Financial Regulation and Compliance

The corporate governance of banks

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FEATURE ARTICLE

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Abstract

Purpose – To consider the implications of the banks fiduciary duty to their depositors (as well as the shareholders) and the government’s fiscal duty to taxpayers (in the presence of deposit insurance) for the corporate governance (CG) of banks.

Design/methodology/approach – Recent contributions to the literature are outlined and assessed in the context of the asymmetric information literature relating to banking.

Findings – The good CG of banks requires regulation to balance the interests of depositors and taxpayers with those of the shareholders.

Originality/value – Linking the bank regulation in literature based on information asymmetry to the CG literature.

Keywords Banks, Corporate governance, Regulation

Paper type Viewpoint

Introduction

Banks are special because their managers have a fiduciary duty to (more risk averse) depositors as well as (more risk prone) shareholders and thus a solution to the “principal-agent problem” aimed at maximising shareholder value is inappropriate. Further, banks are the most important source of external finance, especially for small and medium enterprises (SMEs), and thus play a key role in allocating capital and the corporate governance (CG) of non-financial firms. Further, they are at the core of payments systems and so systemic crises are very costly. Depositor protection helps reduce the risk of systemic crises, but at the cost of increasing moral hazard and adverse selection; requiring the government to protect taxpayers against abuse by banks taking excessive risk. Good regulation, aimed at curbing excessive risk taking, thus becomes a cornerstone of the good governance of banks. This argument can be extended to other financial firms given their fiduciary duty to retail savers as well as shareholders.

The contributions of Macey and O’Hara (2003) and Levine (2003) to the literature on the CG of banks are reviewed and their recommendations assessed and placed within the context of the literature on asymmetric information in banking. The implications for Basel II’s “three pillars” in developed and developing countries and other related issues are then considered before policy conclusions are drawn.

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