Introduction and overview

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This book is aimed at researchers and students of financial institutions in academia as well as in private financial institutions and public regulatory and supervisory authorities. Its objective is to bring the reader to the frontier of research on governance of financial institutions by interpreting and reviewing current research, as well as to push the frontier by presenting original research on new aspects of financial institution governance. To inspire future research the book also includes chapters on governance policy issues that require more attention by researchers.

The recent financial crisis has stimulated a debate on governance of financial institutions as well as research on effects of governance arrangements on the risk-taking, performance and behavior of financial institutions more generally. Furthermore, researchers are asking how regulation, legislation, politics and other factors influence governance of financial institutions and, thereby, their behavior in different dimensions. The contents of this book reflect this variety of research on financial institutions with governance as the unifying theme.

For many countries around the world the recent financial crisis was the worst they had experienced since the Great Depression of the 1930s. Financial institutions clearly were the center of attention as a large number of them either failed or were bailed out by governments during 2007 to 2010. The lengthy list of distressed institutions includes Citigroup, Bank of America, American International Group, Fannie Mae and Freddie Mac in the United States; PNB Paribas, Crédit Agricole and Société Générale in France; Commerzbank and Bayerische Landesbank in Germany; Allied Irish Bank and Bank of Ireland in Ireland; Royal Bank of Scotland, Lloyds Bank and Northern Rock in the United Kingdom; and UBS in Switzerland. More institutions may be added to the list as the process of dealing with still other troubled institutions continues to move ahead. Not surprisingly, these disturbing developments have led to numerous official and unofficial studies assessing what went wrong with financial institutions in so many countries, as well as to rethinking what is the most appropriate way to regulate such institutions to contain risk-taking behavior and to prevent taxpayer bailouts.

Some studies examining the causes of the US crisis have focused on macroeconomic factors such as low interest rates due to huge global capital inflows and an excessively easy monetary policy from 2002 to 2006. It is argued that this low interest rate environment led to a tremendous surge of credit into the housing sector, via mortgages and various other securities backed by mortgages, as investors in the United States and abroad sought higher returns. As a result of the unprecedented availability of funds for housing coupled with extremely lax lending standards for home buyers, home prices soared to unsustainable levels and then collapsed beginning in 2006. This triggered a mortgage market meltdown and a severe economic recession.

Given the dominant size of the US economy, these adverse developments in the financial and real sectors exacerbated financial problems occurring in many other parts of the

globe as US imports declined and investors abroad suffered losses on all the securities they had purchased backed by US home mortgages. To make matters worse, the financial regulatory authorities in the United States and elsewhere failed to detect, or ignored, numerous emerging signs warning of impending troubles. The authorities thus failed to take decisive and timely action to limit the severity of the financial crises so many countries experienced. Once they did start taking action in the midst of the widening and deepening global crisis there was substantial uncertainty as to exactly what was being done and over what time period. This uncertainty only contributed to the inability of financial markets to function normally.

Several chapters in this volume present views of the causes of the crisis. It is inevitable that more studies will be conducted focusing on the role that various factors played in such a devastating financial crisis and the appropriate financial reforms needed to reduce, if not entirely prevent, both the likelihood and the severity of future crises in countries everywhere. Some countries have already responded to the crisis by enacting financial reforms. The United States, for example, enacted the Dodd–Frank Wall Street Reform and Consumer Protection Act in July 2010. Such reforms have already been subjected to careful scrutiny as new regulations are implemented and enforced over time.

Although macroeconomic factors have dominated the explanations for previous financial crises around the world, the recent crisis has focused attention on a number of microeconomic factors, including corporate governance of financial institutions; financial innovation in securitization and derivatives; and behavior and incentives of policymakers, regulators and supervisors. These factors are clearly interdependent, as emphasized in many chapters in this volume.

Corporate governance is an important field of research in finance and economics but so far only a few, relatively recent studies have focused on the corporate governance of banks and other financial institutions. While there have been many studies on the role of corporate governance in explaining the financial performance (e.g., stock return performance) of non-financial firms over time, those focusing solely on banks have been somewhat rare until relatively recently. The depth of the most recent global financial crisis, however, has generated substantially more interest in examining whether differences in the risk-taking behavior of individual banks can be explained by differences in the corporate governance practices at these institutions. The main concern in this regard is that, as with any corporation, conflicts of interest may arise between the top managers of a bank and its shareholders. If not kept in check, the managers may behave in ways that benefit themselves or those close to them at the expense of shareholders. In addition, if allowed, shareholders or a subset of controlling shareholders may influence a bank to engage in excessively risky activities at the expense of other stakeholders, like depositors (or the deposit insurer) and debt holders.

The conflict of interest between shareholders and other stakeholders may be particularly important in banking and financial services more generally because the public and politicians attach social value to particular financial services, such as real estate financing, payment services, consumer credit services and household exposure to risk on financial positions, including deposits.

Obviously, it is important that effort be devoted to mitigating the costs to shareholders and to other stakeholders in a bank from various potential conflicts of interest. It is the

role of the board of directors in particular to mitigate costs to shareholders through the promotion and enforcement of good corporate governance practices. If not corrected, poor corporate governance at banks will adversely affect their performance and hence stock market valuation, and thereby adversely affect the availability and cost of credit to their customers. It will also raise the cost of capital to such banks. Poor corporate governance, moreover, may lead to excessive risk-taking behavior by banks, and thereby increase the risk of not only individual bank failures but also the risk of collapse of a country's entire banking system. More generally, and even worse, given the overriding importance of banks for mobilizing and allocating societies' scarce savings to the most productive projects, poor corporate governance of banks can impede overall economic growth and development in countries by producing less efficient and less stable financial intermediation.

To the extent that banks and other financial institutions provide services that are considered socially valuable or harmful, the activities of a well-governed bank from the shareholders' point of view will stand in conflict with or be insufficient relative to perceptions of the public interest. For this reason the financial sector in most countries is subject to a combination of support and regulatory constraints complicating the task of governance as well as the evaluation of what is good governance. Good governance from the shareholders' point of view need not coincide with public and political perceptions of good governance.

The fact that banks, especially in emerging market economies, are so important in helping finance a country's growth and development and that they receive various benefits from the government (e.g., deposit insurance and lender-of-last resort support) has led most individuals to conclude that simply relying on good corporate governance practices is insufficient. Instead, most individuals have concluded that it is also necessary to impose various regulations on banks to better ensure a safe and sound banking system. As a result, there are a variety of regulations and supervisory practices that govern the behavior of banks, ranging from entry to activity restrictions, capital requirements, ownership restrictions, and merger and acquisition restrictions. Corporate governance and regulatory and supervisory governance therefore should be viewed as complements with the same goal of producing prudential banking practices. The appropriate mix between the two types of governance, unfortunately, is a debatable issue and therefore one that merits still further enquiry.

The purpose of this book is to explore the role of governance, both internal and external, in explaining risk-taking and other aspects of the behavior of financial institutions, as well as to explore market and policy factors that explain the objectives and quality of governance. In light of the recent and severe global crisis it is important to identify the underlying causes of the crises in different countries. Only through analyses of the kind presented in this volume can one hope to implement the financial reforms necessary and sufficient to reduce the likelihood and severity of future crises.

This volume is divided into seven parts with governance as the unifying theme:

- Part I Ownership, Efficiency and Stability.
- Part II Compensation, Performance and Risk.
- Part III Market Discipline: Prerequisites and Effectiveness.
- Part IV Governance, Regulation and Supervision.

- Part V Governance, Strategy and Social Responsibility.
- Part VI Governance in Non-Bank Financial Institutions.
- Part VII Regional and Country Studies.

The first two parts take governance characteristics as given, and focus on analyses of the impact of these characteristics on the performance and risk of the financial system in Part I, and on performance of individual financial institutions in Part II. The delimitation between these two parts is not as sharp as it may at first seem. There is substantial overlap between the themes just as there is overlap between macro-prudential and micro-prudential regulation of financial activity.

Parts III and IV consider governance characteristics as endogenous and determined in interaction with market processes, regulation and supervision. Part III focuses on the role of market discipline in shaping risk-taking incentives of managers of financial institutions and the role of the regulatory and legislative frameworks in strengthening or weakening these incentives. Part IV focuses on the role of and effectiveness of regulation and supervision from a macro-prudential as well as a micro-prudential perspective. There is naturally an overlap between chapters in the two parts. Market discipline and direct regulation of financial activities can be viewed as substitutes for influencing governance of risk-taking. However, legislation and regulation can also be aimed at strengthening market discipline as opposed to being solely aimed at restricting risk-taking activities. The role of externalities and market failures for risk-taking is a crucial factor influencing conflicts of interest between shareholders' and social objectives in both parts. A focus on market discipline in Part III is motivated by market failures created by policy and regulatory intervention in financial markets, while regulation and supervision in Part IV are motivated by other sources of market failures.

In Part V strategic objectives of financial institutions, including social responsibility, are viewed as important aspects of corporate governance. This part includes empirically oriented chapters on merger and acquisition policy, and social responsibility as a potential departure from shareholder wealth maximization.

Most of the analysis in Parts I–V applies not only to banking in the traditional sense but also to all financial institutions participating in markets for direct and indirect credit. Nevertheless, we include in Part VI a group of chapters analyzing governance and behavior of financial institutions with governance structures that differ from traditional corporations. The types of institutions covered are community banks, venture capital firms, open-end and closed-end funds, which are compared from a governance point of view, and microfinance institutions in developing countries.

Lastly, Part VII includes chapters focusing on governance issues in particular regions and countries. While some of the chapters analyze general governance characteristics in a region, others focus on a particular issue that can be considered specific to governance in a region or country. A broad group of countries is covered without an attempt at global completeness. Nevertheless, each country or region included has important lessons for governance or it represents a particular approach to governance. The regions and countries included are New Zealand, the European Union, Japan, South Korea, China, Thailand and India.

We turn now to a brief summary of each chapter within the seven parts.

PART I: OWNERSHIP, EFFICIENCY AND STABILITY

The first chapter in this part, ‘Bank governance: concepts and measurements’, by Frank Song and Li Li, reviews the corporate governance mechanisms of the banking sector and discusses the empirical evidence on the relation between bank governance and performance and the relation between bank governance and risk-taking. Moreover, the authors propose a corporate governance index, which captures four different aspects (i.e., board structure, ownership structure, executive compensation and information disclosure transparency) of bank governance. The index is composed based on a sample of 225 banks from 48 countries over the period 2004–2006.

Using the ownership data of more than 11 000 banks around the world, Iftekhhar Hasan and Liang Song examine the causes and consequences of bank ownership structure in Chapter 2, ‘Bank ownership and performance: a global perspective’. They find strong evidence that banks tend to have a more concentrated ownership in countries with weaker investor protection and banking regulation. Moreover, they find that larger control rights by the controlling shareholder help to improve bank performance, especially in the financial crisis period. These findings shed light on the policy implications for financial crises.

In Chapter 3, ‘Is there a conflict between competition and financial stability?’, Barbara Casu, Claudia Girardone and Philip Molyneux provide a thorough discussion on the risk-taking implications of banking competition, an important external governance mechanism in the banking sector. The chapter reviews the theoretical debates on competition and the risk-taking incentives of banks. It then summarizes the empirical findings in the literature and discusses difficulties and practical issues in measuring bank competition and risk-taking. Various types of bank competition measures (e.g., concentration ratio, Herfindahl index, H-statistics, Lerner index, and persistence of profit) and bank risk-taking measures (e.g., loan loss provisions, Z-score, probability of default) are discussed in detail in the chapter.

The empirical evidence on bank competition and risk-taking is mixed, as reviewed in the previous chapter. But, more specifically, what is the impact of banking sector competition on bank operating efficiency? Chen Lin, Yue Ma and Frank Song analyze this issue in Chapter 4, ‘What drives bank operating efficiency? The role of bank competition and credit information sharing’. The chapter examines the impact of bank competition and information sharing via credit registries or private bureaus on bank operating efficiency. Using data for 1200 banks across 69 countries, the authors find strong evidence that both bank concentration and regulatory entry barriers reduce bank operating efficiency. Moreover, they find that credit information sharing enhances bank operating efficiency and attenuates the negative effect of bank concentration and entry barriers on bank efficiency. They also find that supervisory independence and bank information disclosure are positively associated with bank efficiency, whereas state ownership of the banking sector is negatively associated with bank operating efficiency.

Using micro-oriented loan level data, Joel Houston, Jennifer Itzkowitz and Andy Naranjo examine the implications of information costs, cross-country differences in legal and regulatory costs, and banking sector competition on pricing of syndicated loans in Chapter 5, ‘Corporate borrower nationality and global presence: cross-country evidence on the pricing of syndicated bank loans’. Using a unique sample of 13 000 loans issued

to more than 4000 firms across ten countries, they find that the borrower's nationality, global presence, size and loan type are important determinants of loan pricing. The results suggest the existence of a considerable international segmentation in the syndicated loan market and the importance of information costs and legal and regulatory costs in shaping loan contracts.

The last chapter in this part, Chapter 6 by Benton Gup, offers some policy suggestions for reform. The chapter, 'Lessons learned from recent financial crises', argues that the four key factors that contributed to the recent financial crisis in the United States are population growth, new laws and government-sponsored entities (i.e., Fannie Mae and Freddie Mac), increased liquidity and securitization. As regards policy recommendations, the chapter suggests that lenders should avoid excessive financial leverage, concentrated loan portfolios and high-risk borrowers, and be aware of interest rate risks.

PART II: COMPENSATION, PERFORMANCE AND RISK

Poor managerial incentives are widely referred to as one of the fundamental causes of the recent financial crisis. Chapters in this part examine the link between managerial incentives and bank risk-taking and offer important evidence with respect to the ongoing regulatory reforms on compensation structure in the financial sector. In the first chapter (Chapter 7) of this part, 'Bank ownership and risk taking: improving corporate governance in banking after the crisis', Kenneth Spong and Richard Sullivan examine the impact of managerial ownership on bank risk-taking. Using a sample of state-chartered banks in the Kansas City Federal Reserve District, they find that bank stock ownership by hired managers is positively associated with bank risk-taking, whereas managers' personal wealth concentration in bank investment is negatively associated with bank risk-taking. They also find that a larger share of cash bonus in managerial compensation tends to reduce bank risk-taking.

In Chapter 8, 'Executive compensation and risk-taking in European banking', Rym Ayadi, Emrah Arbak and Willem Pieter De Groen find similar results in a sample of 53 large banks in the European Union across the sample period 1999–2009. Specifically, they find that a long-term incentive plan is associated with more bank risk-taking and default likelihood. However, they do not find any significant impact of option plans and annual bonuses on bank risk-taking.

Jens Hagendorff and Francesco Valscas provide a thorough review of the empirical literature on executive compensation and bank risk-taking in Chapter 9, 'CEO pay and risk-taking in banking: the roles of bonus plans and deferred compensation in curbing bank risk-taking'. They point out that most existing work focuses on equity-linked chief executive officer (CEO) compensation (mainly share and option grants), while non-equity-type CEO compensation schemes (e.g., pensions and other forms of deferred compensation) are largely overlooked. The chapter calls for more research on the relation between debt-linked components of CEO compensation and bank risk-taking.

In a related chapter (Chapter 10), 'Bank failures and CEO compensation', Walter Dolde and John Knopf examine the link between CEO compensation and the likelihood of bank failure using a large sample of 766 publicly traded banks and thrifts in the United States. They find somewhat surprising results that higher stock and options awards to

CEOs reduced the likelihood of failure of institutions during the financial crisis of 2008–2010. On the other hand, they find that bonus compensation is positively associated with the probability of bank failure. They further suggest that regulators should take managerial compensation into account when setting Federal Deposit Insurance Corporation (FDIC) insurance premiums.

In Chapter 11, ‘Restricting risk-taking by financial intermediaries through executive compensation’, Tom Berglund argues that restricting risk-taking managerial incentives in normal circumstances results in a negative long-run effect for productivity in financial intermediation and, as a consequence, reduces economic growth. He proposes to include a clause in the CEO compensation contract that all performance-based compensation will automatically be cancelled should a situation of financial distress occur.

PART III: MARKET DISCIPLINE: PREREQUISITES AND EFFECTIVENESS

In the first chapter of this part, Chapter 12, ‘The lost cause: the failure of the Financial Crisis Inquiry Commission’, Peter Wallison argues that the recent financial crisis was not caused by failures in bank regulation or risk management among the large financial institutions. Instead, he argues that the root cause of the financial crisis was the US government’s housing policies, a factor that has been overlooked in the majority report by the Financial Crisis Inquiry Commission.

In Chapter 13, ‘Market discipline for financial institutions and markets for information’, Apanard Prabha, Clas Wihlborg and Thomas Willett review the literature on the impact of market discipline on risk-taking in financial institutions and on timely information disclosure. They also analyze the causes of the market discipline failure in the recent financial crisis. In their view, the most important market failure of informativeness was that large financial institutions had the incentive to remain strategically opaque so that outside investors could not assess their solvency. They also discuss how different types of financial instruments (e.g., stock price indexes, credit default swaps and subordinated debt) provide more or less timely information. Finally, they lay out four ‘informativeness principles’ for regulators and policymakers to follow with the objective of strengthening the incentives of market participants to acquire, analyze, disclose and signal information.

In Chapter 14, ‘Moral hazard, bank resolution and the protection of depositors’, David Mayes examines the potential impact of deposit insurance schemes on the banking sector in the most recent financial crisis. He argues that deposit insurance needs to be explicit and limited in coverage so that it can provide a credible disincentive to bank risk-taking. The deposit insurance schemes should contain a special resolution regime that facilitates a quick and smooth resolution of banks before losses mount too high. He also suggests that regulators should implement a contingent capital policy to address the issues related to going-concern resolutions for the ‘too big to fail’ financial institutions.

In Chapter 15, ‘The governance of “too big to fail” banks’, Andy Mullineux points out that the corporate governance of ‘too big to fail’ banks is particularly problematic because of the implicit insurance provided by the government at the taxpayers’ expense. The chapter then discusses the ongoing regulatory structural reform (e.g., Volcker Rule,

Dodd–Frank Act) in the banking sector. The chapter also calls for a regulatory mechanism that contains a special resolution regime for ‘too big to fail’ banks and a pre-funded deposit insurance scheme with risk-related premia.

In Chapter 16, ‘Incentives to improve the corporate governance of risk in financial institutions’, Richard Herring discusses in great detail the benefits and costs of two very important aspects of corporate governance of banks: executive compensation and contingent convertible bonds. He argues that reform should focus on the compensation components that are widely agreed to encourage risk-takers to disregard the long-term consequences of their risk-taking behavior. He also argues that a properly structured contingent convertible bond scheme will have a much more direct impact on risk-taking incentives because of the potential credible threat of massive dilution of shareholders’ and managers’ pay-offs.

PART IV: GOVERNANCE, REGULATION AND SUPERVISION

The first chapter (Chapter 17) in this part, ‘The boundary problems in financial regulation’, by Charles Goodhart and Rosa Lastra, emphasizes a generic problem of financial regulation caused by the porous boundaries between regulated and non-regulated firms and between different jurisdictions. Most financial services can be performed in several types of financial institutions without being constrained by the jurisdiction of the institution providing financial services. For this reason regulation of particular financial institutions within specific jurisdictions tends to lose effectiveness over time. If regulation increases the costs of performing certain functions, these functions tend to move to where they can be performed more cheaply.

Systemically important financial institutions (SIFIs) tend to be subject to less market discipline than smaller competitors, as noted in the previous section. There is now a debate about regulation specifically aimed at SIFIs. Ingo Walter proposes in Chapter 18, ‘Financial architecture, prudential regulation and organizational structure’, a regulatory dialectic for examining the issue of derisking the financial system by reducing the size and/or scope of SIFIs. Various policy proposals, including the so-called Volcker Rule imbedded in the US Dodd–Frank Financial Stability and Consumer Protection Act of 2010, are examined against benchmarks. The concluding section of the chapter proposes the appropriate role of activity restrictions and carve-outs in regulatory initiatives designed to address the 2007–2009 financial crisis – or the next one.

One narrative of the financial crisis is that poor corporate governance at financial institutions was a major cause of the crisis. In Chapter 19, ‘Corporate governance and prudential regulation of banks: is there any connection?’, Lawrence White argues that this narrative is largely misguided. Public policy should look to improved prudential regulation, rather than improved corporate governance, for restraining the excessively risky activities of systemically important financial institutions.

Hilton Root concludes in Chapter 20, ‘The policy conundrum of financial market complexity’, that neither the unpredictability nor the rapidity of the financial collapse of 2008 can be explained by the usual culprits: the housing bubble, executive pay, regulators, rating agencies, risk models and global imbalances. The collapse is compared to an avalanche that bears no relationship to the grain of sand that triggered it. To guide regu-

lation policymakers should recognize that success will depend on a more refined knowledge of why some initial events may have prompted an avalanche, while others did not.

Chapter 21, ‘The future of financial regulation: reflections from an emerging market perspective’ by Rakesh Mohan, former Deputy Governor of the Reserve Bank of India, provides an emerging market perspective on the financial crisis and its causes. The objective is to analyze the emerging contours of regulation of financial institutions. A lesson drawn is that the intellectual basis of light-touch regulation does not hold. Accordingly, supervisors must supervise. Furthermore, in emerging markets in particular, the traditional virtues of prudent fiscal policy and stable monetary policy, along with the maintenance of sustainable external accounts, should not be lost sight of in the presence of highly flexible financial markets.¹

PART V: GOVERNANCE, STRATEGY AND SOCIAL RESPONSIBILITY

The nature of governance of financial institutions has changed dramatically with the increased role of securities markets relative to traditional credit markets in the financing of corporations, small and medium-sized enterprises and financial institutions. Financial innovation in derivatives, for example, has augmented marketability further at the expense of relationship banking.

Arnoud Boot and Matej Marinč focus on a potential dark side of marketability in Chapter 22, ‘Financial innovations, marketability and stability in banking’. Based on key insights from the relationship banking literature, including the potential complementarities and conflicts of interest between intermediated relationship banking activities and financial market (e.g., underwriting, securitization) activities, they argue that marketability has possibly led to an excessive proliferation of transaction-oriented banking (trading and financial market activities). They ask whether the proliferation of financial innovations might impact bank-based versus financial market-driven economies differently, and discuss structural changes in financial institutions that could reduce fragility.

In Chapter 23, ‘Bank acquisitions and strategy since the GLB Act’, J. Kimball Dietrich asks whether the increasingly market-oriented financial environment has induced increased diversification of financial firms, as reflected in acquisitions within the financial sector after 1999 when the Gramm–Leach–Bliley Act liberalized restrictions on ‘conglomerization’ of financial firms. He describes and calculates the relative use of the expanded powers of bank management boards by analyzing banks’ and bank holding companies’ mergers and acquisitions from 1999 to 2007. These data in combination with stock market performance data are used to assess the performance and risk of alternative bank strategies concerning diversification.

Interest in social, environmental, ethical and trust (SEET) issues in banking has grown rapidly during the last decade. Andreas Hoepner and John Wilson provide an overview of SEET issues in banking in Chapter 24, ‘Social, environmental, ethical and trust (SEET) issues in banking: an overview’. International initiatives are introduced. The United Nations Principles for Responsible Investment first highlighted the importance of SEET issues to the financial services industry. A structured review of the small but

important literature on SEET issues in banking is presented for the benefit of academics, policymakers and practitioners alike.

Corporate social responsibility (CSR) is an extended version of corporate governance because companies with well-formed corporate governance systems take care of most CSR issues. Although banks are important to the economic system, there is little empirical evidence concerning the relationship between taking care of CSR and bank performance. Chung-Hua Shen and Yuan Chang fill this gap in Chapter 25, 'Corporate social responsibility, financial performance and selection bias: evidence from Taiwan's TWSE-listed banks'.

The tested hypothesis is that taking more care of CSR results in stronger monitoring of the managers' decisions and thus weakens the managers' incentives to extract resources from the firms. By employing several matching methods the authors construct a sample of CSR banks and matching non-CSR banks. The empirical results exhibit little evidence that on average CSR banks, representing the stakeholder model of governance, are outperformed by or outperform non-CSR banks representing the shareholder model of governance.

PART VI: GOVERNANCE IN NON-BANK FINANCIAL INSTITUTIONS

In the first chapter (Chapter 26) in this part, 'Management turnover, regulatory oversight and performance: evidence from community banks', Ajay Palvia from the Office of the Comptroller of the Currency exploits a unique panel of US community banks to examine the role of regulatory oversight in disciplining bank management. The results indicate that weak regulatory evaluations are associated with increased executive turnover after controlling for performance, financial condition and other controls. Further, executive turnover linked to weak regulatory evaluations is found to be positively related to future performance. Overall, the findings are consistent with the explanation that regulatory oversight can lead to improved bank governance.

The ability to reclaim resources from managers is perhaps the most direct way to moderate principal-agent relations. In Chapter 27, 'Redeemability as governance: a study of closed-end and open-end funds under common management', Peter MacKay uses performance data for closed-end and open-end funds to test the hypothesis that the difference in share redeemability across funds within a family induces managers to favor their open-end funds over their closed-end funds (favoritism). This might entail channeling superior trades and resources toward their open-end funds.

Paul Gompers and Yuhai Xuan examine the characteristics of acquisitions of private firms by public companies in Chapter 28, 'The role of venture capitalists in the acquisition of private companies'. They explore the impact that venture capital backing has on the acquirer's characteristics, form of payment and announcement returns, as well as long-run stock price and operating performance. The analysis suggests that the acquirers of private venture capital-backed companies do not suffer any adverse selection problem and continue to have superior performance in the long run.

The last chapter in this part, by Rients Galema, Robert Lensink and Roy Mersland, reviews the literature on microfinance institutions (MFIs). Chapter 29, 'Governance

and microfinance institutions', also provides new empirical evidence on governance and risk, an issue that has been almost completely neglected in the literature. Most previous papers concentrate on the relation between corporate governance and financial and social performance. In this empirical study the authors ask whether larger boards make less extreme decisions by testing whether the larger boards are associated with less return variability.

Another feature of previous empirical microfinance governance studies is that they have been guided by agency theories developed for corporations and Western non-governmental organizations (NGOs). While corporations maximize profits, MFIs have dual objectives. Furthermore, there are many different types of MFIs ranging from the most commercial banks to the least commercial NGO. They all have different trade-offs between financial and social objectives. This chapter calls for new theory on how optimal incentives throughout the institution can stimulate the MFI to reach its dual objectives, and shows how different funding structures create different governance problems.²

PART VII: REGIONAL AND COUNTRY STUDIES

This last part begins with a study of New Zealand. This country stands out as one putting strong reliance on market discipline to constrain risk-taking in comparison with most other industrialized countries. Don Brash, former Governor of the Reserve Bank of New Zealand, provides a review of the regulatory debate and the features of the regulatory structure in New Zealand in Chapter 30, 'Bank governance: the case of New Zealand'. Market discipline in the mainly foreign-owned banking system is achieved by means of an emphasis on disclosure rules, no deposit insurance and establishment of procedures for closing insolvent banks. There were no failures during the recent financial crisis. Nevertheless, there seems to be a trend towards adoption of regulatory features in common with other industrialized countries, partly as a result of the global reach of the Basel guidelines.

In Chapter 31, 'Corporate governance in European banking', Francesca Arnaboldi and Barbara Casu survey the corporate governance features of banking institutions in the EU-15 countries. Working on the notion that corporate governance is influenced by cultural values, the authors present an analysis clustering these European Union (EU) countries on the basis of their legal system, language family and proximity as indicators of cultural differences. The results highlight that cultural and legal differences are still strongly embedded in national cultural identities and that these seem to drive the majority of the differences in corporate governance arrangements. The pluralistic structure of EU banking systems, the varied nature of corporate governance arrangements and different business models represent a strength of the EU banking sector, but are also a factor that may hinder further integration and the emergence of a truly European banking model.

The Japanese model for bank restructuring featured prominently in the debate about financial sector reform in the United States and Europe during the recent crisis, as a model to avoid. Satoshi Koibuchi explores in Chapter 32, 'Debt forgiveness during Japan's lost decade', why the traditional bank-led corporate restructuring was one of the main contributors to the prolonged non-performing loan problem in Japan. The

bank-led corporate restructuring was expected to function as a scheme to resolve the debt overhang problem but announcements of debt forgiveness tended to impact negatively the equity prices of the main banks. The Industrial Revitalization Corporation of Japan (IRCJ) successfully introduced a new rule for sharing the burdens of debt forgiveness in proportion to lenders' loan shares. The IRCJ significantly mitigated the excess burden of debt forgiveness on the main banks.

In Chapter 33, 'Corporate governance of banks in Korea', Heungsik Choe and Byungyoon Lee review the history of the board system adopted by Korean banks and bank holding companies, highlight problems in its application, and present solutions. The Best Practices for Outside Directors of Banks and Related Institutions were announced in January 2010, including several clauses aimed at enhancing the independence and expertise of directors. In a second step the Financial Services Commission (FSC) is trying to enact the Act on Corporate Governance of Financial Institutions to improve the governance system as a whole, including the board system, audit committee, executive directors, major shareholders and compliance officers of all the financial institutions. The authors review the FSC's proposals to improve the corporate governance of Korean banks and discuss how to improve them further.

Regulatory governance has been defined as the capacity to meet delegated objectives, and to provide protection from industry capture and political interference and respect for the regulatory agency to implement the broad goals and policies of the legislature. With this starting point Yufeng Gong and Zhongfei Zhou employ independence, accountability and transparency as criteria for analyzing the regulatory governance of the China Banking Regulatory Commission (CBRC) from a legal perspective. In Chapter 34, 'Banking regulatory governance in China: a legal perspective', the authors discuss advantages and disadvantages in Chinese banking legislation with respect to regulatory governance. They outline a legal framework for guaranteeing sound regulatory governance of the CBRC.

Turning to Chapter 35, 'Corporate governance and bank performance in Thailand', Tientip Subhanij and Wanvimol Sawangngoenyuan provide an overview of policies implemented by the Bank of Thailand to enhance corporate governance in banks, and an empirical analysis of the impact of corporate governance variables on bank performance. The analysis reveals that since 2000, as the number of independent directors relative to board size has increased, banks' performance has improved and the cost-to-income ratio has fallen. Other factors than corporate governance may also have contributed to the positive developments.

In the last chapter (Chapter 36) in this volume, 'Governance issues in Indian micro-finance', Shubhashis Gangopadhyay and S.K. Shanthi ask what role governance plays in resolving fundamental questions regarding the operation of microfinance institutions (MFIs) in India in particular.³ Is there enough justification for subsidizing the microfinance industry with public funds? Do increased interest rates exacerbate agency problems as detected by lower loan repayment rates and less profitability? Is there evidence of a trade-off between the depth of outreach to the poor and the pursuit of profitability or self-sustainability? Is there evidence of 'mission drift' in the functioning of MFIs? Reports of exorbitant profit-making by MFIs, households burdened with multiple loans, coercive recovery by MFI agents and, to top it all, suicides by defaulters created a furor in Indian government and policy circles. Draconian state ordinance followed by

a national level set of recommendations may push a hitherto unregulated fast-growing sector into becoming a highly shackled industry of the pre-reform days.

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NOTES

1. Country studies referring to emerging market economies can be found in Chapters 34 (China), 35 (Thailand) and 36 (India).
2. Chapter 36 in Part VII provides further analysis of MFIs in India.
3. Governance issues in the microfinance industry are discussed in Chapter 29 as well.