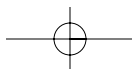
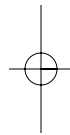
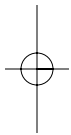


PART

I

*Governance of the  
Financial Sector:  
A Conceptual  
Framework and  
Measurement Issues*



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ROSS LEVINE

# 2

## *Corporate Governance in Finance: Concepts and International Observations*

JUST AS CORPORATE governance influences the efficiency of firm production at the corporate level, so does the effectiveness of a nation's corporate governance system shape economic performance at the country level. Standard agency theory defines the corporate governance problem in terms of how holders of equity and debt influence managers to act in the best interests of the providers of capital. To the extent that shareholders and creditors induce managers to maximize firm value, the efficiency with which firms allocate resources will improve. In the Berle and Means conception of the firm, diffuse shareholders exert corporate governance through voting rights and the election of boards of directors and diffuse debt holders limit managerial discretion through bond covenants.<sup>1</sup> These mechanisms, however, do not always work well around the world. Small investors have a difficult time exercising corporate governance because of informational asymmetries and poor legal, bankruptcy, and regulatory systems. In their comprehensive review of the corporate governance literature, Shleifer and Vishny conclude that outside of the United States and

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1. Berle and Means (1932).

the United Kingdom, small investors play very little role in exerting corporate control.<sup>2</sup> Instead, large investors—large equity holders and large banks—are the primary sources of corporate governance.

If the world is to rely on banks—and other financial intermediaries—to exert effective corporate governance, then the managers of financial institutions must themselves face sound corporate governance. If bank managers face sound incentives, they will be more likely to allocate capital efficiently and then implement effective corporate governance over the firms in which they invest. If bank managers have enormous discretion to act in their own interests, however, rather than in the interests of the bank's equity and debt holders, then corporate governance will be adversely affected. In particular, banks will allocate capital less efficiently, and bank managers may actually induce firm managers to behave in ways that favor the interests of bank managers and firms but hurt overall firm performance. Thus, the corporate governance of banks and other financial intermediaries is crucial for shaping capital allocation both at the firm level and at the country level. Nevertheless, the financial sector has generally received far less attention in the corporate governance literature than seems warranted by its central role in a nation's corporate governance system.

To correct this imbalance, this paper uses standard theories of corporate governance to highlight the special problems facing corporate governance of financial intermediaries and combines this theoretical perspective with international observations to make policy recommendations. As corporations that issue equity and debt, financial intermediaries face standard corporate governance problems. We argue, however, that banks and nonbank financial intermediaries are different from the standard corporation. Financial intermediaries—banks in particular—have special attributes that intensify standard corporate governance problems, and pervasive government involvement raises new impediments to effective corporate control. While this paper's theoretical framework holds for both banks and nonbank financial intermediaries, we focus primarily on banks because we have detailed international information on the regulation and supervision of commercial banks and because banks constitute the largest financial intermediaries around the world and especially in emerging markets. Except in some obvious exceptions, such as the discussion of deposit insurance, the points noted for banks apply to all financial intermediaries. In some cases, we discuss particular characteristics of pension funds and insurance companies.

2. Shleifer and Vishny (1997).

The paper first presents a general description of the corporate governance problem and examines the roles of various sources of governance: equity holders, debt holders, the competitive discipline of output markets, and governments. We then reexamine how each of these governance channels is affected by the special problems facing banks and other intermediaries, especially those in developing countries. We conclude with some policy recommendations.

This paper represents an opening salvo in our research on corporate governance of financial intermediaries. We have initiated a series of microeconomic studies in which we use international evidence to explore how the corporate governance structure of commercial banks influences corporate financing decisions and investment decisions at the firm level.

### Corporate Governance: A Generic Model

This section describes the corporate governance structure of a generic firm. We follow Shleifer and Vishny's comprehensive survey of corporate governance and take an agency perspective that focuses on the separation of ownership and control.<sup>3</sup> How do the suppliers of capital influence managers to act in the best interests of capitalists? We examine how equity and debt holders—diffuse and concentrated holders of debt and equity—attempt to exert corporate governance and the impediments that exist. In our “generic model,” we also consider the government. First, governments construct the basic legal system underpinning corporate governance. Second, governments may influence the flow of corporate finance by restricting corporate activities and insuring corporate finance in the case of banks and occasionally other intermediaries.<sup>4</sup> We consider each of these stakeholders and also discuss the market for corporate control.

#### *Equity: Minority Shareholders*

In the standard Berle and Means firm, diffuse shareholders exert corporate governance by voting directly on crucial issues, such as mergers, liquidation, and fundamental changes in business strategy, and by electing the

3. Shleifer and Vishny (1997).

4. For example, Indian authorities in the 1990s provided guarantees for holders of the largest mutual funds, and banks in several countries (such as Israel in the 1980s) effectively extended their own safety net by attempting to provide minimum prices for shares of underwritten issues.

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 the achievement of particular results. These contracts may include share ownership, stock options, and other contingent compensation mechanisms. In this setup, diffuse shareholders obtain the benefits of holding a diversified portfolio of assets while exerting corporate governance through their voting rights and the board of directors.

Several factors, however, keep diffuse shareholders from effectively exerting corporate control. Informational asymmetries between managers and small shareholders are large. Small shareholders frequently lack the expertise and incentives (that is, they do not have sufficient money on the line) to close the information gap substantially and monitor managers. Also, the board of directors often does not represent the interests of the minority shareholders and instead may be captured by management. To the extent that management captures the board, the probability that incentive contracts will solve the corporate governance problem is lowered. Indeed, incentive contracts “create enormous opportunities for self-dealing for the managers, especially if these contracts are negotiated with poorly motivated boards of directors rather than with large investors.”<sup>5</sup> Also, voting rights are not generally effective because managers have enormous discretion over the flow of information. Furthermore, many countries have no laws protecting the rights of minority shareholders, and many of those that do have such laws on the books do not enforce them, a problem that further hinders corporate governance by minority shareholders. These forces work to provide managers with significant discretion over the control of corporate assets.

### *Equity: Concentrated Ownership*

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, monitor managers, and exert corporate government over managerial decisions. Furthermore,

5. Shleifer and Vishny (1997, p. 745). Jensen and Murphy (1990) show that compensation incentives are inefficient to induce managers to act in investors' interests relative to the personal benefits of managerial control.

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. Nor does concentrated ownership rely as much on the legal system. An owner with 51 percent of the equity does not need elaborate legal support to exert his ownership rights. Furthermore, large shareholders can more effectively negotiate managerial incentive contracts that avoid self-dealing and align investor and manager interests than can a diffuse group of shareholders whose representatives—the board of directors—can be manipulated by management. As ownership becomes more diffuse, managers can more easily manipulate information, form alliances with different groups, and capture control of the firm. Thus, outside of a very few countries, such as the United States and the United Kingdom, concentrated ownership is the standard mechanism for exerting corporate control.<sup>6</sup>

Concentrated ownership raises new corporate governance problems, however. Besides the fact that concentrated ownership implies that wealthy investors are not diversified, concentrated owners may benefit themselves at the expense of minority shareholders, debt holders, and other stakeholders in the firm, with adverse effects on corporate finance and resource allocation. Large investors may pay themselves special dividends, exploit business relationships with other firms they own that profit the investors at the expense of the corporation, and in general maximize the private benefits of control at the expense of minority shareholders.<sup>7</sup> Furthermore, large equity owners may seek to shift the assets of the firm to higher-risk activities since shareholders benefit on the upside, while debt holders share the costs of failure.<sup>8</sup> Finally, Shleifer and Summers show that large investors might have greater incentives than managers to expropriate resources from employees.<sup>9</sup> 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 shareholders and labor has important implications for the effectiveness of corporate governance and hence resource allocation and economic efficiency.

6. La Porta, Lopez-de-Silanes, and Shleifer (1999). Note, it can be argued that concentrated ownership is stimulated by and simultaneously encourages a weak legal system and poor information.

7. DeAngelo and DeAngelo (1988); Zingales (1994).

8. Jensen (1988).

9. Shleifer and Summers (1988).

*Debt: Diffuse*

Debt purchasers provide finance in return for a promised stream of payments and 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. Since the legal obligation of the corporation is to each debt holder, creditors do not need to coordinate to take action against a delinquent firm.<sup>10</sup> Because that factor tends to make debt renegotiation much more difficult, corporate governance may be more severe with diffuse debt holdings than with concentrated debt. Clearly, the effective exertion of corporate control with diffuse debt depends on the efficiency of the legal and bankruptcy systems.<sup>11</sup>

There are barriers, however, that prevent diffuse debt holders from effectively exerting corporate governance. The legal system in many countries gives 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 even in the most developed economies, which further erodes the corporate governance role of diffuse debt. Thus, around the world, legal protection of diffuse debt holders seems insufficient to protect the rights of investors and limit managerial discretion.

*Debt: Concentrated*

As with large equity holders, concentrated debt can ameliorate some of the problems with diffuse debt. For many companies, banks typically are the large creditors. A bank's corporate governance power derives from its legal rights in the event that firms default or violate covenants; the short matu-

10. Shleifer and Vishny (1997, pp. 763–64).

11. Nevertheless, since the legal rights of debt holders are more clearly specified in debt contracts than is the corresponding case for equity contracts, violations of debt covenants and payments are easier to verify than violations of equity commitments where the rights are typically couched in terms of the general fiduciary responsibility of management. For instance, equity is not promised any payments and does not have claim on any particular asset of the corporation.

rity of its loans, so corporations must return regularly; and its frequent dual role as both debt holder and the voter of substantial equity shares (either its own shares or those of other investors). Concentrated debt holders can also renegotiate the terms of the loan, which may avoid inefficient bankruptcies. Thus, large creditors can frequently exert substantial control rights over firms as well as exercise important cash flow power.

Nevertheless, large creditors face important obstacles to exerting sound corporate governance in many countries. First, the effectiveness of large creditors relies importantly on the legal and bankruptcy systems. It is by using—and by threatening to use—legal means that creditors exert influence over management. If the legal system does not efficiently identify the violation of covenants and payments and provide the means to bankrupt and reorganize firms, then creditors lose a crucial mechanism for exerting corporate governance. Outside of a small number of countries, legal systems around the world are demonstrably inefficient at protecting outside investors.<sup>12</sup> Also, with poor legal and bankruptcy systems, the flexibility to renegotiate debt arrangements with large creditors may lead to inefficient renegotiation, the continuation of unprofitable enterprises, and impediments to corporate finance since the balance of power in those renegotiations shifts markedly toward debtors.<sup>13</sup>

Second, large creditors—like large shareholders—may attempt to shift the activities of the corporation to reflect their own preferences. For instance, large creditors may induce the company to forgo good investments and take on too little risk because the creditor bears some of the cost but will not share the benefits.<sup>14</sup> More generally, large creditors may seek to manipulate the corporation's activities for personal gain rather than maximize the profits of the firm. These features suggest that large creditors do not fully resolve the problem of aligning managers' incentives to maximize profits.

Third, large creditors may not be independent. In cases where a single family controls both a bank and a nonfinancial firm, it would be surprising to see much discipline by the former on the latter. Where relatively few families control a large portion of an economy, only foreign creditors may be independent, and this group may suffer from particularly large informational asymmetries and an inability to enforce contracts.<sup>15</sup>

12. La Porta and others (1997, 1998).

13. Gertner, Scharfstein, and Stein (1994).

14. Myers (1977).

15. For the case of East Asian firms, see Claessens, Djankov, and Lang (1999).

*Competition*

Instead of focusing on the legal mechanisms through which equity and debt holders seek to exert corporate control, Alchian and Stigler stress competition.<sup>16</sup> According to this view, market competition forces firms to minimize costs, including the adoption of corporate control mechanisms that minimize the cost of raising external finance. In their extensive survey of corporate governance, Shleifer and Vishny argue 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.”<sup>17</sup> They stress that labor and capital are highly firm specific and cannot be rented in spot markets throughout the day. Thus, people advance capital, and firm managers have discretion over the allocation of those resources. While product market competition constrains firm managers, it does not prevent them from exploiting firm resources for private gains, and this is the core of the corporate governance problem.

A second form of competition may also address governance problems: takeovers. Poorly performing firms may receive a tender offer from another firm, and the shareholders can decide whether they wish to accept the offer. If they accept, 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 argues that takeovers are a crucial and effective corporate governance device in the United States.<sup>18</sup>

Countervailing evidence, however, questions the efficacy of takeovers as a corporate governance mechanism. First, the bidder must engage in extensive and costly research of many firms to identify a worthy target. Then, the bidder pushes up the price of the shares as it tenders its offer and attempts to gain control of the firm. That reduces the bidder’s profits and hence its incentives for researching firms and managers. Second, takeovers may not reflect the failure of management in the target firm, but rather the breakdown of corporate control in the takeover firm. Specifically, the takeover firm’s managers may be maximizing the private benefits of their corporate empires, rather than maximizing firm value. Third, an active

16. Alchian (1950); Stigler (1958).

17. Shleifer and Vishny (1997, p. 738).

18. Jensen (1988, 1993).

takeover market requires a large, liquid capital market that can provide bidders with enormous amounts of capital quickly if they identify a worthy target. Outside a couple of countries, we do not observe such well-developed capital markets. (We recognize that especially for large firms, national boundaries for capital markets are fast becoming the exception.) Finally, powerful managers will work to thwart hostile takeovers through poison pills and antitakeover legislation.<sup>19</sup> Given the political power of managers and the scarcity of large, liquid capital markets, it is not surprising that takeovers are essentially nonexistent as a corporate governance mechanism outside the United States and the United Kingdom.<sup>20</sup>

### *Government*

Government plays a key role in corporate governance by defining the legal environment and sometimes by directly influencing managerial decisions. As emphasized above, the efficiency of the bankruptcy system and the degree to which managers maintain control through the bankruptcy process help determine whether the threat of bankruptcy influences managerial decisions. Similarly, the extent to which equity and bond holders can exert corporate governance depends on the ability to write and then enforce contracts, to oblige management to provide accurate and comprehensive information before shareholders vote on important issues, to enforce the obligations of the boards of directors, to specify and have managerial incentive contracts enforced, and to have confidence in the full range of contractual arrangements that define the firm in modern corporations. Moreover, the forces of political economy that produce the laws, enforcement mechanisms, and bankruptcy processes, and the ability of powerful managers to influence legislation all profoundly shape corporate governance.

Beyond defining the rules of the game, the government may directly influence corporate governance. At one extreme, the government may own the firm, so the government is charged with monitoring managerial decisions and limiting the ability of managers to maximize private benefits at the cost of society. At a less extreme level, governments regulate corporations. Specifically, governments regulate the activities and asset allocations of corporations and may even insure corporate liabilities in favored industries, even in countries that traditionally tend to disavow such support

19. Jensen (1993).

20. Shleifer and Vishy (1997).

(take, for example, the Chrysler bailout in the United States). In theory governments regulate to maximize social welfare, limit adverse externalities, exploit positive ones, deal with monopoly power, and directly prohibit managers from undertaking socially adverse actions.<sup>21</sup> Glaeser and Shleifer argue that governments tend to use regulations instead of the threat of legal sanctions when the legal system does not effectively dissuade managers from taking socially costly actions.<sup>22</sup> Thus, regulations that work *ex ante* may be optimal in situations where the use of *ex post* legal penalties is ineffective.

The problem with using state ownership and regulation of corporate activities to resolve the corporate governance problem is that it places control rights in the hands of government bureaucrats who almost certainly do not have the same incentives as a private owner. Thus, these government bureaucrats are unlikely to induce managers to maximize firm value. Rather, politicians frequently use state enterprises for personal gain by placing cronies in positions of corporate power, catering to special interest groups, or supporting politically influential unions that help politicians to retain power.<sup>23</sup> Indeed, the evidence suggests that public enterprises are extremely inefficient producers and that they frequently disregard social objectives, as evidenced by the finding that state enterprises are worse polluters than private firms.<sup>24</sup>

### *Discussion and Tentative Lessons*

The discussion of the corporate governance problem in a generic firm highlights key ingredients that influence the effectiveness of various corporate control mechanisms. While we recognize that each of these tentative lessons is subject to many qualifications, a broad reading of the literature tends to point in the direction of these lessons even if allowances are needed for special circumstances. First, huge informational asymmetries between the providers of capital and controllers of capital (managers) tend to create more severe corporate governance problems for equity and debt

21. Laffont and Tirole (1993).

22. Glaeser and Schleifer (2002).

23. Schleifer and Vishny (1994).

24. See Boycko, Shleifer, and Vishny (1995) on the efficiency of public enterprises; see Grossman and Krueger (1993) on pollution.

holders than an environment where information is more transparent. Indeed, informational asymmetries lie at the core of the agency problem.<sup>25</sup>

Second, very competitive environments—both in the product market and in the takeover market—tend to reduce the corporate governance problem more than an environment dominated by entrenched monopolies. Substantial differences across industries and countries in the degree of competition and in the effectiveness of the takeover market tend to shape the effectiveness of corporate control. Third, the legal and bankruptcy systems fundamentally shape the feasibility of various corporate governance mechanisms. Whether it is the fiduciary responsibility of managers, the voting rights of owners, the board of directors, incentive contracts, debt covenants, bankruptcy, reorganization, self-dealing, or the ability to have a large, liquid capital market, all of these are defined and made more or less effective by the legal and bankruptcy system. Fourth, government regulation and ownership are key. Do regulations work to thwart market power and ameliorate market imperfections? Or do government actions protect political cronies, empower state discretion over the allocation of resources, and limit the competitive environment? The effectiveness of government actions may differ both across industries and across the globe. It seems clear, however, that government policies play a central role in shaping the effectiveness of various corporate governance mechanisms.

### Governance in Finance

This section discusses special characteristics of banks and nonbank financial intermediaries that intensify the corporate governance problem and reviews empirical evidence. Other financial intermediaries, such as contractual savings institutions and insurance companies, experience many of the same issues. Although we discuss these other financial intermediaries, we focus on commercial banks because we have detailed cross-country information on bank regulation and supervision and because banks are the largest financial intermediaries internationally.

25. This does not imply that a marginal decrease in informational asymmetries will everywhere and always induce better outcomes. But it certainly does suggest that industries with enormous informational gaps between owners and managers will almost certainly face a bigger corporate governance problem than industries with very small informational asymmetries.

In particular, we examine three interrelated characteristics of financial intermediaries and the ways these traits affect corporate governance. First, banks and other intermediaries are more opaque than nonfinancial firms, a fact that fundamentally intensifies the agency problem. Because of the greater information asymmetries between insiders and outside investors in banking, it is more difficult for equity and debt holders to monitor managers and use incentive contracts, and easier for managers and large investors to exploit the private benefits of control, rather than maximize value. It is also unlikely that potential outside bidders with poor information will generate a sufficiently effective takeover threat to improve governance substantially. A more monopolistic sector is likely to ensue, one that will generate less corporate governance through product market competition, compared with an industry with fewer informational asymmetries.

Second, banks, like most intermediaries, are heavily regulated, a characteristic that frequently impedes natural corporate governance mechanisms. For instance, deposit insurance reduces monitoring by insured depositors, reduces the desirability of banks to raise capital from large, uninsured creditors with incentives to monitor, and increases incentives for shifting bank assets to more risky investments. Regulatory restrictions on the concentration of ownership interfere with one of the main mechanisms for exerting corporate governance around the world: concentrated ownership; and regulatory restrictions on entry, takeovers, and bank activities reduce competition, which in turn reduces market pressures on managers to maximize profits. Moreover, bank regulators and supervisors frequently have their own incentives in influencing bank managers that do not coincide with value maximization.

Finally, government ownership of banks fundamentally alters the corporate governance equation. State ownership of banks is widespread in many countries, making corporate governance of the banking industry very different from other industries. We now discuss the special corporate governance problems facing banks in more detail.

The same information problems—except for the particular complications induced by explicit deposit insurance that pertain only to banks—affect nonbank intermediaries. Indeed, pensions and insurance are areas that have seen a government backstop in particular countries (although it is rarely explicit). Pensions and insurance, usually the main other nonbank intermediaries in emerging markets, also are areas that are especially heavily regulated or controlled outright by public bodies.

*Banks Are Opaque*

Although information asymmetries plague all sectors, many assert that this informational asymmetry is larger with financial intermediaries. In product or other service markets, purchasers part with their money in exchange for something now. In finance, money now is exchanged for a “promise to pay” in the future. Also, in many product or service markets, if the object sold—from a car to a haircut—is defective, the buyers often find out relatively soon. However, loan quality is not readily observable for quite some time and can be hidden for extensive periods. Moreover, banks and non-bank financial intermediaries can also alter the risk composition of their assets more quickly than most nonfinancial industries, and banks can readily hide problems by extending loans to clients to cover previous debt obligations they cannot service.

This type of opacity—the difficulty of assessing the ongoing performance of a corporation—is particularly acute in banking, where loans are generally not traded in liquid, efficient secondary markets. The opacity problem is eased for pension funds and insurance companies to the extent that they hold assets that are traded in efficient markets. Insurance liabilities, however, typically suffer from the same information problems as loans, and indeed the information problem can be compounded by the long time lapse between taking out a policy and any payout.<sup>26</sup> Also, many countries do not have efficient securities markets. Like banks, therefore, pension fund and insurance companies frequently suffer from severe informational asymmetries.

Although views are not unanimous, substantial empirical evidence suggests that banks are considerably more opaque than other industries.<sup>27</sup> The observation that a single trader can cripple or bring down a large bank seems to be a recurrent fact, with the more egregious examples being Barings in the 1990s and AIB/Allfirst in 2002. Both incidents nicely demonstrate that information problems affect senior bank managers in their own institutions as well.<sup>28</sup> Similarly, some may view the recent

26. Conversely, insurance companies more often insure particular classes of risk (although they may custom-design large individual risks), which can render their activities more observable than banks making a number of disparate commercial and industrial loans to firms on which information may be more limited.

27. See Bentsen (1999), for example.

28. In both cases, “rogue” traders were disguising heavy losses, and in the case of Allied Irish Bank, this state of affairs apparently continued for five years.

collapse of Enron as a counterexample because it was an energy company whose sudden collapse surprised virtually all observers. Yet Enron collapsed not because of its energy business, but because of its financial intermediation activities, in particular the trading of complex financial products. That conglomerates can be brought down by financial subsidiaries is fully consistent with the contention that banks are generally more opaque than nonfinancial enterprises.

More systematically, Morgan finds that bond analysts disagree more over the bonds issued by banks than by nonfinancial firms. Moreover, using call report data, he shows that disparity in views increases with the size of bank loans relative to total assets.<sup>29</sup> Conversely, holding greater capital tends to reduce the discrepancy between bond analysts' views.<sup>30</sup> Thus, loan-making banks tend to be more opaque than nonfinancial firms.<sup>31</sup>

**IMPLICATIONS FOR EQUITY AND DEBT FINANCIERS.** The greater informational asymmetries between insiders and outsiders in banking make it very difficult for diffuse equity and debt holders to monitor bank managers or to use incentive contracts to align managers' interests with their own. Lower transparency makes it easier for controlling owners and managers to exploit other claimants, whether through risk-taking behavior or outright looting.<sup>32</sup> When outcomes are difficult to measure and easy to manipulate in the short run, managers will find it easier to construct a variety of "compensation" packages that allow managers to benefit at the expense of the long-run health of the financial institution. In many cases

29. Morgan (forthcoming). Interestingly, Morgan finds that disagreement is greater for banks with more cash on their balance sheets, but in addition to possible nervousness (Myers-Rajan, 1998) caused by buildups of cash (what does the bank know about its portfolio, or what complex trade is it about to undertake, which may be interpreted by the market as providing a buffer for an event of which the market is unaware) is the fact that "cash" in bank balance sheets can include a number of IOUs. Banks with a larger fraction of assets in their premises see less variation in bond analysts' views.

30. True, Flannery, Kwan, and Nimalendran (1998) found that investment bank analysts disagreed less about banks than about nonfinancial enterprises and even forecast future earnings more accurately. However, Flannery, Kwan, and Nimalendran focus on the views of investment bankers, while Morgan (forthcoming), focuses on bond analysts, who are likely to have fewer conflicts of interests than investment bankers.

31. There are no comparable studies (that the authors could find) on pension or insurance company opacity. However, the well-known collapse of the Orange County pension funds because of a public manager's gambling in derivatives markets (Jorion, 1995) bears eerie similarity to the failures of Barings Bank and the AIB-Allfirst fiasco, suggesting that the same opacity problem is present in both branches of financial intermediation.

32. Akerlof and Romer (1993).

bankers who are interested in boosting their own compensation in the short run can give a high-interest loan to a borrower in trouble, thereby boosting interest income.<sup>33</sup> And by controlling significant pools of resources, bankers can move asset prices. Thus if a few banks in a market with a high degree of concentration (the norm in developing countries, as noted below) become “bullish” or otherwise want to book more assets in certain sectors, the consequent increase in asset prices will make those interested in more prudent management look like Jeremiahs. Even knowledgeable outside owners will find monitoring difficult in these circumstances, and diffused shareholders will have a much greater problem.

Information problems have potentially dire implications for those who provide funds to intermediaries in the form of debt contracts. Debt holders do not enjoy any upside potential from risk taking but do bear the costs when the risks are so great that the bank’s ability to service its debt is impaired. Yet the fact that opacity makes it easier to loot or engage in excessive risk taking in banking is precisely what gives large creditors (including large depositors) an incentive to monitor closely. Not only does anecdotal evidence suggest that large creditors tend to run first, but empirical evidence provides some support for their ability to do so. For example, Calomiris and Powell show that Argentine banks in the late 1990s with low levels of subordinated (uninsured) debt were also those banks with comparatively high nonperforming loan ratios. Creditors with good information and their money at risk got out.<sup>34</sup>

Opacity also facilitates the ability of insiders to exploit outside investors and the government. In most developing countries, the presence of conglomerates and the domination of large sectors of the economy by relatively few families make insider abuses more likely, most often at the expense of outside equity investors; smaller creditors, including depositors; and ultimately taxpayers. For example, the staggering losses in the Indonesian crisis of the late 1990s are difficult to understand in a relatively undeveloped economy with a high dependence on agriculture—and in the absence of a massive crop failure.<sup>35</sup> Tabalujan documents that at the end of 1996, some banks had lent as much as 85–345 percent of their capital to

33. In the same vein, insurers can inflate their incomes by lowering underwriting standards, or pension managers with compensation contracts based on return alone might take larger risks with their portfolios than is optimal for their clients.

34. Calomiris and Powell (2000).

35. The authors are indebted to Millard Long for this observation.

bank insiders.<sup>36</sup> Such loans, never to be repaid, are the most convenient way to loot banks.

Similarly, La Porta, Lopez-de-Silanes, and Zamarripa find high rates of connected lending in Mexico.<sup>37</sup> They find that 20 percent of total loans go to parties with some relationship to the bank. These loans benefited from interest rates that were about 415–420 basis points below those to unrelated parties, after accounting for various borrower characteristics, such as size, profitability, and leverage. Related borrowers also benefited from longer maturities, were significantly less likely to have to post guarantees or collateral, and were 33 percent less likely to pay back; moreover, the recovery rates on these loans were massively less (78 cents on the dollar lower) than on loans to unrelated parties. The authors conclude that systematic looting was occurring.

Finally, Laeven presents evidence that insiders in Russian banks benefit not so much from more favorable interest rates as from much higher loan volumes.<sup>38</sup> Since 71 percent of all such loans were not repaid (and since interest rates were more controlled or observed at the time), the author reasonably concludes that there was not much point for Russian insiders to haggle over terms!

**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. Takeovers are likely to be less effective when insiders have much better information than potential purchasers do. Although there are no data pertaining to the incidence of hostile takeovers in emerging market banking, an informal survey of World Bank financial sector experts revealed amazingly few such events, apart from takeovers following bank failure. Even in industrialized countries, hostile takeovers tend to be rare in banking, although in recent years merger activity has been on the upswing.<sup>39</sup> Indeed, long delays in the regulatory approval process associated with bank purchases make hostile takeovers in banking extremely rare. Anderson and Campbell find little such activity in Japanese banks up to 1996, notwithstanding the serious problems there.<sup>40</sup> They also found little

36. Tabalujan (2001).

37. La Porta, Lopez-de-Silanes, and Zamarripa (2001).

38. Laeven (2001).

39. See Prowse (1997) on hostile takeovers in banking; Berger, Demsetz, and Strahan (2001) on merger activity.

40. Anderson and Campbell (2000).

relation between bank performance and executive turnover in this case. Since their sample period ended, merger and downsizing finally appear to be occurring there. To be clear, the possibility of takeover in normal times because bank managers are not performing well could be a channel for exerting corporate governance, but it appears generally to be rare, especially in emerging market banking. Takeover after a bank failure, which is happening with greater frequency, does not affect managerial incentives almost by definition.

Furthermore, the absence of active, efficient securities markets can reduce the usefulness of the takeover threat in particular and corporate governance of financial intermediaries more generally. If potential corporate raiders cannot raise capital quickly and efficiently, the effectiveness of the takeover threat as a corporate control device is diminished. Similarly, if bank shares do not trade actively in efficient equity markets, takeovers lose some of their effectiveness as a mechanism for exerting corporate control over banks. Moreover, the absence of well-developed securities markets means that many types of financial instruments that might be used to limit managerial discretion in banks and nonbank financial intermediaries (such as debentures and subordinated debt) do not exist. Thus, many of the prerequisites for corporate control through market competition do not function in many countries.

Product market competition also is less common in banks, especially in developing economies. Information asymmetries should lead to less competition in banking, as bankers overcome information barriers by developing relationships with their clients. A variety of indicators are consistent with little competition in low- and middle-income countries, as seen in table 2-1, where countries are grouped into four income groups. In terms of basic concentration data, the major difference is between the two higher- and the two lower-income groups. With family domination it is not surprising that entry barriers would be higher, as suggested by higher fractions of entry applications denied, and in particular by less entry by foreigners, who might be expected to be less reluctant, compared with other domestic residents, to compete aggressively for business against powerful domestic banks. As noted below, greater state ownership in lower-income countries also likely limits competitive forces. Thus it appears that actual competition "on the ground" is likely to be less in lower-income countries.

Limited competition is also the rule for nonbank financial intermediaries. In addition to information problems, the small size of developing country markets usually limits the insurance market drastically, aided in

Table 2-1. *Bank Regulations across Countries, by Income Group*

Regulation	Income group			
	Low	Low-middle	Upper-middle	Upper
Bank concentration	...	0.72	0.62	0.62
Total deposits in five largest banks (percent)	0.72			
Entry applications denied (percent)	0.45	0.37	0.12	0.05
Foreign entry applications denied (percent)	0.51	0.31	0.04	0.05
Commercial banks that are foreign owned (percent) <sup>a</sup>	0.33	0.26	0.29	0.18
Are there limits on foreign ownership? (yes=1; no=0)	0.13	0.26	0.40	0.23
Are there limits on foreign entry (yes=1; no=0)	0.25	0.21	0.13	0.08
Commercial banks that are state-owned (percent)	0.33	0.31	0.16	0.14
Is a certified audit required? (yes=1)	0.85	0.95	1.00	0.94
Ten largest banks rated by international credit rating (percent)	0.10	0.10	0.35	0.39
<i>Indexes</i>				
Bank accounting transparency <sup>b</sup>	2.25	2.52	2.85	2.55
No deposit insurance <sup>c</sup>	0.60	0.33	0.15	0.29
Private monitoring index <sup>d</sup>	4.85	5.76	6.30	6.52
Number of countries	20	21	20	31

Source: World Bank Database on Bank Regulation and Supervision.

a. Percentage of banking system assets in banks that are more than 50 percent foreign owned.

b. This index adds one for each of the following affirmative answers: (a) the income statement does not include accrued though unpaid interest or principal on nonperforming loans, (b) banks are required to produce consolidated financial statements, and (c) bank directors are legally liable for erroneous information disclosed publicly.

c. Equals one if there is not explicit deposit insurance scheme and if depositors were not compensated the last time a bank failed.

d. This index variable adds one for each of the following affirmative answers: (a) there is a compulsory external audit by a licensed or certified auditor, (b) 100 percent of the top ten banks are rated by international credit rating agencies, (c) there is no explicit deposit insurance and depositors were not compensated that last time a bank failed, (d) the income statement does not include accrued or unpaid interest or principal on nonperforming loans, (e) banks are required to produce consolidated financial statements, (f) bank directors are legally liable for erroneous information disclosed, (g) off-balance sheet items are disclosed publicly, (h) banks disclose risk-management procedures, and (i) subordinated debt is part of capital.

some cases by government ownership. Thus, in Latin America, more than 80 percent of the market is controlled by the top five life insurance firms in four countries (Mexico, Peru, Trinidad and Tobago, and Uruguay), and more than 40 percent of the market is controlled by the top five life insurance firms in another five countries (Argentina, Brazil, Chile, Colombia, and the Dominican Republic).<sup>41</sup> The level of concentration usually is in excess of that for banks.

### *The Impact of Regulation on Governance*

The fact that banks are key players in national payment and credit systems combined with fears of contagion mean that virtually all governments energetically regulate and supervise banks.<sup>42</sup> To be sure, formal comparisons of the “degree of regulation” between banks and nonfinancial firms are not straightforward. It is true that some industries, such as nuclear power, also are heavily regulated, due to concerns about a different type of fallout. But even governments that intervene little in other sectors heavily regulate banking.<sup>43</sup> Moreover, the explosion of international standards in banking attests to the great degree of official involvement. The heavy hand of regulation not only results from banks being different—in many ways because of their opacity—but also results in making banks and their corporate governance different. In this section we review how regulation affects the different channels for corporate governance.

**RESTRICTIONS ON SHAREHOLDERS.** Although concentrated equity is a common 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 from concerns about concentrations of power in the economy or about the type of people who control a bank.<sup>44</sup> 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

41. Data, from the World Bank, were not available for all Latin American countries.

42. This idea has been subject to much debate. See World Bank (2001, ch. 2) for a brief summary of some of these views. Whether legitimate or not, concerns about contagion have led to the rapid spread of deposit insurance schemes in recent years.

43. In the early 1990s it was said by the generally less interventionist U.S. authorities that twenty-three government supervisors reported daily to their work at Citibank.

44. As Louis Brandeis (1914) put it, “A license for banking is a license to steal.”

certain level and may need regulatory approval above some proportion. Of the 107 countries in a recently compiled database of bank regulation and supervision, 41 limit the percentage of bank capital that a single entity can own to 50 percent or less, while another 38 put the limit at 25 percent or less.<sup>45</sup> Additionally, there may be constraints on who can own banks, such as the prohibition on ownership by nonbanks, or by securities firms or insurance companies (the United States recently lifted such a prohibition).

Government regulatory restrictions are often ineffective at limiting family dominance of banks, yet the regulatory restrictions on purchasing equity can actually protect these family-controlled banks from takeover and thereby hinder corporate control. Powerful families have used a plethora of channels to build up control in banks and nonbank firms, as in the case of East Asia.<sup>46</sup> The aforementioned restrictions then would not prevent concentrated family ownership, but rather would defend the existing owners. Where the restrictions are so effective that they thwart the emergence of controlling shareholders, they can give managers much greater power.

**COMPLICATIONS FROM DEPOSIT INSURANCE.** Deposit insurance, whether implicit or explicit, substantively changes the equity and debt channels of corporate governance. Deposit insurance reduces the incentives of depositors (and any other creditors who believe the government insures their claims) to monitor banks and thus directly hinders corporate governance. Furthermore, deposit insurance also induces banks to rely less on uninsured creditors with incentives to monitor and more on insured depositors with no incentives to exert corporate governance. Thus, deposit insurance indirectly reduces the percentage of financing raised from large creditors, who have the incentives and ability to monitor banks. Furthermore, deposit insurance has developed together with lower capital-to-asset ratios. As noted earlier, capital-to-asset ratios started declining before the advent of explicit deposit insurance. Nevertheless, the manifestation of a safety net for banking appears to be mainly responsible for the large subsequent drop. Moreover, the rise of central banks as lenders of last resort also reduced the need for capital in banking (compared with nonbanks). Thus deposit insurance tends to reduce the fraction of money raised through equity, and the smaller base of equity holders faces increased incentives to increase the risk of bank assets since they reap the benefits of success and share failure with debt holders.

45. Barth, Caprio, and Levine (2001b).

46. Claessens, Djankov, and Lang (1999).

**LIMITS ON COMPETITION.** Government interventions also limit competitive forces in banking. The direct and indirect restrictions on ownership reduce the role of market forces in the market for corporate control. Regulatory restrictions on banks' activities and even their pricing reduce competition in output markets. In addition to restrictions on banks' ability to underwrite equity, conduct real estate or insurance business, or take ownership in nonbank firms, banks in emerging markets are subject to a variety of other constraints.<sup>47</sup> Minimum branching requirements (often in rural areas), directed credit guidelines, portfolio restrictions (such as minimum percentages of deposits or assets invested in government securities) or liquidity requirements, and limits on interest rates and fees are among the restrictions that are more common in developing countries.

Governments also limit competition in other segments of the financial sector. Governments frequently manage pension funds directly or tightly limit competition by managers in an attempt to keep out possibly unqualified or unscrupulous managers. And for nonetheless sound reasons, choices for pension managers are quite constrained, and where the choice even exists, pension account owners often have restrictions on their ability to change their manager, a quite different situation from that under the Anglo-American regulatory framework. Thus in Argentina and Chile, banks outnumbered pension funds by as many as ten to one in the late 1990s, whereas in the United Kingdom and the United States, the number of banks was tiny relative to the number of pension funds. While the rationale for restrictions can be debated, the impact on competition seems unambiguous. In sum, as uncompetitive as emerging market banking appears to be, nonbank intermediation is even less competitive, so it is likely that this channel for governance is weaker still.

**GOVERNING THE GOVERNORS.** Owners and the markets, two key sources of governance over banks, are motivated to maximize or protect the value of their debt or equity claim. Governments' motives are quite different. Although governments at times behave like debt holders, enjoying all the downside but little of the upside from banking (although they should get higher tax revenue as banks profits grow), the government does not pay for the costs of bank failure but rather passes the bill to taxpayers. Government regulators and supervisors, without their own funds at risk, are insulated from market forces. Moreover, rather than serving as objective and independent monitors of banks, they are subject to a variety of political

47. Barth, Caprio, and Levine (2001a).

forces and even, as is the case in a number of emerging markets, are exposed to civil lawsuits, often for arbitrary reasons. Consequently, they may not enjoy much independence from the industry they regulate.<sup>48</sup> In contrast, such protection is more the rule in industrial economies.

Where democratic traditions are weak and where there is little oversight of supervisors through government checks and balances, the considerable scope these supervisors have to use their position to extract rents from the banks they regulate is perhaps of even more concern—particularly where supervisors are poorly paid. Barth, Caprio, and Levine in fact find a very strong positive relationship between corruption and countries with powerful supervisory agencies, tight restrictions on commercial bank activities, and entry barriers that limit competition.<sup>49</sup> They find a negative relationship between corruption and countries that promote private sector monitoring of banks (even when controlling for many other country characteristics). Although enhanced supervisory powers are associated with deeper financial systems in the presence of very strong political openness, greater supervisory power generally exerts a negative impact on bank development. In this context, the move to improve supervisory powers without political oversight can damage the corporate governance of banks in the sense of putting the supervisors directly at odds with the owners and markets.

Yet even in high-income countries, the task of supervision and its oversight is fraught with difficulty. For example, one “bonus” that supervisors face is the possibility of taking a job with the bank that they are supervising, a possibility that surely could lead to less vigorous supervision. This is not just a theoretical consideration: Horiuchi and Shimizu 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.<sup>50</sup> Banks with *amakudari* officials performed more poorly—that is, they had lower capital levels and higher numbers of nonperforming loans—than banks without them. Few countries in the world have any restriction on regulators’ job choices or sources of compensation after their stint in government, and any restrictions likely would be difficult to enforce.<sup>51</sup> This suggests that without a revolution in the way regulators and

48. Boot and Thakor (1993). Interestingly, Barth, Caprio, and Levine (2001) find that a composite indicator of supervisory independence from political interference and from civil lawsuits is associated with greater banking development.

49. Barth, Caprio, and Levine (2001b).

50. Horiuchi and Shimizu (2001).

51. Barth, Caprio, and Levine (2001a)

supervisors are compensated, expectations of their efficacy in monitoring banks, especially in emerging markets, should be modest.

### *Bankers as Bureaucrats*

The ultimate way in which bureaucrats intervene with the operation of a bank is through outright government ownership. Although such ownership has been decreasing in recent decades, by the late 1990s, about 40 percent of the assets in the banking systems of emerging markets were in state-owned banks.<sup>52</sup> This figure is much higher in some of the more populous countries, such as Brazil, China, India, and since the 1997 crisis, Indonesia. The World Bank calculates that in the late 1990s more than 40 percent of the world's population lived in a country in which the majority of bank assets were in majority-owned government banks.<sup>53</sup>

When the government is both the owner and regulator, there is a conflict of interest between its two roles, and any hope of independent supervision would appear unrealistic. Indeed, in some countries, such as China, the government executives who run the state banks outrank the heads of any oversight agencies. More generally, as already noted above, bureaucrats might be expected to be less motivated by market forces and more responsive to political influence than are their counterparts in the private sector.<sup>54</sup>

Barth, Caprio, and Levine show that government ownership of banks is negatively associated with development of the banking sector and positively associated with measures of bank inefficiency, such as interest rate spreads and overhead costs.<sup>55</sup> They also find some link between government ownership and crises, although this link is less robust than that found by Caprio and Martinez.<sup>56</sup> There is no evidence, even in weak institutional

52. La Porta, Lopez-de-Silanes, and Shleifer (2002).

53. World Bank (2001).

54. Many would hope to come up with ways to improve bureaucratic performance, including by writing contracts to compensate bankers as in the private sector, or by delegating management or contracting out management of state-owned banks to private parties. However, the former appears difficult to do, and the latter is a dangerous path with little hope of success. As World Bank (1995) so carefully adumbrated, management contracting has worked only for businesses that are relatively simple and transparent, and in which reputation matters. So this strategy may work for hotels, where it is easy for one and all to see if service is up to standards and if the towels are clean. Banking is anything but transparent, and reputation, although it used to be important in some countries, does not matter here where government guarantees are present.

55. Barth, Caprio, and Levine (2001b).

56. Caprio and Martinez (2000).

settings, that government-owned banks overcome market failures and channel credit to productive ends.

The conflict of interest for the government as owner and regulator of banks likely becomes overwhelming when government owns a substantial stake in industry as well.<sup>57</sup> Thus if one set of bureaucrats—say, those overseeing a given firm—do their job poorly, they can try to hide the problems with a bank loan from a fellow bureaucrat. A similar tendency might operate between related parties controlling a bank and a firm, but at least then the markets and the government exist to provide some oversight, whereas with state banks, the government has been removed as an effective monitor. Last, 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 entities have no incentive to monitor state banks. In sum, neither the owners, the markets, nor the supervisors are likely to be providing effective corporate governance when banks are state owned.<sup>58</sup>

One potential check on government-run banks is competition in the output market, but here again these forces are muted. In particular, the banks that are most likely to be willing to compete against the state—foreign banks—usually are kept out of the market.<sup>59</sup> This lack of competition explains their aforementioned finding of higher interest costs and higher overheads. Government ownership also effectively stymies nonbank competition as well. The absence of standard corporate governance mechanisms does not necessarily mean that all state banks are bad. Rather, the results indicate that those countries with a greater share of state ownership in banking experience poor outcomes. Equally, considerations of corporate governance in emerging market banking without taking state ownership into account likely miss the major actor in the play.

57. Thus the success of Germany notwithstanding, the largest share among industrial countries of state ownership in banking may be partly due to the lack of state ownership in virtually any other sector. World Bank (2001, ch. 4) also notes that an impressive protection of creditor rights appears useful as well.

58. That explains why Barth, Caprio, and Levine (2001b) and La Porta, Lopez-de-Silanes, and Shleifer (2002) find uniformly negative results from state ownership in banking. Cornett and others (2002) also find that during the East Asian crisis, the performance of state banks deteriorated more markedly than that of privately owned banks, and this effect was greater the larger the overall presence of state banks. World Bank (2001) notes that the empirical evidence argues for a reduction in state ownership, especially where it is most widespread, but not necessarily a complete abandonment thereof. This last finding is consistent with this view, in that the costs of state ownership appear to grow as it increases.

59. Barth, Caprio, and Levine (2001b).

State ownership or control also features in pensions and insurance, much less so in other nonbank activities, such as investment banking. Countries, such as India, in which state ownership is important in banking (total assets in state banks totaled about 80 percent in the late 1990s) may have an even higher state presence in insurance (the top five state companies in India have 100 percent of the nonlife insurance market, the only one with data).

### Implications for Policy and Future Research

To summarize then, the corporate governance problem in finance is pronounced. The severity of information problems in finance weakens all of the traditional corporate governance mechanisms—control by both diffuse and concentrated equity and debt holders, competitive forces in product markets and in the market for corporate control, regulation, and supervision. Significantly, the opacity of finance facilitates the ability of shareholders and senior managers to engage in risk shifting: shifting the assets and investments of the firm to riskier activities.

Governments intervene pervasively in the financial sector with adverse implications for the corporate governance of financial institutions. In banking, deposit insurance dampens the incentives of creditors to monitor banks, and regulatory restrictions often impose limits on competition and takeovers. Government ownership of banks removes the government as an independent monitor, greatly weakening incentives for the private sector to monitor and significantly weakening competition in banking. These government interventions together with an accommodating regulatory and legal environment can facilitate bankers' engaging in looting: profiting themselves while letting the bank go bankrupt.

Although the stated task of bank regulation and supervision is to enhance corporate governance, limit risk taking, and stop looting, the opacity of banking makes this difficult, and regulators and supervisors quickly can develop their own agendas that may have little to do with market-oriented corporate governance. Furthermore, the opacity of the supervisory process itself and the ability of private sector banks to pay highly attractive salaries relative to those in the public sector contribute to skills shortages in the supervisory agencies and heighten the risk of corrupt activities.

All these problems are more prevalent in emerging markets than in industrial countries. In emerging markets, information is scarce, and its

quality is less reliable. Bank and nonbank finance concentration is usually high. The dominance of the economy by a relatively small number of families or conglomerates is pronounced, and competitive forces therefore muted. Regulation and supervision often are less developed, and state ownership is far more pronounced. As others have noted, the problem in emerging markets is not the separation of ownership and control. The problem is that ownership and control of significant parts of the economy, banking included, are so highly concentrated in the hands of politically powerful families that many of the mechanisms that act to serve as a check on insiders in high-income countries are not present or are distinctly weakened. Thus if banking is particularly fraught with corporate governance problems, banking in emerging markets experiences these difficulties even more so. This section briefly reviews policy recommendations to improve corporate governance in developing countries and also suggests future research efforts to support improvements in this area.

### *Strategy for Improving Governance*

Existing research shows that countries enjoy better-developed financial systems with a lower likelihood of serious financial crisis when the government supports the ability of private sector entities to monitor banks, permits banks to engage in a wide range of activities, allows foreign entities, minimizes state ownership, and encourages diversification.<sup>60</sup> Stated differently, the government's job can be seen as fostering the ability and incentive of all the different potential monitors of banks to do their jobs well. This research does not imply that efforts to improve bank supervision are nugatory, but rather that they need to be focused on supporting the private sector, rather than on attempting to replace the responsibilities of private owners and market participants.

Existing research thus suggests a strategy for authorities seeking to improve governance in banking. As a first step, it is critical that governments recognize and curb any of their own behaviors that thwart the private sector's ability and incentive to monitor banks. Thus, for example, in countries in which government ownership is pronounced, private sector monitoring cannot be expected, and competitive forces clearly are blocked. In these cases, embarking on a program to reduce government ownership

60. Barth, Caprio, and Levine (2001b)

would seem to be essential; without this step it is difficult to conceive of the success of other efforts to ameliorate the governance problem. Private sector monitoring is virtually nonexistent in countries with blanket deposit insurance or extremely generous deposit insurance coverage (such as coverage in very low-income countries, where insurance levels are ten to fifteen times per capita gross domestic product). Reducing coverage to much lower levels is essential to enhance private sector monitoring.

A second step in improving governance in banking involves directly reducing the opacity of banks by improving the flow of information. Although transparency of banking information in emerging markets is receiving increased attention in the wake of the East Asian crisis (and perhaps more so in the aftermath of the Enron collapse), the likely reinforcement of opacity by existing ownership patterns in emerging markets suggests that this task is even more important and yet more difficult than has been recognized. In effect, authorities need to engage in the unpopular task of shaking up cozy relationships among powerful interest groups in their society. This task is not as simple as superficial adherence to international standards; rather, it is a process that requires sustained commitment over a period of time in order to effect. In addition to improvements in accounting and auditing, improvements to credit information will facilitate the expansion of banking by those interested in providing finance to groups that were previously excluded. Enhancing corporate finance reporting in the media and educating people about the importance of this issue in a wide swath of civil society will help make a lasting contribution to better corporate governance. This is not easy: the same family groups that control banks may also control the media, so broader antitrust activity may be necessary in order to make greater transparency effective. Moreover, it is worth stressing again that these changes will not happen to the extent that governments underwrite risk.<sup>61</sup>

Third, although better information may indirectly enhance the contestability of the banking market and invigorate the market for corporate control in banking, opening to foreign banks offers a direct mechanism for creating competitive pressures in banking. Barth, Caprio, and Levine

61. For example, it is no coincidence that before the existence of deposit insurance the United States, the financial press included weekly and even daily "Bank Note Monitors," which reported on the health of banks issuing debt instruments that were actively traded. With the advent of deposit insurance, the market for this reporting disappeared.

found that it was not so much the presence of foreign banks as the contestability of markets (associated with relative openness to foreign entry) that contributed to the development and stability of emerging market banking.<sup>62</sup> Foreign banks, and indeed foreign entry in other markets, will serve to increase the competitiveness of the economy in general and lessen the reliance on family or conglomerates relationships. Clarke and others show that increased foreign presence in emerging market banking has the attractive benefit of improving access to credit, even by small and medium-size enterprises.<sup>63</sup> The resulting increase in competition in the economy can pay dividends in the long-term to the corporate governance problems discussed here. Clearly the same should apply to foreign competition in insurance and pension management.

Fourth and most important, the potential monitors of banks—owners, markets (large creditors in particular) and supervisors—need clear and strong incentives to do their jobs well. As stressed above, the legal and bankruptcy systems do not operate well in many countries. Thus bank managers can control banks with little to fear from outsider investors or even from bankruptcy, as is clearly evident from Japan's ten-year banking crisis. Owners, particularly controlling shareholders, will have the incentive to monitor their banks well (meaning in accordance with society's goals) only to the extent that their own resources are really at risk and that there are healthy profits in return for safe and sound banking. Unfortunately, ensuring that capital is real and that weak lending practices have not eroded it is not simple in practice.

The incentives facing insider owners and managers can be enhanced in a number of ways. The ability of authorities to influence inside owners and managers is enhanced if regulators can impose penalties in cases of fraud or improper conduct. Similarly, the incentives of inside owners and managers are clearly enhanced if small shareholders and debtors can confidently use an efficient court system that supports their rights. More generally, regulation has not focused much attention on the compensation of senior managers. For example, an attempt to vary capital requirements in line with the extent to which banks' compensation policies encourage or discourage excessive risk taking is a promising area for new research.<sup>64</sup> The

62. Barth, Caprio, and Levine (2001b).

63. Clarke and others (2001).

64. John, Saunders, and Senbet (2000) show that adjusting management compensation to bring it in line with the risk premium on risk-based deposit insurance can reduce the risk-shifting behavior of

supervisory process in some countries is getting close to this issue when supervisors examine the systems that banks have in place for managing their risks. We suspect that as important as risk management is as a process, the incentives inside the individual banks for taking risk will determine the efficacy of any processes that are written down. Certainly, the threat of legal recourse for those who suffer losses when directors do not fulfill their fiduciary duties would improve the incentives for this group, and it might also encourage them to support reforms in compensation policies for senior bank officers. Compensation policies of directors themselves also demand greater attention to and further research on the extent to which bank and corporate performance is a function of differences in compensation.

To improve corporate governance of financial intermediaries, policy-makers must seek to enhance the ability and incentives of creditors and other market participants to monitor banks. Recently, subordinated debt proposals have received increased attention, although we fear that in the wake of the Argentine crisis, success in this area will be undervalued.<sup>65</sup> Unfortunately, in the discussion of revisions to the Basel capital accord, subordinated debt has not received much attention, and only the various shadow regulatory groups (in the United States, Europe, and Latin America) have seriously been promoting this idea. Although the ability of creditors to monitor banks will improve as the information environment develops, ensuring that market participants have incentives to do their job seems important as well. Just as strategic shareholders (large shareholders with significant exposure) are widely thought to be important in the governance process, large creditors, who did not benefit from upside risks, are a useful component of the oversight of the risk-taking behavior of banks.

Incentives for supervisors matter as well. In view of the slow progress in improving the incentives facing supervisors, it is not surprising that Barth, Caprio, and Levine find that enhanced supervisory powers had a generally *negative* payoff in terms of financial sector development and

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bank managers. However, this presumes that the risk premium captures adequately the risks that are being borne by the bank, which in countries that have implemented this approach is unlikely in view of the slight difference in the premiums. In practice at the very least it is an untested system, but the central idea of the importance of linking compensation to risk taking is promising.

65. World Bank (2001). It should be recognized that the Argentine crisis resulted from inconsistency between fiscal policies and other macroeconomic factors and the exchange rate regime, not from the banking sector. In fact, two different administrations there were looking to the banks as a way to pay for the crisis, not as its source.

crisis prevention.<sup>66</sup> One explanation for their finding could be the presence of greater concentration of economic power and family control in emerging markets, which can easily weaken the de facto independence of bank supervision and make it easier to reward supervisors for weak supervision.<sup>67</sup> In this case, the adoption of international best practices in bank supervision is not likely to suffice. As in the case of customs collection, the outright hiring of foreign supervisors might be one way to achieve greater independence and lessen possible corruption. Although no country has yet formally chosen to hire a foreign supervisory agency to oversee its own banks, foreign entry into banking systems has in practice yielded the same result in countries such as New Zealand, where foreign banks comprise virtually the entire banking sector. Improvements in the level and structure of compensation for bank supervisors also can contribute to better performance, and along with legal restrictions might reduce the migration of supervisors to the management teams of the banks that they supervise. Again, research here would be beneficial, but it will be problematic until better data are available on the extent of wage differentials between supervisory agencies and private sector banks.

The above arguments apply to nonbank financial intermediaries. Fortunately, pension funds and insurance companies are less subject to runs and generally have been smaller in developing countries. Until now, in emerging markets they generally have had far less assets under their control than banks, but this likely will change. Insurance products generally show a high-income elasticity of demand, and the lowering of population growth rates and flattening of demographic pyramids may heighten interest in funded pension systems, so attention to improving their governance is timely. Gathering more and better data on these branches of finance accordingly should be a priority, for if they follow the experience of high-income countries, their assets will soon dwarf those of banks.

The governance problem in finance is severe, but it is not hopeless. History shows that success is possible. Better-governed banks—banks that were able to contribute to development yet that could also withstand macroeconomic disturbances—used to be more common. Notwithstanding waves of failure by small U.S. banks in the nineteenth century, depositor losses in the now industrialized countries were minor and tax-

66. Barth, Caprio, and Levine (2001b); see also World Bank (2001).

67. For example, if a family has extensive holdings, it can easily reward a bank supervisor with a sinecure well removed from banking activities.

payers' losses nil. This state of affairs resulted from clear incentives for the various actors reviewed here. Not the least of these incentives was the practice for bankers to post bonds and for supervisors even to receive deferred compensation. We can only hope that the scale of banking losses in emerging markets and the consequent increased attention to this topic will help promote reform efforts.

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