Foreword 2

The 2007–2009 crisis in world financial markets, triggered by defaults on subprime mortgages in the US, and the 2010–2011 crisis in the euro zone, raise questions about macroeconomic policy, financial stability, the design of financial regulation and supervision, and the corporate governance of banks and other financial institutions. Interventions by the official authorities, including massive recapitalization of some of the world’s largest banks, underscore that the stability of individual banks has been at risk. Moreover, there has been considerable concern about systemic risk; that is, problems at individual banks have threatened the stability of the banking and financial system as a whole, especially after the collapse of Lehman Brothers in September 2008.

The recent financial crisis clearly shows the importance of having a well-conceived and coherent system and an institutional structure that help to prevent such crises from occurring in the first place and to resolve a crisis once it has occurred. Such a system did not exist when the crisis started in August 2007.

However, in the decade before the crisis started in 2007, several proposals on how to create such an institutional structure had been under discussion among academics, bankers and regulators. Unfortunately, the existence of relatively benign economic conditions in which banks were highly profitable, and the prevalence of a relatively close relationship between regulators and bankers (‘regulatory capture’), prevented the implementation of these proposals.

The recent financial crisis has created a new momentum for designing and implementing a new regulatory and supervisory structure which will make the occurrence of crises less likely and the resolution easier once a crisis has occurred. New proposals are currently being discussed internationally under the auspices of, primarily, the Basel Committee on Banking Supervision, the Financial Stability Board and the European Commission. These proposals focus on: (1) a substantial increase of bank capital requirements, including the use of contingent capital instruments as a way of strengthening market discipline; (2) the design of credible resolution or ‘prompt corrective action’ schemes which would require bank supervisors to take prespecified actions when bank capital starts to decline and to close or to restructure financially a bank when capital falls below the lowest threshold or trigger point; (3) the creation of more adequate deposit insurance systems characterized by risk-related insurance pricing and immediate payout of insured deposits in the case of a bank failure; (4) a more adequate measurement and monitoring of systemic risk in the banking and financial system; and (5) the design of executive compensation schemes for top management of banks focusing more on longer-term performance.

These reform proposals have the explicit goal of limiting guarantees and moral hazard in the banking and financial system, thereby enhancing the incentive compatibility of financial regulation and supervision. The existence of explicit deposit insurance systems, as well as implicit guarantees associated with the perception that (large) banks will almost always be bailed out by the government, is creating perverse incentives towards increased
risk-taking and a reduction of bank capital ratios. In order to address this moral hazard problem it is essential to reduce the need for government-provided bailouts.

In this volume, the Research Handbook on International Banking and Governance, the recent financial crisis is analyzed with governance as the unifying theme. The central question is how corporate governance arrangements of banks and other financial institutions affect risk-taking, performance and behavior of financial institutions more generally.

In most countries governments impose various regulations on banks to ensure a safe and sound banking system. As the editors note in their ‘introduction and overview’ chapter, corporate governance on the one hand and regulatory and supervisory governance on the other hand should be viewed as complements, with the same goal of producing prudential banking practices. The appropriate mix between the two types of governance is a debatable issue and, therefore, one that merits further enquiry.

The present volume aims at providing a contribution to this debate by exploring the role of governance studied under seven main themes: (1) ownership, efficiency and stability; (2) compensation, performance and risk; (3) market discipline: prerequisites and effectiveness; (4) governance, regulation and supervision; (5) governance, strategy and social responsibility; (6) governance in non-bank financial institutions; and (7) regional and country studies.

Through its broad scope of issues related to the corporate governance of banks and other financial institutions, analyzed from the background of the recent financial crisis, this new volume provides a timely and thorough perspective on how to reform the financial system in order to make future banking crises far less likely. Moreover, given the fact that the volume contains contributions from internationally recognized scholars, coming from the US, Europe, Asia and elsewhere, it provides excellent reading material for academics, students, bankers, regulators and supervisors, and others who have a genuine interest in the question of how to ensure banking and financial stability in the future.

Harald Benink
Professor of Banking and Finance
Tilburg University
Tilburg, the Netherlands
Chairman, European Shadow Financial Regulatory Committee