in the narrower sense of internal governance. For banks, this comprises the rules and recommendations under bank supervision concerning the board and bank structures, internal procedures and demands on the board and key function holders of banks, but without prudential regulation (though some authors use the term *prudential corporate governance*).[175]

Second, the focus of this paper is on banks in the general sense of the word, but other financial institutions, in particular the insurance business, are also mentioned, although briefly[176]. This seems appropriate because the banks were in the forefront of the dire developments before and in the financial crisis[177] and therefore much of the ensuing regulation and governance discussion focused on them. The term banks and bank governance is therefore used as an abbreviation also for other (not necessarily all) financial institutions.

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[172] As to external corporate governance see supra part A I 2 b.

[173] M. Köhler, 'Der Markt für Unternehmenskontrolle', in K. J. Hopt and G. Wohlmannstetter (n. 168), p. 245 at 246; similarly G. Wohlmannstetter, 'Corporate Governance von Banken', in K. J. Hopt, G. Wohlmannstetter (n. 168), p. 31 at p. 51 et seq. Cf. also M. J. Flannery, 'Market Discipline in Bank Supervision', in: A. N. Berger, P. Molyneux and J. O. S. Wilson, eds., *The Oxford Handbook of Banking*, Oxford (Oxford University Press) 2010, p. 377, and A. A. Dick, T. H. Hannan, 'Competition and Antitrust Policy in Banking', *ibidem*, p. 405. On EU takeover law see K. J. Hopt, Europäisches Übernahmerecht, Tübingen 2013.

[174] Cf. supra Part A III 2 b, c; as to protectionism cf. U. Bernitz/W.-G. Ringe, eds., *Company Law and Economic Protectionism,* Oxford (Oxford University Press) 2010; K. J. Hopt, 'Obstacles to corporate restructuring: observations from a European and German perspective', in: M. Tison, H. de Wulf, C. van der Elst, R. Steennot, eds., *Perspectives in Company Law and Financial Regulation (Essays in Honour of Eddy Wymeersch*), Cambridge (Cambridge University Press) 2009, p. 373 at 378 et s.

[175] P. Davies, *Better prudential regulation: capital and liquidity*, lecture in Cambridge on 30 November 2012; S. Emmenegger (n. 169), p. 1. Cf. also European Banking Authority (EBA), *EBA Guidelines on Internal Governance* (GL 44), London, 27 September 2011, I 28 p. 9: 'Corporate governance is ... the set of relationships between an institution, its management, its shareholders and other stakeholders. Internal governance is a limited but crucial component of corporate governance, focusing on the internal structure and organization of an institution.' and with more detail I 30 p. 10.

[176] See in particular infra Part B I 4 b.

[177] E. Tafara, 'Foreword, Observations about the crisis and reform', in E. Ferran, N. Moloney, J. G. Hill and J. C. Coffee, Jr., eds., *The Regulatory Aftermath of the Global Financial Crisis*, Cambridge (Cambridge University Press) 2012, p. 1 at p. 44 et seq., also available as Cambridge University Research Paper at < http://ssrn.com/abstract=2028003 >, p. XI at p. xxiv: "There is little denying that the recent financial crisis, while involving all types of market participants, was essentialy a banking crisis."; Tafara is director of the Office of International Affairs of the SEC.

I. Regulatory developments in the European Union in 2011 and 2012 as to governance of financial institutions

1. Trend towards more regulation and harmonization of bank governance in the European Union

Traditionally, general corporate governance has not favoured harmonization and regulation in the European Union. The fate of the late 5th Directive on the structure of the company, including board structure and labour co-determination, is well remembered: It had been declared to be dead even by voices from within the European Commission. But we also know that the Commission has not given up on its plan to harmonize company law, though it is moving forward more carefully, for example with the recommendation on boards of 2005,[178] and more recently with its Green Paper on *The EU corporate governance framework*[179] and its consultation on the Future of European Company Law.[180] In December 2012 the Commission has come up with a new Company Law Action Plan that includes the Commission's reaction to its Corporate Governance Green Paper.[181] This Action Plan moves forward carefully, but is more courageous than many observers had expected.[182] Eilís Ferran has just published an article on the European Union's crisis-driven regulatory reform[183] in which she focuses on the factors driving Member States and the EU institutions in this field. In this paper, she also dealt with corporate governance. Based on significant path dependencies in national corporate governance systems and on the varieties of capitalism literature,[184] she is very sceptical as to whether the Commission will be successful in its ambitious plans. This scepticism is well-founded as far as general corporate governance of listed companies is concerned.

[178] European Commission Recommendation of 15.2.2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, OJEU L 52/51.
[179] European Commission, Green Paper, The EU corporate governance framework, Brussels, 5 April 2011, COM(2011) 164 and European Commission, Feedback Statement, Summary of Responses to the Commission Green Paper on The EU Corporate Governance Framework, Brussels 15 November 2011, D(2011).
[180] European Commission, Consultation on the Future of European Company, Brussels, 20 February 2012.
[181] European Commission, Action Plan: European company law and corporate governanance – a modern framework for more engaged shareholders and sustainable companies, Brussels, COM(2012) 740/2.
[182] See K. J. Hopt, 'Europäisches Gesellschaftsrecht im Lichte des Aktionsplans der Europäischen Kommission von 2012', Hachenburg memorial lecture, Mannheim 26 October 2012, forthcoming in *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 2013, issue 2.
[183] E. Ferran, 'Crisis-driven regulatory reform: where in the world is the EU going?', in: E. Ferran et al. (n. 177), p. 1. Cf. also 'Banken in der Krise', October issue of the *Zeitschrift für Bankrecht und Bankwirtschaft (ZBB)* 2012, 312-428 with several articles on the tension between bank supervision and business judgment of bank management.
[184] E. Ferran (n. 183) at p. 20 et seq.

Yet as far as corporate governance of banks and other financial institutions is concerned, the situation is certainly different,[185] according to some observers even very different. Undoubtedly European financial regulation has already taken the whole field of disclosure and transparency over from corporate law.[186] The relics of shareholdings disclosure rules we still have in our national company laws have been actually or functionally superseded by European capital market law rules. But European law has also intruded, or is about to intrude, far into the internal governance of banks and other financial institutions. This conclusion seems inevitable if one takes a closer look at the regulatory developments in 2010/2011 and 2012. It is based on the Commission's Feedback Statement on Corporate Governance in Financial Institutions of 11 November 2010[187] and the EBA Guidelines on Internal Governance of 27 September 2011[188] together with its Guidelines on the Assessment of the Suitability of Members of the Management Body and Key Function Holders of 22 November 2012.[189] It is true that the Draft Capital Requirement Directive (CRD IV) of 20 July 2011[190] is still being debated and may be watered down, but it is most often overlooked that in related fields, such as insurance (Solvency II),[191] credit rating agency regulation[192] and the European market infrastructure regulation (generally referred to as EMIR),[193] there are more or less comprehensive corporate governance rules already in place, either in the form of directives (as in the case of insurance) or outright in the form of a European regulation (as in the two other cases). If such European regulations aim for maximum harmonization, as it is the recent trend, or at least in the attempt of the Commission in financial regulation, then there is no

[185] Cf. generally N. Moloney, 'EU Financial Market Regulation After the Global Financial Crisis: "More Europe" or More Risks?' *Common Market Law Review* 47 (2010) 1317.
[186] E. Ferran (n. 183) at p. 44. Disclosure and transparency are also the focus of the European Commission's Action Plan (n. 181 and n. 182).
[187] European Commission, Green Paper, Corporate governance in financial institutions and remuneration policies, Brussels, 2 June 2010, SEC(2010) 669 final and accompanying document, COM(2010) 284 final; critical remarks by Peter O. Mülbert, 'Corporate Governance in der Krise', 174 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR)* 375 (2010); European Commission, Feedback Statement, Summary of Responses to Commission Green Paper on Corporate Governance in Financial Institutions, Brussels, 11 November 2010; see also European Parliament, Resolution of 11 May 2011 on corporate governance in financial institutions.
[188] EBA *Guidelines* (n. 175).
[189] EBA Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2012/06) of 22 November 2012.
[190] European Commission, Proposal for a Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms ..., Brussels, 20 July 2011, COM(2011) 453 final. The proposal is accompanied by the Proposal of a Regulation on prudential requirements for the credit institutions and investment firms, Brussels, 20 July 2011, SEC(2011) 949 final.
[191] Directive 2009/138/EC of 25.11.2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast), O.J.EU L 335/1, 17 December 2009. Cf. Clifford Chance and McKinsey & Company, eds., *Risk governance in insurance* (Frankfurt a.M.) 2012.
[192] Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16.9.2009 on credit rating agencies, O.J.EU L 302/1, 17 November 2009 with later amendments.
[193] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4.7.2012 on OTC derivatives, central counterparties and trade repositories, O.J.EU L 201/1, 27 July 2012.

more room for stricter national regulation and gold plating. If not, national regulatory efforts can continue, accompanied by ever more international reports. Most recent examples are the Inquiry of the UK Treasury Select Committee (May 2012)[194] and the Report of the Group of Thirty of April 2012.[195]

2. European Commission, Feedback Statement on Corporate Governance in Financial Institutions of 11 November 2010

The Green Paper on Corporate Governance in Financial Institutions of 2 June 2010 was part of an increased effort by the Commission to tackle the problem of corporate governance. It was followed by two other green papers on auditing and on general corporate governance and by a consultation of the Commission on the Future of European Company Law. The Commission is aware of the functional interrelation of these efforts but, for obvious reasons after the financial crisis, has taken up corporate governance of financial institutions first. While the regulation of banks and of the insurance business has traditionally been separate, and continues to be so with minor exceptions on the European level, it is telling that the Green Paper does not make this distinction. This reflects the experience from the financial crisis with the interrelatedness of the manifold financial institutions and the emerging need to take a 'holistic' view. The issues dealt with in the Green Paper were the functioning of boards and their role in risk oversight, as well as the governance of risk management more generally, remuneration and conflicts of interest, external auditors, the role of shareholders as regards risk-taking by financial institutions, and supervisory authorities and enforcement. The main outcomes will quickly be summarized.

a) Structure and functioning of the board

The majority of respondents[196] were in favour of a mandatory prohibition on joining the functions of the Chairman and of the CEO, while opponents saw no conclusive evidence that financial institutions without such a separation had done worse in the financial crisis. The majority also thought that recruitment policies should ensure that directors have adequate skills, though this should not be mandated by law, and considered increased diversity in

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[194] UK Treasury Select Committee, *Consultation on Corporate governance and remuneration in the financial services sector*, 24 May 2012.
[195] Group of Thirty, *Toward Effective Governance of Financial Institutions*, Washington, 12 April 2012.
[196] Here, and in the following, the majority means the majority of the respondents that provided an answer to the question.

boards important for avoiding ‘group think’ and herd behaviour. External evaluation was considered useful, and a small majority even favoured disclosing the main conclusions of the evaluation to the supervisor. A mandatory restriction on the number of boards on which a director may sit was considered inappropriate, but directors should devote sufficient time for their mandate and the expected time commitment could even be defined in an appointment letter for each director. A large majority was not in favour of creating a specific duty of care with regard to depositors, the primary fiduciary duty of the boards being to the shareholders. But it is obvious that the best interests of the financial institutions include the interests of different stakeholders. Remuneration was an issue, with detailed questions and answers, as were conflicts of interest. But the vast majority of respondents were opposed to any increase in civil and criminal liability of directors. They feared that this would be detrimental to sound initiative and make director recruitment more difficult.

b) Risk management function and internal control system

Much concern was articulated as regards improving the risk profile and strategy of the financial institutions. While a separate risk committee and a risk report were not considered indispensable, the board should approve the risk strategy and be responsible for the oversight of its implementation. The chief risk officer (CRO) should be independent and have a close relationship with the board. Some even suggested that the CRO should be a member of the board. At the very least, the CRO should be able to report directly to the board or to the risk committee. The majority was opposed to a requirement as in the Sarbanes-Oxley Act that executives should expressly approve a report on the adequacy of internal control systems, but a minority favoured this and pointed out that such an obligation already existed in their countries under the law or the Code.[197]

c) Shareholders, external auditing and supervision

The majority was in favour of mandatory disclosure of voting policies and records by institutional investors. They also pleaded for a code of best practice. The Code of the International Corporate Governance Network (ICGN) and the UK Stewardship Code are examples. The identification of shareholders by the company should be facilitated in view of

[197] Respondents from the UK pleaded for statement of the board on internal control and its own responsibility for reviewing the effectiveness of the company’s system of internal control, as under the Turnbull guidance of 1999/2005.

‘empty voting’. Measures should be taken to incentivize shareholders to engage more in the corporate governance of the financial institution. Cross-border voting was an issue.

The majority was not in favour of increasing the duty of information of external auditors.

Almost all respondents thought that supervisory authorities should be able to challenge the efficiency of internal governance structures, in particular in view of a possible negative impact on financial stability. The traditional ‘fit and proper test’ should be extended to include technical and professional skills as well as individual qualities of directors.

d) Inclusion of a number of actions into the European Company Law Action Plan of December 2012

A number of actions mentioned in the Commission’s Feedback Statement on Corporate Governance in Financial Institutions have now been included in the European Company Law Action Plan of December 2012 and are on the agenda for (listed) non-financial companies too. These actions include among others: disclosure of board diversity policy and of risk management (amendment of the accounting Directive, 2013), improving the quality of corporate governance reports (possibly non-legislative initiative, 2013), disclosure of voting and engagement polices as well as voting records by institutional investors and improving shareholder control over related party transactions (possibly Shareholders’ rights Directive, 2013), improving the information available on groups and recognition of the concept of “group interest” (initiative to be determined, 2014) and developing guidance to increase legal certainty as regards the relationship between investor cooperation on corporate governance issues and the rules on acting in concert (cooperation between the Commission, the competent national authorities and ESMA, 2013). The fear that there might be a tendency of spill over of bank governance requirements to firm governance that has been articulated in the previous article[198] is clearly justified. The Commission seems to pursue a policy of mutual reinforcement of its activities as to corporate governance of financial institutions and of companies in general without clearly distinguishing these two fields and articulating the specific corporate governance needs for each of them.

[198] Supra Part A III 4.

3. EBA Guidelines on Internal Governance of 27 September 2011 and Guidelines on the Assessment of the Suitability of Members of the Management Body and Key Function Holders of 22 November 2012

While the Green Paper and the responses to it provide a blueprint on what corporate governance measures the European Commission may intend to take for financial institutions, subject of course to Member State approval or resistance, the European Banking Authority (EBA) is already part of the established new institutional architecture of European Union financial market supervision.[199] What the EBA as supervisor sets out as Guidelines on internal governance of banks is a *fait accompli*. The Guidelines of September 2011[200] consolidate earlier principles of the Committee of European Banking Supervisors (CEBS) of 2009 and 2010 and other guidelines. The EBA is concerned about improving internal governance in the banking system[201] and remarks that its deficiencies, 'while not a direct trigger for the financial crisis, were closely associated with it and so were a key contributory factor.'[202] The Guidelines are limited to internal governance and do not deal with external auditors, shareholders and other external stakeholders.

a) Corporate structure and organization

The EBA sees the main weakness of corporate structure and organization in the complexity of institutions that were not sufficiently counterbalanced by appropriate internal governance arrangements. The complexity and riskiness of the products and services offered added to these deficiencies, in particular in case of cross-border groups. The worry about bank groups in general, and cross-border groups in particular, is evident in many places in the Guidelines. The EBA expressly states that the Guidelines are applicable to both institutions on a single-

[199] Cf. E. Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision', and E. Wymeersch, 'The European Financial Supervisory Authorities or ESAs', in: E. Wymeersch and K. J. Hopt (n. 168), p. 111, 232; N. Moloney, 'Reform or Revolution? The Financial Crisis, EU Financial Markets Law and the European Securities and Markets Authority', *International and Comparative Law Quarterly* 60 (2011) 521.

[200] EBA Guidelines (n. 175); these guidelines have been followed by Member States' banking supervisory authorities, for example in Italy by the Banca d'Italia, 'Applicazione delle disposizioni di vigilanza in materia di organizzazione e governo societario delle banche' (11.1.2012), *Rivista delle Società* 57 (2012) 416 et seq. with comment by P. Marchetti, at 413 et seq., cf. also the consultation of the Banca d'Italia of September 2012 on internal control and risk government, Rivista delle Società 57 (2012) 1301 et seq. For Germany see on risk management Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), Mindestanforderungen an das Risikomanagement – MaRisk, Rundschreiben 10/2012 (BA) of 14.12.2012, and on control of bank and insurance company board members by the BaFin Merkblatt zur Kontrolle der Mitglieder von Verwaltungs- und Aufsichtsorganen gemäß KWG und VAG, 3.12.2012.

[201] Unlike the Green Book, the Guidelines concern only banks, as the competences for the insurance sector lie with the European Insurance and Occupational Pensions Authority (EIOPA).

[202] EBA Guidelines (n. 175) II. 17, p. 7.

entity basis, and to parents and subsidiaries on a consolidated or sub-consolidated basis, unless otherwise stated.[203] In the responses to the EBA consultation paper concern has been expressed, for example by the British Bankers' Association, that the complexity of multinational banks is often a result of local, legal or regulatory requirements and that the Guidelines should be applied at group, not at single-entity level because the decisions of multinational banks on key activities such as liquidity, risk and capital management are taken centrally.[204] The Guidelines opt for checks and balances at group level. The parent's management body has overall responsibility for adequate internal governance across the group, while the management body of a regulated subsidiary must follow, 'unless legal or supervisory requirements or proportionality considerations determine otherwise.'[205] In view of the complexity of the structures, the EBA states the principle of 'know-your-structure', in particular in case of non-standard and non-transparent activities and when operating through special-purpose or related structures or in jurisdictions that impede transparency.

The EBA does not advocate any particular board structure, whether unitary or dual, but uses the term 'management body' in a functional sense; for the EBA it is only important that the particular task or responsibilities are carried out.[206] But as critically remarked in the consultation process, much of the text is still written from the perspective of the unitary system. Occasionally, the dual system is addressed specifically, for example when it is (rightly) stated that the formal separation into two bodies is not enough for securing the objectivity and independence of the supervisory body, which still need to be assured by appropriate selection of independent members.[207] For the one-tier system, the EBA mentions that the chair and the CEO should not be the same person or, if otherwise, this should be counterbalanced, for example by having a lead senior independent director.[208]

b) Management body and suitability

The Guidelines contain many principles and rules for the management body. They include, for example, the duties and responsibilities of this body, the assessment of the internal

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[203] EBA Guidelines (n. 175) II. 2.3, p. 16.
[204] British Bankers' Association (BBA), response to CEBS CP44 Consultation paper on the Guidebook on Internal Governance, January 2011.
[205] EBA Guidelines (n. 175) II. 5, p. 17.
[206] EBA Guidelines (n. 175) II. 31 et seq., p. 10, III. 10 p. 22 et seq.
[207] EBA Guidelines (n. 175) III. 12, p. 15: Explanatory note.
[208] EBA Guidelines (n. 175) III. 14.5 p. 27 with details. On lead senior independent directors, see K. J. Hopt, 'Comparative Corporate Governance: The State of the Art and International Regulation', *American Journal of Comparative Law* 59 (2011) 1 at 34, also available at < http://ssrn.com/abstracts=1713750 >.

governance framework, succession planning, independence, conflicts of interest, remuneration, organisation. The management body must put in place appropriate internal alert procedures for communicating internal governance concerns from the staff whose confidentiality must be respected (whistle blowing). All this goes far beyond what the law or the codes require or recommend of the boards of nonfinancial entities.

Expertise, qualification and independence are already addressed in the Guidelines, but the Guidelines on the Assessment of the Suitability of Members of the Management Body and Key Function Holders of 22 November 2012[209] sets out in much more detail the processes, criteria and minimum requirements for assessing the suitability of members of the management body and of key function holders of a credit institution. It is important to note that the proposed Guidelines are not limited to members of the management body in its management function, but also in its supervisory function, ie. the criteria are also to apply to supervisory board members. Furthermore, the proposed Guidelines also extend to key function holders, who have a crucial role in the day to day management of the business. This again is a special provision for banks and goes far beyond actual corporate governance of nonfinancial institutions. The assessment criteria cover reputation, experience and governance. The assessment process is twofold, not only by the institution itself, but also by the supervisors.

c) Risk management and internal control

The EBA's particular concerns are risk management and internal control. At the outset the EBA outlines the three-lines-of-defence model. The first line is risk management, the second is internal control and the third line comprises the internal audit function. The control functions (including the risk control function, the compliance function and the internal audit function) must be organizationally independent from the units they control. *Risk tolerance* or *risk appetite* is used to describe the absolute risks the bank is *a priori* open to take and the actual limits the institution pursues. Specialized committees of the management body are not mandatory, but the audit committee and the risk committee are dealt with prominently. When going into details, the Guidelines distinguish clearly between risk management and internal audit.

[209] EBA Guidelines of 22 November 2012 (n. 189).

For risk management,[210] the overall development of a special risk culture of the institution is key. A holistic view of all relevant risks is important for risk management, e.g. financial and non-financial, on and off balance sheet, and whether or not contingent or contractual. Concentration, reputational, compliance and strategic risks are mentioned expressly. These risks must be evaluated bottom up and top down. Remuneration must be aligned to the risk profile. Details of the Guidelines cover the risk management framework, forward and backward-looking tools and also new products in particular. For the latter, a well-documented new product approval policy (NPAP) is considered to be necessary.

As regards internal control,[211] the internal control framework should include three control functions: a risk control function, a compliance function and an internal audit function. These control functions must report directly to the management body. The group control functions should oversee the subsidiaries' control functions. Particular attention is given to the risk control function (RCF). RCF has a special role in strategy and decisions (though accountability for the decisions taken remains with the management body), in related party transactions, in complexity of legal structure, in material changes, in risk measurement and assessment and in monitoring. Trends and emerging risks must be analysed. Back-testing of risk outcomes against previous estimates is necessary. An institution, as well as the whole group, must appoint a chief risk officer and should consider granting the CRO a veto right. The CRO and the management body or relevant committees should be able to communicate directly among themselves. The internal audit function (IAF) must assess the quality of the internal control framework.

4. Other EU (draft) instruments with corporate governance requirements

The EBA guidelines do not have the legal status of binding law, but are, as the name says, just guidelines. But since they set out the EBA's view of appropriate supervisory practices, the EBA expects all competent authorities and financial markets participants to whom the Guidelines apply to comply with them, unless otherwise stated. This means that they dominate actual bank governance practice, though there is some leeway to depart from them. Yet it is mostly overlooked in the bank governance discussion that a good number of European instruments, some still in draft stage, others in force, comprise legally binding corporate governance requirements.

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[210] EBA Guidelines (n. 175) III. 20 et seq., p. 32 et seq.
[211] EBA Guidelines (n. 175) III. 24 et seq., p. 37 et seq.

a) Draft Capital Requirement Directive (CRD IV) of 20 July 2011

The Draft Capital Requirement Directive (CRD IV) of 20 July 2011[212] should be mentioned first, because this will be the revised[213] basic text on the access to the activity of credit institutions and the prudential supervision of them. In the explanatory notes the Commission makes ample reference to corporate governance. This is due to the fact that the Proposal contains new rules for corporate governance of credit institutions. The Commission justifies these rules with the aim of increasing the effectiveness of risk oversight by boards, improving the status of the risk management function and ensuring monitoring by supervisors of risk governance. To achieve these objectives, the Commission has put forward a whole range of corporate governance provisions.[214] Among them are the overall responsibility of the management body for the institution's strategic objectives, risk strategy and internal governance; the separation of the functions of the chair of the management body and the CEO; and the establishment of a nomination committee that is to evaluate the balance of knowledge, skills, diversity and experience of the management body. Members of management may not combine at the same time more than one of the two combinations: (1) One executive directorship with two non-executive directorships, or (2) four non-executive directorships. Directorships held within the same group are counted as one single directorship. The institutions shall put in place a policy promoting gender, age, geographical, educational and professional diversity on the management body. The EBA shall develop draft regulatory standards on all this. More than half of the text of the governance sub-section deals with remuneration, including the establishment of a remuneration committee in significant institutions. Why all these new rules are necessary in order to reach the stated objectives is not explained in more detail.

b) Solvency II-Directive of 25 November 2009, Regulation on Credit Rating Agencies of 16 September 2009 and European Market Infrastructure Regulation of 4 July 2012

[212] CRD IV (n. 190).
[213] Directives 2006/48/EC and 2006/49/EC of 14 June 2006, O.J.E.U L 177/1 and 177/201, 30 June 2006.
[214] Title VII ch. 2 section II subsection 3 on Governance contains the following articles: Article 86 Governance arrangements; Article 87 Management body; Article 88 Remuneration policies; Article 89 Institutions that benefit from government intervention; Article 90 Variable elements of remuneration; and Article 91 Remuneration committee

It remains to be seen whether all these corporate governance rules will be part of the final text of the CRD IV Directive. Yet most often it is not realized that there are a number of other European instruments also dealing with corporate governance for certain financial institutions or related firms and that these instruments contain legal rules that are already in force.

The Directive on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) of 25 November 2009[215] is the equivalent of the Draft CRD IV-Directive for credit institutions and investment firms. In its chapter IV on Conditions governing business, this Directive contains a subsection on the system of governance with detailed rules on general governance requirements, fit and proper requirements, risk management, internal control and internal audit.[216] The emphasis is clearly on risk but, unlike in the CRD IV Proposal, there are no specific rules on the board, board diversity and board committees.

Annex I of the Regulation on credit rating agencies of 16 September 2009[217] contains rules for the independence and avoidance of conflicts of interest, and among them extensive organizational requirements. The credit rating agency must have an administrative or supervisory board. At least one third, but no less than two, of the members of the administrative or supervisory board must be independent members who are not involved in credit rating activities. The majority of the administrative or supervisory board, including its independent members, must have sufficient expertise in financial services. If credit ratings on structured finance instruments are issued, at least one independent member and one other member of the board must have in-depth knowledge and experience in structured finance instruments at a senior market level. A credit rating agency must have in place sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems.

[215] Solvency II Directive (n. 191); J. Bürkle, 'Europarechtliche Vorgaben für die interne Governance im Versicherungssektor, *Wertpapier-Mitteilungen Zeitschrift für Wirtschafts- und Bankrecht (WM)* 2012, 878.
[216] Title I, ch. IV Section 2 on System of governance contains the following articles: Article 41 General governance requirements; Article 42 Fit and proper requirements for persons who effectively run the undertaking or have other key functions;Article 43 Proof of good repute; Article 44 Risk management; Article 45 Own risk and solvency assessment; Article 46 Internal control; Article 47 Internal audit; Article 48 Actuarial function; Article 49 Outsourcing and Article 50 Implementing measures.
[217] Regulation on credit rating agencies (n. 192).

The Regulation on OTC derivatives, central counterparties and trade repositories (EMIR Regulation) of 4 July 2012[218] contains organizational requirements for central counterparties (CCP).[219] A CCP must have a board comprising at least one third, but no less than two, independent members. The members of the board, including its independent members, must have adequate experience in financial services, risk management and clearing services. A risk committee must be established. Competent authorities may request to attend risk-committee meetings in a non-voting capacity and to be duly informed of the activities and decisions of the risk committee.

II. Review of these regulatory developments and recent academic research

After having summarised these regulatory developments in the European Union, it is now time to review some of the more important rules and recommendations and confront them with recent academic research, if it is available. Before doing so, two observations are appropriate. First, while the sheer range of European and international contributions to general corporate governance is legion, relatively limited attention has been given by academic research more specifically to the corporate governance of banks, even though this is slowly changing.[220] In view of the importance of banks and financial institutions for the economy as a whole, and of the regulatory developments in the last five years, this is surprising,[221] and unfortunately there has been very little connection between this academic research and regulatory activities.[222]

Secondly, the following review and criticisms should not be confounded with blunt policy recommendations.[223] Not only are corporate governance reforms, like other reforms,

[218] European Market Infrastructure Regulation (EMIR) (n. 193).
[219] Title IV ch. 1 on organisational requirements contains the following articles: Article 26 General provisions; Article 27 Senior management and the board; Article 28 Risk committee; Article 29 Record keeping; Article 30 Shareholders and members with qualifying holdings; Article 31 Information to competent authorities; Article 32 Assessment; Article 33 Conflicts of interest; Article 34 Business continuity; Article 35 Outsourcing.
[220] Cf. the references in K. J. Hopt (n. 168), para. 11.07 (p. 340 et seq.) nn. 27-29. The most recent survey is by F. M. Song and Li Li, 'Bank governance: concepts and measurements', in: J. R. Barth, C. Lin and C. Wihlborg, eds., *Research Handbook on International Banking and Governance*, Cheltenham (Edward Elgar) 2012, pp. 17-24: 'Bank Governance: Selected literature review', pp. 39-41; 'Special Issue: Governance, Policy and the Crisis', 12 (issue 1 and 2) *International Review of Finance* (2012).
[221] Similarly F. M. Song and Li Li (n. 220), p. 17.
[222] H. Mehran, A. Morrison and J. Shapiro, 'Corporate Governance and Banks: What Have We Learned from the Financial Crisis?' *Federal Reserve Bank of New York Staff Reports no. 502*, June 2011, p. 1, available at < http://ssrn.com/abstract=1880009 >.
[223] „Regulation is a messy, complex, and often thankless task." This is rightly stated by J. Black, 'Restructuring Global and EU Financial Regulation: Character, Capacities, and Learning' in E. Wymeersch et al. (n. 168), p. 3 at p. 44. But regulation is unavoidable, see K. Pistor, *On the Theoretical Foundations for Regulating Financial*

dependent on many factors – their cost and benefits and possible alternatives, an evaluation of which is finally up to the legislators and regulators – but corporate governance reforms that may be beneficial in some countries may be less beneficial in other countries, as the variety of capitalism literature has demonstrated.[224]

1. Limited role of bank governance failures for the financial crisis

After initial hesitation and doubts behind the reasons for the financial crisis, there is now a wealth of literature describing and analysing the financial crisis and its reasons.[225] This literature also deals, even though mostly more marginally, with the role of bank governance failures for the financial crisis. Opinions still fluctuate and differ as to what this role is and, in particular, how relevant it is.[226] But in the meantime the clear majority view is that the role of bank governance failure in the financial crisis was rather limited. Far more important were other factors, such as the lax monetary policy of the American Federal Reserve Bank, the policy and practice of credit financing the housing of broad masses of the population, the securitization of credit in complicated and opaque financial instruments, the failures of the rating agencies as well as of the regulators and supervisors and, last but not least, the greed and short-sightedness of investors including financial institutions, in particular the German state banks (*Landesbanken*).[227] This is not to say that internal bank governance failures were irrelevant. In conformity with the Basel Committee on Banking Supervision,[228] the relevant failures were in risk management and internal control, in the profile and practice of directors and senior management, in complex and opaque corporate and bank structures, in perverse incentives by the remuneration structures then in place and in insufficient disclosure and

Markets, Columbia Public Law Research Paper No. 12-304, available at < http://ssrn.com/abstract=2113675 >; J. C. Coffee, Jr. (n. 170), at p. 306 and passim with a (too) harsh criticism of R. Romano and others as "Tea Party Caucus" of corporate and securities law professors. As I said elsewhere: "The market knows better than the state, provided that the state sets the appropriate rules of the game", in approval E. Ferran (n. 183), p. 109.

[224] Cf. among others P. A. Hall and D. Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, Oxford (Oxford University Press), 2001. See also E. Ferran (n. 184).

[225] Cf. for example M. Hellwig, *Systemic Risk in the Financial Sector, an Analysis of the Subprime-Mortgage Financial Crisis*, Jelle Zijlstra Lecture 6, Wassenaar 2008. For a recent view from the USA see E. Tafara (n. 177). Cf. G. Gorton and A. Metrick, 'Getting Up to Speed on the Financial Crisis: A One-Weekend-Reader's Guide', *Journal of Economic Literature* 2012, 50:1, 128-150; A. W. Lo, 'Reading About the Financial Crisis: A Twenty-One-Book Review', *Journal of Economic Literature* 2012, 50:1, 151-178.

[226] Supra Part A II 1.

[227] See Part B II 2 b, R. Fahlenbrach and R. M. Stulz (n. 244) and Part B II 5, G. A. Ferrarini, M. C. Ungureanu (n. 314) and E. Ferran (n. 314); J. C. Coffee, Jr. (n. 170), p. 336 et seq. Cf. also A. Turner, *The Turner Review: Regulatory Response to the Global Banking Crisis*, London (Financial Services Authority) 2009, who was chair of the FSA. He cites seven proximate causes: (1) Large, global macroeconomic imbalances, (2) an increase in commercial banks' involvement in risky trading activities, (3) growth in securitized credit, (4) increased leverage, (5) failure of banks to manage financial risks, (6) inadequate capital buffers and (7) a misplaced reliance on complex maths and credit ratings in assessing risk. Taken up by Group of Thirty (n. 195), p. 11.

[228] Basel Committee (n. 169) no. 20 et seq.: III A – F.

transparency.[229] The European Banking Authority concedes that these bank governance failures were not a direct trigger for the financial crisis, but considers these practices to be 'a key contributory factor'.[230] In a later statement, the EBA holds 'weak governance arrangements, in particular inadequate oversight by and challenge from the supervisory function of the management body' to be among the 'underlying causes of the financial crisis.'[231] Similarly, the European Commission states that '(a)lthough corporate governance did not directly cause the crisis, the lack of effective control mechanisms contributed to excessive risk-taking on the part of financial institutions.'[232] Politicians all over Europe hold excessive remuneration to have been a major cause of the financial crisis and have reacted with legislation curbing remuneration of bank directors and key personnel.[233] But when evaluating these statements of the EBA, the Commission and in particular the politicians, one must keep in mind that for them highlighting corporate governance failures, and specifically remuneration excesses, helps to play down their own regulatory and oversight failures and to justify ever more intruding rules and recommendations as to bank governance. I shall come back to the bank governance failures later on.

2. 'Bank governance is special'

One of the earliest contributions to the topic from E. F. Fama – *What's different about banks?*[234] – concluded that banks are special. So is corporate governance of banks and other financial institutions, and academic literature now seems to agree on this point.[235] The

[229] K. J. Hopt (n. 168), paras. 11.17-11.21 pp. 344-346. Similar evaluation by R. H. Schmidt and F. Noth, 'Die Entwicklung der Corporate Governance deutscher Banken seit 1950', forthcoming in *Bankhistorisches Archiv 2013*: remuneration, risk management, investors and lack of competence of the internal control organs.
[230] EBA, Guidelines (n. 175), I. 17 p. 7.
[231] EBA, Guidelines of 22 November 2012 (n. 189), p. 4.
[232] European Commission, *Feedback Statement* (n. 187), p. 2.
[233] This is one more area in which reforms and requirements for financial institutions and for non-financial (listed) companies should be distinguished more clearly. The danger of perverse risk incentives is much more relevant for, and to a certain degree even specific to financial institutions. Cf. Part A II 1 a (4).
[234] E. F. Fama, 'What's different about banks?', *Journal of Monetary Economics* 15 (1985) issue 1, 29. See also later the *Federal Reserve Bank of New York (FRBNY) Economic Policy Review* 9 (2003) no. 1 (April), Special Issue on: Corporate Governance: What Do We Know, and What is Different about Banks?
[235] H. Mehran *et al.* (n. 222), p. 3 et seq.: 'Why is the Governance of Banks Different from That of Nonfinancial Firms?'; s; see already Part A II 1 and III 1 a and infra Part B II 2 b (3) with n. 257. Most recently K. Langenbucher, 'Bausteine eines Bankgesellschaftsrechts', *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR)* 176 (2012) 652; J. Ludwig, *Branchenspezifische Wirtschaftsaufsicht und Corporate Governance,* Berlin (Duncker & Humblot) 2012, in particular p. 238 et seq. concerning the specificities of internal corporate governance of credit institutions and insurance companieT. O. Brandi and K. Gieseler, 'Der Aufsichtsrat in Kreditinstituten', *Neue Zeitschrift für Gesellschaftsrecht (NZG)* 2012, 1321; R. Behle, 'Aufsichtsrechtliche Verantwortlichkeit der Organmitglieder von Kreditinstituten', in Bankrechtliche Vereinigung, ed., *Bankrechtstag 2012,* Berlin (de Gruyter), forthcoming in 2013.

differences have heterogeneous reasons, rooted partly in the banking business and bank structures, partly in the incentives and competences of the persons involved.[236]

a) Banking business and bank structures

In the literature written after the financial crisis, for example by Wohlmannstetter (2011)[237] and by Mehran and others from the Federal Reserve Bank of New York (2012),[238] it has been stressed that the banking business is, or has become, more opaque and complex than non-financial business. This is reflected in bank structures, in particular in groups and cross-border banking. As the financial crisis has evidenced, the boards of the banks have not been able to adequately control the risk-taking of their management, nor have the auditors, the rating agencies and the supervisors. Increasingly, it is now up to the courts and to arbitral tribunals to judge whether management itself has understood the risks that have been taken, or at least whether they have misunderstood them negligently.[239] Many synthetic bank products are evidence of this. In particular, the systemic risks of banking have not been recognised or have been underestimated. We commonly hear slogans such as *too big to fail* and *too connected to fail* and more specifically *too risk-correlated to fail*.[240] The development of increasingly complicated bank structures has added to this opaqueness and complexity and the difficulties in understanding and evaluating them. It has been noted that the Citi group has around 2,500 subsidiaries and that it operates in 84 countries.[241] Furthermore, while traditionally the functions of banking, securities business and insurance were separate, today most of the large international financial institutions are financial conglomerates combining two or all three of these functions. Some of them are so complex that they are systemically relevant.[242] This

[236] According to the Group of Thirty (n. 195), p. 13, behaviour is more important than frameworks and structures, but on p. 16: 'the best board cannot counterbalance a week internal control and risk management architecture'. See also the terms used by the Group: 'hardware' (organization structures and procedures) and 'software' (people, skills, values), *ibid.* at p. 19, 29 et seq.
[237] Wohlmannstetter (n. 173).
[238] *Ibid.*
[239] This is why the whole area of directors' liability has come to be the center of attention in Germany and in other countries. The business law section of the German Lawyers Association (*Deutscher Juristentag*) will devote its 2014 congress in Hannover to this topic. But see also infra Part B II 3 at the end.
[240] J. C. Coffee (n. 170), p. 342 et seq.; L. Schwarcz, 'Systemic Risk', *Georgetown Law Journal* 97 (2008) 193 at 202 et seq.
[241] R. Herring, J. Carmassi, 'The Corporate Structure of International Financial Conglomerates, Complexity and Its Implications for Safety and Soundness', in: A. N. Berger et al. (n. 173), p. 195 at p. 199.
[242] On these so-called large complex financial institutions (LCFIs, so named by the Financial Stability Forum) R. Herring, J. Camrassi (n. 241) p. 197 et s.; the problems arising from systemic risk reach further and are not treated here in more detail, cf. O. de Bandt, P. Hartmann, J. L. Peydró, 'Systemic Risk in Banking: An Update', in: A. N. Berger et a. (n. 173), p. 633; J. C. Coffee, Jr., 'Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight', *Columbia Law Review* 111 (2011) 795; P. O.

opaqueness and complexity of banking business and bank structures has led to grave risk management and internal control failures.

b) The incentives and competences of the persons involved

Not only is the banking business special, but the principal-agent conflicts situation in banks and financial institutions also differs from that in non-financial firms.[243] This can be shown for all persons involved: the management, the board, the shareholders, the debtholders and the supervisors. Let us have a look at all five of them.

(1) Bank management

In practice and academia there is agreement that the remuneration system for bank management has been shown to have created perverse incentives in the years leading up to the financial crisis. It is true that remuneration schemes that reward risk-taking are common not only in banking, but also in parts of industry. But in banking, where risk-taking is part of the business model, such incentives have perverse effects. This is now well established and has been documented in several academic studies, for example by Fahlenbrach and Stulz (2010) and others.[244] What mattered was stock ownership by banking managers, their wealth diversification and the structure of managerial compensation.[245] As Fahlenbrach and Stulz (2010)[246] show, what is particularly interesting is that CEOs with incentives better aligned with shareholders' interests performed more poorly. We will come back to this shortly when we have a look at the incentives of bank shareholders.[247]

(2) Bank boards

Today it is also widely agreed that many bank boards did not fully understand or under-evaluated the risks taken by the management they had to control. This was aggravated by the

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Mülbert and R. D. Citlau, 'The Uncertain Role of Banks' Corporate Governance in Systemic Risk Regulation, ECGI Law Working Paper No. 179/2011.

[243] See already supra Part A II 1.

[244] R. Fahlenbrach and R. M. Stulz, 'Bank CEO Incentives and the Credit Crisis', *Journal of Financial Economics* 99 (2011) 11, available at < http://www.ssrn.com/abstract=1439859 >; H. Mehran *et al.* (n. 222); K. R. Spong and R. J. Sullivan, *Bank Ownership and Risk Taking: Improving Corporate Governance in Banking after the Crisis*, September 2010, available at < http://ssrn.com/abstract=1900609 >.

[245] K. R. Spong *et al.* (n. 244).

[246] R. Fahlenbrach and R. M. Stulz (n. 244).

[247] See infra Part B II 5.

fact that risk management in many banks was lacking or badly deficient.[248] In view of the special risk of banking business, this is particularly troubling. Yet recent literature, for example Beltratti and Stulz (2012) and Ferreira et al. (2012),[249] found also that banks with more shareholder-friendly boards – before it was bank management and the CEOs – performed significantly worse. Other studies found that composition and characteristics of bank boards mattered[250], that banks with more independent boards fared less well.[251]

(3) Shareholders

In the above-mentioned study, Beltratti and Stulz[252] raised the question whether their findings that banks with more shareholder-friendly boards performed significantly worse poses a challenge to the thesis that bank governance was a major cause of the crisis. Under a shareholder-centred concept of bank governance, this is indeed a conundrum. Yet the authors suggest that bank boards may have pursued policies favoured by shareholders. The findings of other studies lead into the same direction: that shareholder structure has an influence on risk taking.[253] Owner-controlled banks had higher profits before the crisis as compared with manager-controlled banks, but did worse during the crisis.[254] Monitoring by major stockholders is relevant.[255] Firms with higher institutional ownership did worse.[256]

These studies confirm that the theory of bank governance must be considered to be different from general corporate governance as has been described in more detail in the 2011/2012 article and seems by now to be widely accepted.[257] While the shareholders as ultimate risk-

[248] H. Mehran *et al.* (n. 222).
[249] A. Beltratti, and R. M. Stulz, 'The credit crisis around the globe: Why did some banks perform better?' *Journal of Financial Economics* 105 (2012) 1, cf. idem, Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation, 2009, available at < http://www.ssrn.com/abstract=1433502 >; D. Ferreira, D. Kershaw, T. Kirchmaier and E. Schuster, Shareholder Empowerment and Bank Bailouts, November 2012, available at < http://ssrn.com/abstract=2170392 > with further references.
[250] K. R. Spong *et al.* (n. 244).
[251] D. H. Erkens, M. Hung and P. Matos, 'Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide', Journal of Corporate Finance 18 (2012) 389, available at < http://ssrn.com/abstract=1397685 >. Cf. also D. Ferreira, T. Kirchmaier and D. Metzger, Boards of Banks, September 20, 2012, available at < http://ssrn.com/abstract=1620551 >.
[252] See n. 249 and Part B II 2 b (2).
[253] L. Laeven and R. Levine, 'Bank governance, regulation, and risk taking', *Journal of Financial Economics* 93 (2009) 259, available at < http://ssrn.com/abstract=1142967 >; D. Ferreira et al. (n. 249).
[254] R. Gropp and M. Köhler, Bank Owners or Bank Managers: Who is Keen on Risk? Evidence from the Financial Crisis, February 23, 2010, available at < http://ssrn.com/abstract=1555663 >.
[255] K. R. Spong *et al.* (n. 244).
[256] D. H. Erkens *et al.* (n. 251).
[257] Supra Part A II 2 b; see in more detail L. Laeven and R. Levine (n. 253); M. Becht, 'The Governance of Financial Institutions in Crisis', in S. Grundmann *et al.,* eds., *Festschrift für Klaus J. Hopt*, Berlin (De Gruyter)

bearers might be expected to check directors' risk-taking, the situation differs greatly according to the shareholder structure of the bank. Normal shareholders do not understand the risks in play and are merely interested in the share price and the dividends, even more so when shareholdings are diversified. Shareholders even tend to push directors into more risk-taking that may be more profitable, at least in the short term. The latter is true also for institutional shareholders[258] who hold only relatively small stakes in the bank and usually are not interested in, nor able to control, the internal corporate governance of all the banks they have invested in. Even if there is a controlling shareholder, there is no guarantee that the controlling shareholder will confine excessive risk-taking. As stated before, controlling shareholders have their own agenda, in particular in the case of bank groups and groups that are active in cross-border banking. Risks taken and borne by one member of the group may benefit the parent or another member of the group. In addition, controlling shareholders are also subject to over-optimism and the temptations of empire-building. Therefore it has righly been remarked that banking reforms that seek to give more power to the shareholders as the Dodd-Frank Act are "ironically counter-productive".[259]

(4) Debtholders

It follows that the theory of bank governance differs from the general theory of corporate governance as it is not shareholder-centred, but debtholder-oriented though, of course, the typical shortcomings of corporate governance on non-financial companies continue to exist also in financial companies.[260] It is typical for banks to have many more stakeholders, namely depositors and other bank creditors, than non-financial firms. They are the ones who are interested in getting their money back and are not interested in more risk-taking that would only benefit the shareholders and, by the way of bonuses, the management.

2010, vol. 2, p. 1615 at p. 1619 et seq.; G. Wohlmannstetter (n. 173), p. 44 et seq. with a behavioural focus; P. O. Mülbert, Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms, ECGI Law Working Paper No. 130/2009, April 2010, p. 14 ff, 19 f (the paper is still based on the 2006 version of the Basel Committee; for the 2010 version, see supra n. 169); as of 2012 J. C. Coffee, Jr. (n. 170), p. 336 et seq., 341: 'Financial institutions are a special case.'

[258] J. C. Coffee, Jr. (n. 170), p. 336 et seq., 339 et seq.; J. Winter, 'The Financial Crisis: Does Good Corporate Governance Matter and How to Achieve it?', in E. Wymeersch et al. (n. 168), p. 368 at p. 378, 387, also available at <http://ssrn.com/abstract=1972057 >.

[259] J. C. Coffee, Jr. (n. 170), p. 341.

[260] This fact has been used as an argument that the principal agent conflicts are the same in both fields and that therefore corporate governance is basically the same too. Yet this would neglect the specific risk aspects as described in the text and the ensuing specificities of debtholder governance and of the need for state supervision of financial institutions.

Yet when changing the perspective from shareholder governance to debtholder governance, the control deficits do not disappear, but just shift from one stakeholder group to another.[261] This is because the normal depositors are not in a position to exercise control over a bank for excessive risk-taking. They have even less incentive to do so if there is a deposit insurance system in place, as is the case in Europe and in the USA. While the large creditors are theoretically able to step in, they are very often secured creditors who are not affected by excessive risk-taking of the bank unless there is an actual or threatened bank crisis.

(5) Supervisors

Since the 1930s and before, this obvious lack of control over the banks by shareholders and debtholders alike has led to extensive bank-specific regulation and supervision that is well known and not the focus of this article. The financial services industry is a regulated industry, and this for very good reasons, as the financial crisis has proved yet again. The aim of bank regulation and supervision is both the protection of the stakeholders, in particular the depositors, and protection against the dangers for the system. While this is a truism, recent literature has shown that there is a *quid pro quo* of bank regulation and supervision: Strengthening official supervision weakens the independence of the board and the monitoring efforts of the stakeholders.[262]

In the remaining part of this paper, the consequences of these empirical findings and theoretical insights will be confronted with the above-reported regulatory developments in 2011 and 2012.[263]

3. Specific bank governance with corporate law reforms on the side

All of the regulatory developments in 2011 and 2012 described in this paper focus on governance measures that are specifically geared at banks. Regulatory measures that are intended to strengthen shareholder and debtholder control are not found, or are at least not the focus of activity. While this is due to the perspective of bank supervision (inherent, for

[261] As to risk shifting from the shareholders to the creditors, asymemetric information and corporate structure see R. Herring, J. Carmassi (n. 241), p. 201 et s.
[262] Li Li, and F. M. Song, *Bank Regulation and Board Independence: A Cross-country Analysis*, Hong Kong University, hku.hk 2009. See also L. Laeven and R. Levine (n. 253).
[263] See supra Part B 1.

example, in the EBA Guidelines and the (draft) instruments regulating access to the activity of financial institutions), this is also in line with what has been found here before.

Strengthening debtholder governance, for example by extending fiduciary duties to debtholders as suggested by earlier policy recommendations,[264] has not turned out to be convincing,[265] quite apart from the fact that there are many grounds for bank liability already under current law. In response to the Green Paper on Corporate Governance of Financial Institutions, the vast majority of respondents were opposed to any increase in civil and criminal liability of directors[266] and in reaction to the answers to its consultation, the European Commission in its Action Plan of 2012[267] has refrained from making this a major reform proposal.[268] Effective implementation should be studied first and increased liability could dampen sound initiatives and might make it more difficult to hire good directors. This is not to say that general corporate law reforms, such as introducing or reaffirming the stakeholder goal for directors, may not also have certain benefits for bank governance. But these benefits are contested, and in any case they are only minor.[269]

Strengthening shareholder governance, in particular by trying to incentivize institutional investors for governance questions, has met with approval by a clear majority of the respondents to the Green Paper,[270] though it is doubtful whether these answers were specifically for bank governance and not rather for corporate governance more generally. This issue has been discussed for quite a while and has met with broad sympathy. As stated in its 2012 company law action plan the European Commission intends to follow this route.[271] Yet the hopes set at getting institutional investors to actively and consistently participate in internal corporate governance are rather doubtful, according to some even futile.[272]

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[264] J. R. Macey and M. O'Hara, 'The Corporate Governance of Banks', *FRBNY Economic Policy Review*, Vol. 9, No. 1, April 2003, 91; available at < http:/ssrn.com/abstract=795548 >. Cf. supra Part A II 1 a. See J. G. Hill, 'Why did Australia fare so well in the global financial crisis?', in E. Ferran et al. (n. 177), p. 203 at p. 292 et seq., 294, contending that more severe liability of directors may even have played a role for Australia in faring better in the financial crisis than other countries.

[265] H. Mehran *et al.* (n. 222), p. 17. Cf. also M. J. Roe and F. C. Venezze, A Capital Market, Corporate Law Approach to Creditor Conduct, 9 January 2013, < http://ssrn.com/abstract=2103217 >; C. K. Whitehead, Creditors and Debt Governance, 12 February 2011, < http://ssrn.com/abstract=1760488 >.

[266] Green paper (n. 14), Answers to questions 6.1 and 6.2. Cf. supra Part A III 1 d.

[267] Supra n. 181.

[268] Cf. K. J. Hopt (n. 182).

[269] Cf. K. J. Hopt (n. 208), *American Journal of Comparative Law* 59 (2011) 1 at 28 et seq. with further references.

[270] Green Paper (n. 179), Answers to questions 5.1 and 5.2: disclosure of institutional investors' voting practices and polices being compulsory, code of best practice.

[271] European Commission, Action Plan (n. 181) 2.4 and 3; cf. supra Part B I 2 d.

[272] See J. C. Coffee (n. 258) and J. Winter (n. 258).

4. Supervisory law requirements for board and bank structure, and internal procedures

a) Risk management and internal control

Nearly all of the above regulatory initiatives focus on risk management and internal control.[273] This is key for the EBA Guidelines, which present a three-line control concept: risk management, internal control and internal audit.[274] As mentioned above, the Guidelines see the following as important factors: The risk culture, the alignment of remuneration with risk profile, the risk management framework and a separate risk control function. The risk control function should be under the exclusive responsibility of the Chief Risk Officer (CRO), who monitors the institution's risk management framework across the entire organization.[275] A specific risk committee of the board, an independent risk management function and a chief CRO (with the status at least equal to the CFO) are also part of other policy measures, for example of the CRD-IV Proposal for a Directive[276] and the Solvency II Directive.[277]

These measures are broadly in line with the recent literature, for example Mehran *et al.* (2011)[278], with their emphasis on risk management and have also been considered to be of utmost concern in the my earlier article.[279] The importance of the CRO and the risk committee have been analysed by Ellul and Yerramilli (2010)[280] for US bank holding companies, with the expected result that stronger risk controls lead to lower risk and lower volatility.

b) Bank structure and bank groups

The dangers and difficulties for bank supervision that arise from bank structures are well known. Yet the policy implications, in particular the pros and cons of ring-fencing and other

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[273] This confirms what has been said in the earlier article, supra Part A III 2 d.

[274] EBA Guidelines (n. 175), paras. 20 et seq., 24 et seq., 28 et seq., p. 32 et seq., 37 et seq., 43 et seq.

[275] EBA Guidelines (n. 175) para. 27 p. 42.

[276] CRD IV Draft Directive (n. 190).

[277] Solvency II (n. 191)

[278] H. Mehran *et al.* (n. 222), p. 12 et seq.

[279] K. J. Hopt (n. 168), p. 25 et seq. See also Group of Thirty (n. 195), p. 21 et seq., 45 et seq. on risk governance; *idem* at p. 46: the essence of financial institutions' governance is understanding risk. But see also C: van der Elst, The Risks of Corporate Legal Principles of Risk Management, 10 June 2010, available at < http://ssrn.com/abstract=1623526 >.

[280] A. Ellul and V. Yerramilli, 'Stronger Risk Controls, Lower Risk: Evidence from U.S. Bank Holding Companies', *Working Paper* 2011, Indiana University, available at < http://ebookbrowse.com/yerramilli-pdf-d69151777 >.

measures restricting the freedom of banks to provide all kind of financial services under the universal banking model, are highly controversial and still under discussion. In the USA (Dodd-Franks)[281] and the United Kingdom (Vickers Report)[282] and to a certain degree in Brussels (Liikannen Report)[283] such measures have been viewed favourably by policy-makers, though there is wide-spread resistance, while in Germany and other countries in continental Europe with a universal banking tradition, there is clear resistance to such plans.[284] This resistance does not only come from banks, but also from most German economist, prominently for example from Martin Hellwig.[285] But the political agenda, in particular before and after general elections, is different, as in France where separation will been mandated, though in a mild form, and most recently also Germany may follow. Yet this is an area that is not directly related to internal governance and must be left aside in the present context.

But a short observation concerning bank groups is appropriate. The EBA Guidelines are well aware of the special problems of bank groups for effective supervision[286] and treat them in the context, for example, of know-your structure, internal control and the risk control function. This is so because there are dangers for both, for the parent from a risky subsidiary and for the subsidiary if the group becomes financially distressed.[287] These problems are of great practical importance, because the legal framework for groups and the information flow within the groups, in particular in international banking groups, is not up to the necessities of overall responsibility of the bank parent for all members of the group. Since these difficulties result

[281] Dodd-Frank Act, § 619; see J. C. Coffee, Jr. (n. 170), p. 361 et seq.; J. D. Duffie, Market Making Under the Proposed Volcker Rule, 16 January 2012, available at < http://ssrn.com/abstracts=1990472 >

[282] Independent Commission on Banking (Vickers Commission), *Final Report: Recommendations,* London, September 2011, available at http://bankingcommission.independent.gov.uk/ and, following these proposals, HM Treasury and Department for Business, Innovation and Skills, *Banking reform: delivering stability and supporting a sustainable economy,* Cm 8356, London (HM Treasury) June 2012. Cf. GA Walker, 'Structural regulation and financial reform: The Independent Commission on Banking', *Law and Financial Markets Review* 2011, 418; see also Banking Reform Bill published, *Law and Financial Markets Review* 2012, 429.

[283] E. anen, *High-level Expert Group on reforming the structure of the EU banking sector, Final Report,* Brussels, 2 October 2012 with the recommendation of requiring legal separation of certain particularly risky financial activities from deposit-taking banks within the banking group.

[284] Cf. E. Ferran (n. 183), p. 23 et seq., 39 et seq. Cf. also H. Mehran *et al.* (n. 222), p. 18 et seq.; F. Arnaboldi and B. Casu, 'Corporate governance in European banking', in: J. R. Barth *et al.* (n. 220), p. 588. On universal banking see a. D. Morrison, 'Universal Banking', in: A. N. Berger et al. (n. 173), p. 171 P. K. Staikouras, 'Universal Banks, Universal Crises? Disentangling Myths from Realities in Quest of a New Regulatory and Supervisory Landscape', Journal of Corporate Law Studies 11 (2011) 139. The most recent French banking structure draft reform act of December 2012 provides for some limits, but does not go very far and cannot be considered to be a clear move towards the separation system, 'Loi de séparation et de régulation des activités bancaires – Remettre la finance au service de l'économie réelle', Paris, 19 December 2012.

[285] M. Hellwig, f. ex. in his lecture at Cambridge, UK, on 29 November 2012.

[286] EBA Guidelines (n. 175), II. 6 p. 18 et seq., III. 24 et seq., p. 37 et seq., III 26 p. 40.

[287] R. Herring, J. Camrassi (n. 241), p. 205 et s.

from the law, they tend to be neglected by economic and financial literature. But legal literature has recognised and analysed the problems created by bank groups for the internal governance in the group, for auditing and for supervising them (Binder, Erdland *et al.*, Andriowsky and Lautenschläger *et al.*, all 2011),[288] quite apart from the unresolved and controversial question whether cross-border banking groups that have subsidiaries located in different EU jurisdictions need European supervision, rescue and resolution.[289] This is in line with the renewed interest of the European Commission and others in European framework rules for corporate groups more generally.[290]

c) Board structure

All policy measures in the above regulatory instruments and proposals in 2011 and 2012 include rules and recommendations for the structure of the boards of the banks, for example separation of the chair and the CEO, establishment and functions of board committees and independence requirements. Examples are the EBA Guidelines,[291] the CRD IV Proposal for a Directive[292] and the Solvency II Directive.[293] This is in line with the fact that the board is ultimately responsible for the bank and is a central player in bank governance.[294] Many policy considerations and reform measures of general corporate governance for boards[295] are also relevant for bank boards, for example the increasing duties of the board, the trend towards professional boards, the quest for improving the information flow from management to the

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[288] J.-H. Binder, 'Interne Corporate Governance im Bankkonzern', in: K. J. Hopt, G. Wohlmannstetter (n. 168), p. 685; A. Erdland and A. Neuburger, ‚Corporate Governance von Finanzkonglomeraten', in: *idem* (n. 168), p. 717; E. Andriowsky, 'Herausforderungen bei der Prüfung eines Bankkonzerns', in: *idem* (n. 168), p. 735; S.Lautenschläger and A. Ketessidis, 'Führung von gruppenangehörigen Banken und ihre Beaufsichtigung', in: *idem* (n. 168), p. 759.

[289] Cf. among many G. A. Ferrarini, F., 'Nationally Fragmented Supervision Over Multinational Banks as a Source of Global Systemic Risk: A Critical Analysis of Recent EU Reforms', in E. Wymeersch et al. (n. 168), p. 193, also available at < http://ssrn.com/abstract=1923756 >. As to the experiences with the present system of cooperation of different supervisory agencies in colleges of supervisors see J. Black (n. 223), p. 3 at p. 37 et seq.; as to the experiences with IOSCO's Multilateral Memorandum of Understanding (MMoU) see A. van Cauwenberge, 'Developments Regarding Global Cooperation in Supervision of Financial Markets', in E. Wymeersch at al. (n. 168), p. 391.

[290] European Commission, Action Plan (n. 181) 3.2 and 4.6, apart from other improvements of the framework for cross-border operations of EU companies; cf. supra Part B I 2 d and K. J. Hopt (n. 182) with further references.

[291] EBA Guidelines (n. 175).

[292] CRD IV Draft Directive (n. 190).

[293] Solvency II (n. 191)

[294] Group of Thirty (n. 195), p. 13: boards of directors play the pivotal role in financial institutes' governance. Cf. for non-financial institutions K. J. Hopt (n. 208) *American Journal of Comparative Law* 59 (2011) 1 at 19-44 and P. Davies, K J. Hopt, 'Boards in Europe – Accountability and Convergence', *American Journal of Comparative Law* 61 (2013) (forthcoming). See also P. Davies, K. J. Hopt, R. Nowak, G. van Solinge, eds., *Corporate Boards in European Law: A Comparative Analysis,* Oxford (Oxford University Press) 2013 (forthcoming).

[295] *Ibid.*

board and the need for the board to be able to directly contact the heads of risk management, compliance and internal control. All this has been spelled out by experts in these fields.[296]

But some research is specific to banks.[297] The pros and cons of one-tier boards and two-tier boards specifically for banks have been discussed[298] and the positive experience with a two-tier system for banks in one-tier system countries like Switzerland and Belgium, also recently adopted in Italy, have been underlined.[299] The counter argument is that the separation between the chair of the board and the CEO is sufficient and that the control of management can also be effectuated in one-tier boards. Board size is larger in banks than in non-financial institutions,[300] a fact that does not seem to have negative consequences.[301] But still, usually smaller bank boards are recommended.[302]

What is particularly interesting is that the traditional reliance on independent directors has been shattered by empirical work on banks. Banks with more independent directors have done worse in the financial crisis.[303] Some conclude that for banks greater independence comes at the price of less expertise to monitor the actions of the CEO, and may in the end even be a bad thing.[304] This reinforces the doubts in the benefits of overly strict independence requirements for board members in general. There is usually a negative correlation between independence and competence, and modern corporate law appears to be moving away from focusing exclusively on independent directors and instead emphasises the need for competence and experience.[305]

5. Supervisory law requirements for the (management) board and key functions holders of the bank

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[296] S. Reckhenrich, 'Neue Anforderungen an den Bankvorstand', in: K. J. Hopt and G. Wohlmannstetter (n. 168), p. 469; R.-E. Breuer, 'Die Professionalisierung der Aufsichtsratsarbeit in der Bank', in: *idem* (n. 168), p. 515; O. K. Brandt and M. Karg, 'Berichterstattung an den Aufsichtsrat', in: *idem* (n. 168), p. 583.

[297] Cf. the comparative data given by F. Arnaboldi *et al.* (n. 284), p. 588 at p. 592 et seq. See already supra Part A III 3 a and b.

[298] F. Arnaboldi *et al.* (n. 284), p. 597. Cf. also Group of Thirty (n. 195), p. 28, 43.

[299] See supra Part A III 2 a.

[300] F. Arnaboldi *et al.* (n. 284), p. 594 et seq.

[301] H. Mehran *et al.* (n. 222), p. 9; R. B. Adams and H. Mehran, 'Bank Board Structure and Performance: Evidence for Large Bank Holding Companies', *Journal of Financial Intermediation* 21 (2012) 243.

[302] Group of Thirty (n. 195), p. 35: 'A board of 10 to 12 members can operate efficiently, cohesively and decisively.'

[303] D. H. Erkens *et al.* (n. 251); H. Mehran *et al.* (n. 222).

[304] R. B. Adams, 'Governance and the Financial Crisis', International Review of Finance 12 (2012), 7, April 2009 version available at < http://ssrn.com/abstract_id=1398583 >; but cf. also H. Mehran *et al.* (n. 222), p. 10.

[305] K. J. Hopt (n. 208), *American Journal of Comparative Law* 59 (2011) 1 at 36 et seq.; M. Roth, 'Unabhängige Aufsichtsratsmitglieder', *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR)* 175 (2011) 605 at 625 et seq.

For a long time, bank regulation and supervision has emphasised the qualifications of actual bank management. Since the financial crisis, there has been an increased focus on this qualification.[306] The EBA makes a point not to advocate any particular structure of the board, whether a unitary board or a dual board, and addresses its qualification requirements to the 'management body', whether the management body in its management function or the management board under the two-tier system.[307] The qualification requirements for the management body are high.[308] In the more recent EBA Guidelines of 22 November 2012, the suitability requirements for members of the management body and key function holders are spelt out in considerably more detail.[309] These requirements extend to key function holders in the bank. Interviews of the supervisory agencies not only with management, but also with holders of significant influence functions (SIFs) have become common practice. So is direct access of bank executives to supervisors.

This emphasis on qualification is in line with general corporate governance findings. Competence and experience of board members are at least as important for banks as independence.[310] As reported in the above-mentioned earlier paper on bank governance,[311] Hau and Thum[312] have analysed the profile of the 29 largest German banks and the biographies of 593 supervisory bank board members. They found that: (1) The public banks (in particular state banks or *Landesbanken*) had losses between the first quarter 2007 and the third quarter 2008 that were three times as high as other privately owned banks; and (2) that the management and financial experience of the board members in the other banks was systematically higher than that in the public banks. The correlation between the losses of the banks and the qualification and experience of the bank directors was statistically highly significant and indicated causality between the two. Yet some other findings may qualify this. Mehran *et al.* (2012) mention that greater expertise of bank directors may be a further alignment with risk-taking incentives. There is speculation that the more technical members

[306] See supra Part A III 3 b.
[307] EBA Guidelines (n. 175) II.32, p. 10, III.10, p. 22.
[308] EBA Guidelines (n. 175), III.13, p. 25 et seq. There is, of course, also an issue about the time spent on the job, H. Mehren *et al.* (n. 24), p. 12. The Group of Thirty (n. 195), p. 29, mentions that a 40-50 day time requirement not unusual.
[309] EBA Guidelines of 22 November 2012 (n. 189).
[310] See supra Part A III 4 c.
[311] K. J. Hopt (n. 168), para. 11.18, p. 344 et seq.
[312] H. Hau and M. Thum, 'Subprime Crisis and Board (In)Competence: Private vs. Public Banks in Germany', June 21, 2010, *INSEAD Working Paper* No. 2010/45/FIN, available at < http://ssrn.com/abstract=1627921 >. See also the harsh critique by Wohlmannstetter (n. 3), p. 31, 47 et seq., 61 et seq.

may be focused on the details, while the non-financial experts may ask the important, high-level strategic questions.[313]

Much of the more recent bank regulatory effort, maybe too much, has been spent on the perverse incentives created by remuneration systems. This is in line with much of the literature[314] and does not need to be repeated here.[315] It has been reported that, prior to the crisis, banks included stronger risk-taking incentives for CEOs.[316] As already mentioned, Fahlenbrach and Stulz (2010)[317] found that CEOs with incentives better aligned with shareholders' interests performed worse. This can be explained by the shareholders being more risk-inclined, as mentioned above.[318] But it is questionable whether regulatory pressure provides sufficient incentives for bank directors.[319] In any case bankers' pay regulation is not among the most important issues in reshaping international financial architecture.[320]

III. Summary and theses

I. Corporate governance of firms and its relevance for banks and other financial institutions

1. Corporate governance is the system by which companies are directed and controlled (Cadbury). This concept is appropriate for banks, too. Yet for banks and other financial institutions, the scope of corporate governance goes beyond the shareholders (equity governance) to include debtholders (debt governance). Some include the state as stakeholder, but the role of the state is better understood as setting the rules of the game in a regulated industry.

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313 H. Mehran et al. (n. 222), p. 10 et seq.

314 Eg., R. Fahlenbrach and R. M. Stulz (n. 244); H. Mehran *et al.* (n. 222), p. 5 et seq.; L. A. Bebchuk and H. Spamann, 'Regulating Bankers' Pay', 98 *Georgetown L. J.* 247 (2009); G. A. Ferrarini, N. Moloney and M. C. Ungureanu, 'Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis', June 9, 2009, ECGI Law Working Paper No. 126/2009, available at < http://ssrn.com/abstract=1418463 >; G. A. Ferrarini and M. C. Ungureanu, 'Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks', *Vanderbilt L. Rev.* 62, No. 2 (2011), 431, available at < http://ssrn.com/abstract=1707344 >; E. Ferran, 'New Regulation of Remuneration in the Financial Sector in the EU', *European Company and Financial Law Review (ECFR)* 2012, 1. But see also R.B. Adams (n. 304) who finds that bank directors earned significantly less compensation than their counterparts in non-financial firms. Cf. more generally R. S. Thomas and J. G. Hill, eds., Research Handbook on Executive Pay, Elgar 2012.

315 See supra Part A III 3 d.

316 D. H. Erkens *et al.* (n. 251), p. 10.

317 R. Fahlenbrach, R. M. Stulz (n. 244).

318 See section III 2 b (1) above.

319 R. B. Adams and D. Ferreira, 'Regulatory Pressure and Bank Directors' Incentives to Attend Board Meetings', 12 *International Review of Finance* 227 (2012).

320 E. Ferran (n. 314), p. 1 at p. 2; E. Avgouleas, *Governance of Global Financial Markets,* Cambridge (Cambridge University Press) 2012, p. 126 et seq., 129.

2. For firms, both internal and external corporate governance by markets are relevant. From the perspective of bank regulation and supervision, internal governance of banks is at the center stage. External corporate governance, in particular by the market of corporate control (takeovers), is more important for firms than for banks, at least under continental European practice.

3. Not only banks are special. Specific corporate governance needs exist also for insurance companies and other financial institutions. All players in the financial markets must be supervised, though not necessarily regulated. For some, mere disclosure may suffice, at least initially.

II. Governance of financial institutions

4. Whether failures in the (corporate or internal) governance of banks were a major cause of the financial crisis is highly controversial. The fact is that there were wrong incentives inspired by compensation practices, deficiencies in board profile and practices (especially but not exclusively in state-owned banks), and failures in risk management and internal control. This was exacerbated by complex and opaque bank and bank group structures and by the legal and practical difficulties of regulating and supervising cross-border operations of bank groups. While these deficiencies did play a certain role, there were many other and more important causes that led to the financial crisis. Systemic risk is not avoided by governance measures.

5. Equity governance and debt governance face partly parallel and partly divergent interests of management, shareholders, debtholders, and supervisors. Management tends to be risk-averse for lack of diversification, but may be more risk-prone because of equity-based compensation, in end games and under similar circumstances. Shareholders are risk-prone and interested in corporate governance. Debtholders are risk-averse and interested in debt governance. Supervisors are risk-averse and interested in maintaining financial stability and in particular in preventing systemic crises. All this contributes to making the governance of financial institutions special. This is confirmed by recent empirical research.

6. Deposit insurance and bail-out have an ambiguous role. Both encourage undue risk-taking and free-riding, but they are indispensible for depositor protection and mastering systemic crises. This trade-off requires careful balancing. Whether this succeeds depends on the details and the concrete situation.

III. Internal governance of financial institutions: Corporate and supervisory reform proposals under discussion

7. Corporate law reforms are less suited for the governance of banks and other financial institutions. Labor codetermination in the board does not benefit debtholders. Representation of the debtholders or of the deposit insurers in the board is also of doubtful use. Particular problems exist in state-owned banks. Directors of firms and banks already have far-reaching duties and liabilities under the present law. The problem is rather enforcement. Enforcement is being stepped up in the wake of the financial crisis.

8. Strengthening supervisory law requirements is more promising. Regarding board and bank structure, prominent proposals include the following: clearer separation of the management and control function by a two-tier board, as in Switzerland and Belgium; establishment of a separate risk committee of the board or an independent chief risk officer (CRO); dealing with the problem of complex or opaque bank structure; and group-wide corporate governance in single entities as well as in the bank group.

9. Appropriate supervisory law requirements are needed for bank-internal procedures, specifically for risk management, internal control and compliance, as well as for internal and external auditing. Facilitating the exercise of shareholder rights can be left to the corporate governance of the firm. While the financial crisis showed clearly that more regulation, supervision and enforcement were unavoidable, there are now signs of overregulation. Also here it must be remembered: The market knows better than the state, provided that the state sets the appropriate rules of the game.

10. In the end, everything depends on the people. Therefore supervisory law requirements need to address foremost the profile and practices of the board. The traditional wisdom of corporate governance of the firm is to have independent non-executive directors (NEDs). Yet the experience of the financial crises and recent empirical studies show that qualification and

experience of bank board members is at least as important, if not more important. This has been demonstrated particularly in the failures of state-owned banks. Professionalization, continuous formation, and external evaluation are therefore important desiderata to be monitored and enforced by bank supervision.

11. In addition, fit and proper tests for the management, key function holders and major shareholders of banks are useful. So are appropriate incentives and the elimination of negative incentives, in particular as far as compensation of the board, the management, and key personnel is concerned. Measures that enhancing long-term orientation and shareholders' say on pay are rightly on the reform agenda.

IV. Spilling over of bank governance to firm governance?

12. There is growing concern that the severe requirements of bank regulation and bank supervision will spill over to the corporate governance of the firm. It is true that there is such a phenomenon in relation to risk-prevention standards, requirements on the profile and practices of the board and compensation. Yet general supervision of corporations is out of question, apart from the already-existing securities markets supervision, and a more general spilling over of bank governance requirements to the general firm would lead to overregulation and impair the fair play of the market.

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