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The Corporate Governance of Banks

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The Corporate Governance of Banks:
A Concise Discussion of Concepts and Evidence

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Abstract

This paper examines the corporate governance of banks. When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms, boosts capital formation, and stimulates productivity growth. Thus, weak governance of banks reverberates throughout the economy with negative ramifications for economic development. After reviewing the major governance concepts for corporations in general, this paper discusses two special attributes of banks that make them special in practice: greater opaqueness than other industries and greater government regulation. These attributes weaken many traditional governance mechanisms. Next, the paper reviews emerging evidence on which government policies enhance the governance of banks and draws tentative policy lessons. In sum, existing work suggests that it is important to strengthen the ability and incentives of private investors to exert governance over banks rather than relying excessively on government regulators. These conclusions, however, are particularly tentative because considerably more research is needed on how legal, regulatory, and supervisory policies influence the governance of banks.

I. Introduction and Motivation

Research finds that banks are critically important for industrial expansion, the corporate governance of firms, and capital allocation. When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms, boosts capital formation, and stimulates productivity growth. Thus, the functioning of banks has ramifications for the operations of firms and the prosperity of nations.[1]

Given the importance of banks, the governance of banks themselves assumes a central role. If bank managers face sound governance mechanisms, they will be more likely to allocate capital efficiently and exert effective corporate governance over the firms they fund. In contrast, if banks managers enjoy enormous discretion to act in their own interests rather than in the interests of shareholders and debt holders, then banks will be correspondingly less likely to allocate society's savings efficiently and exert sound governance over firms.

Banking crises dramatically advertise the enormous consequences of poor governance of banks. Banking crises have crippled economies, destabilized governments, and intensified poverty. When bank insiders exploit the bank for their own purposes, this can increase the likelihood of bank failures and thereby curtail corporate finance and economic development.

While banks are important, this alone does not motivate a separate analysis of the governance of banks. Banks are firms. They have shareholders, debt holders, boards of directors, competitors, etc. This suggests that one can simply think about the governance of banks in the same way that one thinks about the governance of a shoe company, or an automobile company, or a pharmaceutical company.

Banks, however, have two related characteristics that inspire a separate analysis of the corporate governance of banks. First, banks are generally more opaque than nonfinancial firms. Although information asymmetries plague all sectors, evidence suggests that these informational asymmetries are larger with banks (Furfine, 2001). In banking, loan quality is not readily observable and can be hidden for long periods. Moreover, banks can alter the risk composition of their assets more quickly than most non-financial industries, and banks can readily hide problems by extending loans to clients that cannot service previous debt obligations. Not surprisingly, therefore, Morgan (2002) finds that bond analysts disagree more over the bonds issued by banks than by nonfinancial firms. As detailed below, the comparatively severe difficulties in acquiring information about bank behavior and monitoring ongoing bank activities hinder traditional corporate governance mechanisms.

Second, banks are frequently very heavily regulated. Because of the importance of banks in the economy, because of the opacity of bank assets and activities, and because banks are a ready source of fiscal revenue, governments impose an elaborate array of regulations on banks. At the extreme, governments own banks. Of course, banking is not the only regulated industry and governments own other types of firms. Nevertheless, even countries that intervene little in other sectors tend to impose extensive regulations on the commercial banking industry. Furthermore, the explosion of international standards through the BIS, the IMF, and World Bank virtually assures heavy government involvement in the banking industry. As described below, however, many government regulations adversely distort the behavior of bankers and inhibit standard corporate governance processes. In terms of ownership, the World Bank (2001) calculates that in the late 1990s 40 percent of the world's population lived in countries where the majority of banks assets were held in state controlled banks.[2] When the government is the owner, this changes the character of the governance of banks. The pervasive hand of government regulation and ownership of banks warrants an independent discussion of the governance of banks.

II. Conceptual Framework

This section briefly describes the corporate governance of corporations in general. I examine how small and large equity and debt holders exert corporate governance and discuss impediments to their abilities to monitor and shape bank behavior. I also examine the role of market competition in corporate governance. I rely heavily on Shleifer and Vishny's (1997) comprehensive review. The next section discusses how the special features of banks complicate the governance of banks.

A. Diffuse shareholder

In textbook models of a firm, diffuse shareholders exert corporate governance by directly voting on crucial issues, such as mergers, liquidation, and fundamental changes in business strategy, and indirectly by electing the boards of directors to represent the interests of the owners and oversee the myriad of managerial decisions. Incentive contracts are a common mechanism for aligning the interests of managers with those of shareholders. The board of directors may negotiate managerial compensation contracts that link compensation with achieving particular results.[3] Thus, diffuse shareholders may exert corporate governance directly through their voting rights and indirectly through the board of directors.

A variety of factors, however, keep diffuse shareholders from effectively exerting corporate control. There are large informational asymmetries between managers and small shareholders and managers have enormous discretion over the flow of information. Small shareholders frequently lack the expertise to monitor managers. Furthermore, the large costs associated with monitoring managers accompanied by each small investors small stake in the firm may induce a "free-rider" problem: each investor relies on others to undertake the costly process of monitoring managers, so there is too little monitoring. Given the difficulties in acquiring information, the voting rights mechanism may not work effectively. Also, the board of directors will not represent the interests of the minority shareholders, if – as occurs to often – management captures the board. Finally, in many countries, legal codes do not adequately protect the rights of minority shareholders and legal systems frequently do not enforce the legal codes that are actually on the books concerning minority shareholder rights. These forces work to provide managers with significant discretion over the control of corporate assets.

B. Concentrated shareholders

One corporate governance mechanism for preventing managers from deviating too far from the interests of owners is concentrated ownership. Large investors have the incentives to acquire information and monitor managers. Furthermore, large shareholders can elect their representatives to the board of directors and thwart managerial control of the board of directors. Large shareholders will also be more effective at exercising their voting rights than an ownership structure dominated by small, comparatively uninformed investors. Finally, well-informed, large shareholders can more effectively negotiate managerial incentive contracts that align owner and manager interests than poorly-informed small shareholders whose representatives – the board of directors – can be manipulated by management.

Concentrated ownership raises new corporate governance problems, however. Large investors may pay themselves special dividends and exploit business relationships with other firms they own that profit themselves at the expense of the corporation or bank. In general, large shareholders maximize the private benefits of control at the expense of small investors (DeAngelo and DeAngelo, 1985; Zingales, 1994). Thus, while concentrated ownership is a common mechanism for confronting the corporate governance issue, it has its drawbacks. Again, the legal system's ability to thwart insider arrangements that exploit small stakeholders has important implications for the effectiveness of corporate governance.

C. Diffuse Debt holders

Debt purchasers provide finance in return for (i) a promised stream of payments and (ii) a variety of other covenants pertaining to corporate behavior, such as the value and risk of corporate assets. If the corporation violates these covenants or defaults on the payments, then debt holders typically obtain the rights to repossess collateral, throw the corporation into bankruptcy proceedings, vote in the decision to reorganize, and vote on removing managers. Clearly, the effective exertion of corporate control with diffuse debt depends on the efficiency of the legal and bankruptcy systems.

There are barriers, however to diffuse debt holders effectively exerting corporate governance. Small debt holder maybe unable to monitor complex organization and will face the same "free-rider" incentives as small equity holders discussed above. Legal systems in many countries give companies the right of an automatic stay on assets and managers frequently remain in place pending a decision by the bankruptcy court. This makes repossession of assets difficult even for secured creditors and reduces the governance power of debt holders. Furthermore, inefficient bankruptcy proceedings frequently take years to complete, which further erodes the corporate governance role of diffuse debt.

D. Concentrated Debt Holders

As with large equity holders, concentrated debt can ameliorate some of the information and contract enforcement problems with diffuse debt. Because of their large investment, large debt holders are more likely to have the ability and the incentives to exert control over the firm by monitoring managers and influencing the composition of the board of directors. Large creditors obtain various control rights in the case of default or the violation of covenants. In terms of cash flow, concentrated debt holders can also renegotiate the terms of loans, which may avoid inefficient bankruptcies. Thus, large creditors frequently exercise substantial control rights and cash flow power over corporations.

Nevertheless, large creditors face obstacles. First, the effectiveness of large creditors relies importantly, though arguably to a lesser degree than with small debt holders, on legal and bankruptcy systems. If the legal system does not efficiently identify the violation of contracts and provide the means to bankrupt and reorganize firms, then creditors lose a crucial mechanism for exerting corporate governance. Second, large creditors – like large shareholders – may attempt to shift the activities of the corporation or bank to reflect their own preferences. For instance, large creditors may induce the company to forego good investments and take on too little risk because the creditor bears some of the cost but will not share the benefits (Myers, 1977). More generally, large creditors may seek to manipulate the corporation's activities for personal gain.

E. Role of competition in product market and takeovers

Instead of focusing on the legal mechanisms via which equity and debt holders seek to exert corporate control, Alchian (1950) stress that market competition forces firms to minimize costs, including the adoption of corporate control mechanisms that minimize the cost of raising external finance. Nevertheless, in their extensive survey, Shleifer and Vishny (1997, p. 738) conclude that although "… product market competition is probably the most powerful force toward economic efficiency in the world, we are skeptical that it alone can solve the problem of corporate governance."

A second form of competition may also address governance problems: takeovers. Poorly performing firms may receive a tender offer and the shareholders can decide whether to accept the offer. If they accept the offer, the acquiring firm may fire the managers of the target firm. A fluid takeover market would thus create incentives for managers to act in the best interests of the shareholders to avoid being fired in a takeover (Jensen, 1988, 1993). Evidence, however, suggests that given the power of managers and the scarcity of liquid capital markets, takeovers are essentially nonexistent as a corporate governance mechanism outside of the U.S. and the U.K. (Shleifer and Vishny, 1997).

III. The Governance of Banks: Special Features[4]

As discussed, banks have two traits that motivate a separate analysis. Specifically, banks are generally more opaque than non-financial firms and governments heavily intervene in the banking industry more frequently. I now examine the implications these traits for the governance of banks.

A. Opaqueness of Banks: Implications for Corporate Governance

1. Opaqueness: Implications for governance by equity and debt holders

The greater informational asymmetries between insiders and outsiders in banking make it very difficult for diffuse equity and debt holders to monitor bank managers. As noted, controlling owners have incentives to increase the bank's risk profile. Debt holders, however, do not enjoy any upside potential from risk taking but do on the downside if the bank cannot service its debts. The greater opacity of banks makes it harder for debt holders to control banks from this risk shifting.

In terms of incentive contracts, greater informational asymmetries make it more difficult to design contracts that align managers' interests with bank equity holders. When outcomes are difficult to measure and easy to influence in the short-run, managers will find it easier to manipulate pay-offs from 'compensation' packages. Bankers who are interested in boosting their compensation in the short run can give a high interest loan to a borrower in trouble, thereby boosting interest income. And by controlling significant pools of resources, bankers can move asset prices that trigger payments to themselves under incentive contracts. Furthermore, since managers frequently control the boards of directors that write the incentive contracts, managers of opaque banks can often design compensation packages that allow managers to benefit at the expense of the long-run health of the bank.

While many argue that large creditors – e.g., holders of subordinated debt and debentures – can ease informational asymmetries in banks and boost corporate governance, there are complicating factors. Large creditors rely on legal systems that are frequently unable to support their rights, with adverse implications for corporate governance. Also, large creditors may use their insider status to benefit themselves at the expense of the less-informed investors and efficient corporate governance as shown by Calomiris and Powell (2000). Beyond these complicating factors, there are other difficulties associated with relying on subordinated debt to improve governance as discussed below.

Opaqueness also makes it easier for insiders to exploit outside investors and the government. In many countries, the domination of large sectors of the economy by relatively few families makes insider abuses more likely, most often at the expense of outside equity investors, depositors, and ultimately taxpayers. La Porta, Lopez-de-Silanes and Zamarripa (2003) find high rates of connected lending in Mexico. They find that 20% of total loans go to related parties. These loans benefited from interest rates that were about 415-420 basis points below those to unrelated parties. Related borrowers also benefited from longer maturities, were significantly less likely to have to post collateral, were 33% less likely to pay back, and the recovery rates on these loans were massively less (78 percent lower) than on loans to unrelated parties. Similarly, Laeven (2001) presents evidence that insiders in Russian banks diverted the flow of loans to themselves and then defaulted 71% of the time.

2. Opaqueness: Implications for governance by competition

The opacity of banks can weaken competitive forces that, in other industries, help discipline managers through the threat of takeover as well as through competitive product markets. Product market competition is frequently less intense in banking. Bankers typically form long-run relationships with clients – to ameliorate the informational problems associated with making loans – and these relationships represent barriers to competition

Takeovers are likely to be less effective when insiders have much better information than potential purchasers. Even in industrialized countries, hostile takeovers tend to be rare in banking (Prowse, 1997). Indeed, long delays in the regulatory approval process associated with bank purchases makes hostile takeovers in banking extremely rare. Post-failure takeover, which is happening with greater frequency, almost by definition, does not affect managerial incentives.

Furthermore, the absence of an efficient securities market hinders takeover and hence corporate governance. If potential corporate raiders cannot raise capital quickly, this will reduce the effectiveness of the takeover threat. Similarly, if bank shares do not trade actively in efficient equity markets, this will further hinder takeovers as an effective governance mechanism.

Moreover, the absence of efficient securities markets means that many financial instruments – such as subordinated debt and debentures -- that might be used to limit managerial discretion do not exist. There exist sound motivations for creating a group of large, sophisticated uninsured creditors with the incentives and ability to monitor banks as a plan for enhancing corporate governance. Nonetheless, this plan presupposes the existence of efficient securities markets, which do not exist in most countries.

B. Bank Regulation: Implications for Governance

1. Regulation: Implications for governance by shareholders and competition

Although concentrated equity is a common corporate governance mechanism for dealing with the inability of diffuse equity holders to exert effective corporate control, most governments restrict the concentration of bank ownership and the ability of outsiders to purchase a substantial percentage of bank stock without regulatory approval. These restrictions may arise due to concerns about concentrations of power in the economy or about the type of people who control a bank. These restrictions are put into effect usually by requirements that purchasers of bank stock have to alert government officials as their holdings increase above a certain level, and may need regulatory approval above some proportion. Of the 107 countries in the Barth, Caprio, Levine (2003, henceforth BCL) database of bank regulation and supervision, 41 have a limit on the percentage of bank capital owned by a single entity that is less than 50% and 38 have limits less than 25%. Additionally, there may be constraints on who can own banks, such as the prohibition on ownership by nonbank firms, or by securities firms or insurance companies in some countries (such as the United States till recently).

Nonetheless, a perverse paradox seems to operate: government regulatory restrictions are often ineffective at limiting family dominance of banks, but the regulatory restrictions on purchasing equity actually protect these family-controlled banks from takeover and hinder corporate governance. There are a plethora of channels by which powerful families have built up control in banks and nonbank firms, as in the case of East Asia (Claessens, et al). More broadly, Caprio, Laeven, and Levine (2003, henceforth CLL) show that families frequently enjoy control rights over banks through pyramid and other schemes. Indeed, CLL show that around the world, banks are typically not widely-held; rather, 75 percent of banks have a single owner that holds more than 10 percent of the voting rights.[5] Of these controlling owners, more than half are families. The regulatory restrictions on share purchases, therefore, do not prevent family ownership but rather defend the existing owners from competition for control.

2. <u>Regulations: Implications for governance by depositors</u>

Deposit insurance – implicit or explicit – substantively changes the equity and debt channels of corporate governance in a number of manners. First, deposit insurance reduces the incentives of depositors to monitor banks, which directly hinders corporate governance. Second, deposit insurance induces banks to rely less on uninsured creditors with incentives to monitor and more on insured depositors with no incentives to exert corporate governance. Third, deposit insurance – along with the rise of central banks as lenders of last resort – have helped produce banks with very low capital-asset ratios relative to other firms. As capital-asset ratios fall, this increases the incentives of controlling owners to increase the riskiness of the bank. Thus, deposit insurance both increases the ability of owners to increase risk because depositors no longer have incentives to monitor and deposit insurance increases the incentives for bank owners to increase risk because of lower capital-asset ratios.[6] Not surprisingly, therefore, countries with more generous deposit insurance tend to have a higher likelihood of suffering banking crises (Demirguc-Kunt and Detragiache, 2003).

3. Regulation: Implications for competition

Many government interventions limit competition in banking. Governments frequently restrict ownership concentration and regulate who can own banks. This impedes competition for corporate control. In terms of reducing competition in output markets, many countries impose regulatory restrictions on banks' ability to underwrite equity, conduct real estate or insurance business, or take ownership in nonbank firms (see BCL). Furthermore, many countries impose minimum branching requirements (often in rural areas), directed credit guidelines, portfolio restrictions (such as minimum percentages of assets invested in government securities), liquidity requirements, and limits on interest rates and fees. While there may exist sound motivations, the regulating-hand of the government frequently restricts competition and thereby hinders a key corporate governance mechanism.

IV. What Bank Regulatory Policies Work Best?

A. Why Do Governments Intervene in Banking?

1. Governments may try to overcome information and transaction costs

In weakening standard corporate governance mechanisms, the greater opacity of banks intensifies the potentially constructive role for government regulations. Moreover, the beliefs that (i) banks are important for economic development and (ii) bank failures exert negative externalities throughout the economy further motivate government regulation.

Besides pure informational asymmetries, limitations in investor protection laws and in the legal system's ability to enforce laws hinder effective corporate governance. Thus, government policies that ameliorate the adverse effects of information and transaction costs can improve the governance of banks and enhance social welfare. Assuming both that governments have the ability and the will to overcome market and institutional failures, regulations can enhance the corporate governance of banks.

2. Governments may have less benevolent motives

A countervailing view holds that governments do not have the will to overcome information and transactions costs and instead emphasizes that governments regulate and own banks for different reasons. Banks have money, so governments have incentives to tax banks as a source of fiscal revenue and to induce banks to lend to politically favored customers. Similarly, bankers can exert a powerful influence over governments and regulators, so that regulations serve to promote the interests of incumbent bankers rather than promote social welfare. In short, government regulations reflect less benevolent motivations than enhancing the corporate governance of banks.

Indeed, a long and influential view holds that governments and regulators do not maximize social welfare; they maximize their own welfare (Hamilton, et al., 1788; Buchanan and Tullock, 1962). Rather than exerting a "helping hand" to ease market failures, governments may instead use a "grabbing hand" to satisfy political objectives (Shleifer and Vishny, 1998).[7] Politicians and regulators may induce banks to divert the flow of credit to politically connected firms, or powerful banks may "capture" politicians and induce official regulators to act in the best interests of banks rather than in the best interests of society (Becker and Stigler, 1974; Rajan and Zingales, 2003). For example, one 'bonus' that regulators face is the possibility of taking a job with the banks that they are supervising. Horiuchi and Shimizu (2001) document that in the case of Japan, the regular 'descent from heaven' (*amakudari*) of bank supervisors into senior positions with commercial banks led to less safe banking. Banks with amakudari officials performed more poorly – had lower capital levels, and higher non-performing loans

– than banks without them. Thus, the political/regulatory capture view suggests that direct official supervision of banks may actually reduce the efficiency of corporate governance of banks.

B. Approaches to Government Regulation: What Works Best in Practice?

1. Strong official supervision and regulation

Recent empirical work advertises the dangers of power bank regulatory agencies and instead supports the regulatory/political capture view. BCL measure the power of the regulatory agency as the agency's legal ability to force banks to give them information and the agency's ability to take disciplinary actions against banks if the banks to not follow the agency's rules. BCL find that greater regulatory power is positively associated with national levels of corruption and negatively associated with overall levels of bank development. Furthermore, BCL show that regulatory power is positively linked with regulatory restrictions on the entry of new banks, which is consistent with regulators impeding competition. Finally, BCL show that strict capital standards – which have become the mainstay of conventional regulatory practices – do not create safer banks or enhance bank efficiency.

Using the same measure of regulatory power, Beck, Demirguc-Kunt, and Levine (2003, henceforth BDL) show that powerful regulatory agencies tends to increase the likelihood that firms need corrupt ties with banks to obtain credit. These data are consistent with the political/regulatory capture view. The results, however, are inconsistent with the view that regulators effectively reduce informational asymmetries and other market frictions.

2. Constrained official regulation

Economists have attempted to derive mechanisms that simultaneously recognize the importance of market failures, which motivate government intervention, and political failures, which suggest that politicians and regulators do not necessarily have incentives to ease market failures. Thus, the goal is to create mechanisms that negate the "grabbing hand" of politicians and regulators while creating incentives for official agencies to improve social welfare (Shleifer and Vishny, 1998; Haber et al, 2003).

One approach to improving regulation is to align the interests of regulators with society. For example, many argue that creating an independent agency with a well-defined objective is a useful mechanism for balancing market and political failures. This view holds that if supervisors are independent from the government and if supervisors have proper incentives, then this reduces the likelihood that politicians will use the supervisory agency to induce banks to funnel credit to favored ends. Similarly, if the supervisory agency is independent from banks and if supervisors have proper incentives, then this lowers the probability that banks will capture supervisors.

Evidence is sympathetic to the independent supervisor view. For instance, BDL find that the independence of the supervisory agency reduces the pernicious effects of a powerful regulatory agency. Thus, powerful regulatory agencies have less of an adverse impact on the obstacles faced by firms in raising bank credit when the agencies are independent of the government and the banks.

In a related argument, many researchers suggest that broad national institutions, such as the openness and competitiveness of the political system or the effectiveness of the media, influence the effectiveness of bank regulatory agencies. Specifically, where political systems are closed and uncompetitive, there is greater scope for political and regulatory capture. Where the media is owned and/or controlled by the government, the media is unlikely to uncover evidence of political/regulatory capture and thereby unlikely to improve bank regulations.

BCL in fact find that stronger regulatory powers were associated with deeper financial systems in the presence of very strong political openness. Similarly, BDL find that political openness and a privately-owned, unrepressed media also reduce the adverse impact of regulatory power on the financing obstacles faced by firms and the need for firms to use corruption to obtain bank credit. In this context, the policy advice being advanced by international agencies to empower regulatory agencies may hurt the corporate governance of banks unless the country has highly developed political and media institutions.

3. Regulations that empower the private sector

The private empowerment view suggests that bank regulations should focus on enhancing the ability and incentives of private agents to overcome informational barriers and exert corporate governance over banks (Grossman and Hart, 1980; Hay and Shleifer, 1998). Furthermore, this view argues that many empowered bank creditors will be less susceptible to capture by politicians and banks than a single government supervisory agency. Thus, special connections and corruption may play less of a role in countries that foster private monitoring.

Evidence tends to support the view that regulations that power the private sector work best to improve the governance of banks. BCL construct a measure of the degree to which regulations empower the private sector. This measure includes information on regulations that force banks to disclose information to the public and impose severe penalties on a bank's directors or officers for providing inaccurate or misleading information. BCL find that strong private empowerment regulations boost overall bank development and efficiency. Furthermore, BDL find that (1) strong private empowerment reduces the reliance on corrupt ties with bank official by firms to receive bank credit and (2) strong private empowerment tends to lower the financing obstacles faced by the average firm.

Work on deposit insurance emphasize that it is important to give private creditors sound incentives. As noted earlier, more generous deposit insurance tend to induce banks to assume greater risks and fail more frequently (Demirguc-Kunt and Detragiache, 2003). Beyond bank fragility, BDL find evidence consistent with the view that less generous deposit insurance will reduce the diversion of bank credit toward riskier firms and thereby facilitate the financing of firms in general.

In related work, CLL examine whether laws that protect minority shareholders boost the valuation of banks. They find the investor protection boosts the valuation of banks. At the same time, they find that strong regulatory agencies do not boost bank valuations. This implies that shareholders are willing to pay more for bank in countries where investor protection laws protect their interests, but strong regulatory agencies do not ease investor concerns that bank managers will exploit small investors.

In sum, these results are consistent with the view that regulations that empower private monitoring increase the effectiveness of the corporate governance of banks.

4. Bureaucrats as bankers: State-owned banks don't solve the governance problem

As noted in the Introduction, an extreme –though largely unsuccessful -- way to deal with the governance problem is government ownership of banks. In terms of regulators exerting governance, the government is virtually removed as an effective monitor in the case of government owned banks. When the government is both the owner and regulator, there is a conflict of interest in its two roles. Indeed, in some countries, such as China, the government executives who run the state banks outrank the heads of any oversight agencies. In terms of private creditors exerting corporate governance over government banks, incentive problems arise. Although private sector participants, such as large creditors, have an incentive to monitor private banks, with state owned banks there is no doubt that the government is providing a guarantee. Thus, private sector creditors face reduced incentives to monitor state banks. In terms of market competition, the link is again broken with government owned banks. Regulators tend to enact policies that restrict competition and protect government run banks. For example, government regulators have a greater propensity to prohibit the entry of the only banks willing to compete against the state – foreign banks -- when the banking industry is dominated by state-owned banks (BCL). In sum, the evidence indicates that those countries with a share of state ownership in banking experience worse outcomes on average. BCL and LLS (2001) find uniformly negative results for the impact of state ownership on overall banking sector development and banking sector efficiency.

V. Conclusions & Policy Lessons

In summary, I very briefly outline this papers two broad policy conclusions and mention areas needing additional research. First, governments should seek to do less harm. Where government ownership is widespread, privatization programs are essential. Where government depost insurance coverage is extremely generous, it is crucial to enact reforms that induce the emergence of creditors with the ability and incentives to monitor banks. Where governments use regulatory agencies to reward friendly constituents and protect politically-connected banks from competition, there is a need for deep political reforms and the development of institutional mechanisms to de-politicize regulation. Here the problems frequently run very deep. As noted, the problem in banking is frequently that politically powerful families control the banks and the political system, so that regualtory policies are frequently used to impede, not support, effective corporate governance. Research is needed, however, on stategies for implementing fundamental changes.

Second, besides limiting the grabbing-hand of government, public policy should seek to enhance private monitoring of banks. While banks are complex, opaque entities, governments can improve the development and enforcement of accounting and auditing standards. Governments can demand accurate information disclosure and punish violators. Furthermore, the private sector needs incentives to undertake the costly taks of monitoring banks. Thus, government guarantees – implicity and explicit – on bank liabilities directly hinder corporate governance of banks. Again, while easy to state, implementation of these objectives may hurt extremely powerful groups in society and thus reduce the probability of successfully initiating reforms to boost information disclosure. Moreover, to improve private monitoring, governments need to enhance the operation of legal and bankruptcy system. As stressed throughout this esssay, the traditional corporate governance mechanisms rely on well-functioning legal and bankruptcy systems that effectively support the rights of shareholders and creditors. But, these institutions do not operate well in most countries. Thus, it is not too soon to begin the long-process of building sound legal and bankruptcy systems

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[1] For a review of the impact of banks on the economy, see Levine (1997, 2004).

[2] La Porta et al. (2002) find that about 40 percent of the assets in the banking systems of emerging market economies were in state-owned banks.

[3] These contracts may include share ownership, stock options, and other contingent compensation mechanisms.

[4] This paper builds on Caprio and Levine (2002) and excellent examinations of the corporate governance of banks such as Prowse (1997), Macey and O'Hara (2003), John and Qian (2003), Adams and Mehran (2003).

[5] CLL's examination of the ownership and valuation of banks follows the pioneering work by LLS (1999) on the ownership of corporations around the world and LLSV's (2002b) work on corporate valuations.

[6] Besides low capital-asset ratios, a second characteristic of the capital structure of banks is that liquid demand deposits form the bulk of their liabilities while illiquid, longer-term loans compose the majority of bank assets.

[7] Shleifer and Vishny (1998) use the phrase "grabbing hand" to describe the maximizing behavior of politicians in contrast to the "helping hand" view, which assumes that governments maximize social welfare. These phrases contrast nicely with the "invisible hand" theory, which posits that with (i) no market frictions, (ii) social maximizing governments, and (iii) well-defined and enforced property rights, private agents will produce efficient outcomes.