Bank Governance and the Crisis:
Did board (in)competence matter for bank performance during the recent crisis?

By Harald Hau, Johannes Steinbrecher and Marcel Thum

The recent financial crisis has revived the interest in issues of the stability and supervision of the banking sector. In fact, there is a general agreement now that bank supervision before the crisis was often too lenient and ineffective. Since this leniency has been the result of political lobbying of the financial industry, it is questionable whether a reformed banking regulation and supervision could resist opportunistic political behavior in the future. In this case, the political exposure of bank supervision requires a more general approach to banking stability, including additional policy measures by which banking stability can be enhanced in the presence of imperfect banking supervision.

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One such policy dimension concerns bank governance, about which a series of questions can be posed: Did bank supervisory board members really provide the management board with guidance and control as their mandate formally requires? Does the composition of the bank board matter for bank performance in a financial crisis like the current one? Does the political connection of board members enhance or weaken the bank supervision?

Unfortunately, the economic literature so far provides only relatively weak evidence on the role of boards for firm performance. Most of the corporate finance literature so far has focused on formal rather than qualitative measures of boardroom composition: board independence, board size, and directors' stock ownership. For instance, board size is generally found to be negatively correlated with performance measures.[1] With a large supervisory board, the free-riding of individual board members may lead to a low monitoring effort. Research has also dealt with the role of board independence as measured by the number of outside directors. Here, the evidence remains mixed; recent work seems to find no significant effect of board independence on firm performance.[2] There is also some evidence that director ownership in a firm correlates with better firm performance.[3] Only a few studies take a closer look at qualitative properties of board composition. For instance, the industry experience of board members correlates positively with abnormal stock returns and negatively with earnings manipulation as measured by fewer negative income restatements.[4] There is also some recent evidence that a larger share of political affiliated board members is related to higher ex-ante credit risk in the loan portfolios of banks.[5]

What is still lacking, however, is an analysis that focuses on specific supervisory skills, which could have an influence on the governance in banks. Therefore we designed a setup to examine a potential linkage between the competence of board members and the performance of the corresponding banks during the recent crisis. We particularly focus on the differences in governance between (profit-orientated) public and private banks since profit-orientated state-owned banks in Germany seemed to show a systematic underperformance during the crisis.

Board competence in private and state owned German banks

To explore this important question, we've examined the biographical background of 593 supervisory board members of Germany's leading banks.[6] The sample consists of all German banks with more than 40 billion Euros in total assets in 2007. Since monitoring and the quality governance cannot be observed directly, we use indirect measures to check whether supervisory boards have at least the necessary competences for monitoring the executives. To obtain a measure of the monitoring potential in the supervisory boards of the banks, we define 14 different biographical criteria that proxy for boardroom competence in the context of the subprime crisis. The variables capture a board member's educational background (3 indicator variables), finance experience (6 indicator variables), and management experience (5 indicator variables). Finance experience, for instance, comprises whether a board member has some banking experience, whether the board member has financial market experience, and whether this experience was gained after 1990. For every affirmative answer, we assign one point to the board member. The overall board competence levels are calculated by averaging each of the corresponding variables.

The figure shows the means for the competence indices of all private and public bank supervisory boards, respectively. Each index is scaled, such that values can vary in the range 0 to 10. For each competence index, the supervisory boards of state-owned banks exhibit significantly lower competence levels. For instance, almost 33% of the board members in private banks feature prior banking experience in their curriculum vitae, whereas in the state-owned banks this criterion holds true for only 11% of the board members. Recent financial market experience exhibit only 7% of the board members in state-owned banks. However 27% of the board members in private banks have gained financial market experience since 1990.

The pattern is almost the same with regard to the educational background. Private bank board members have 30% more business and economic degrees then the corresponding board members in state-owned banks. Regarding MBAs and PhDs, this gap becomes even bigger. Moreover, private bank board members feature significantly more management experience. Almost 25% of the private bank board members have gained some top level management experience in the financial industry. In state-owned banks, only 9% of the board members fulfill this criterion. Summing all of the competence indicators, a private bank supervisory board member had on average a 1.5 times higher competence measures than an average board member of state-owned bank (see the Total Index in Figure 1). Regarding just the financial competence measures the discrepancy becomes even bigger. Here private bank board members had on average a 3 time higher competence level than their counterparts in state-owned banks.

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Overall, the evidence on supervisory board composition of German banks shows a large competence gap between private and state-owned banks, in particular with respect to management and financial experience. It seems quite plausible that the board (in-)competence of state-owned bank supervisory boards had an effect on their performance during the recent crisis.

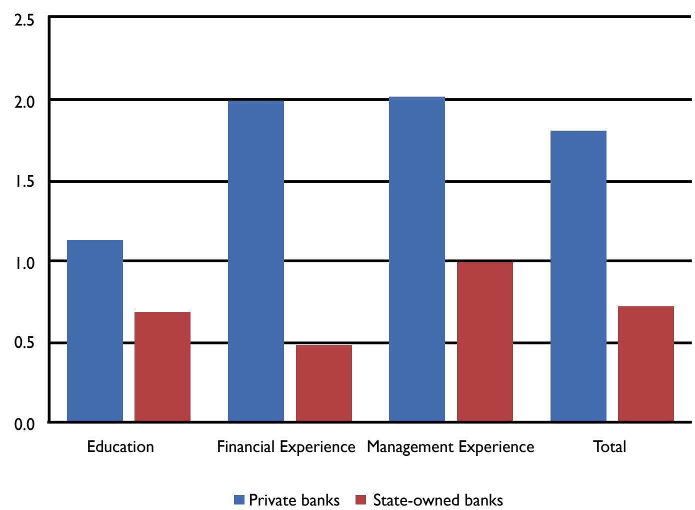

Figure 1. Supervisory board members in private and state-owned banks

Supervisory boards of state-owned banks exhibit significantly lower competence levels in all indices measured.

Is there a link between governance and crisis performance?

To examine the linkage between board competence and crisis performance, we explore if the relative underperformance of state-owned banks compared to private banks in the recent subprime crisis can be related to governance structures. As a performance measure, we use the crisis-related write-downs and losses reported by the banks during 2007 and 2008. The most reliable sources for crisis-related losses are interim reports, which are systematically pursued for all banks in our sample. Self-reported losses

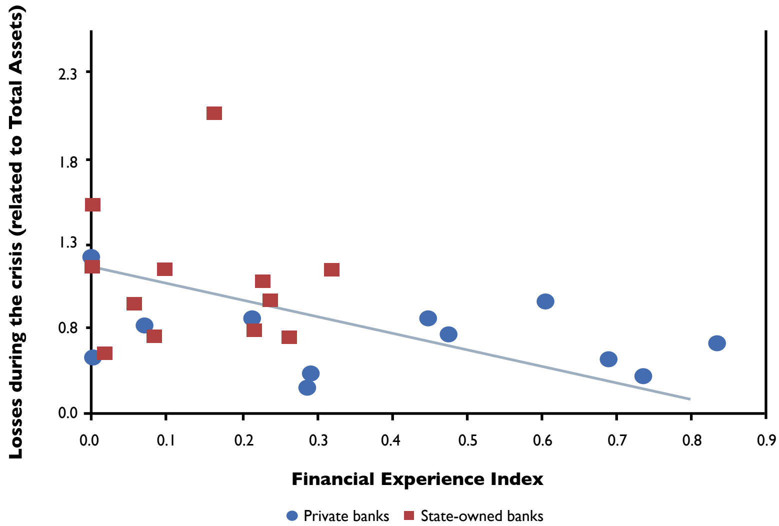

Figure 2. Subprime-related bank losses and financial experience of supervisory boards

The monitoring ability of the supervisory board due to its financial experience had a significant positive influence on the performance of banks.

for 18 banks were initially collected by the council of economic experts for a study on the subprime crisis published in May 2008.[7] We extend this data set to the 29 largest German banks and update reported losses to the third quarter of 2008. Our data confirm that a lower supervisory board competence in finance is related to higher losses in the financial crisis. The strongest evidence can be found for the linkage between financial experience and exhibited losses. This correlation is depicted in Figure 2.

Figure 2 shows the index of financial competence, which is the most important competence for effectively governing banks, on the horizontal axis. On the vertical axis, we plot the losses during the financial crisis (first quarter 2007 to third quarter 2008 as far as available). Since the analyzed banks differ in size, we normalize the losses by total assets of each bank. The results suggest that banks with financially competent supervisory boards exhibit lower losses. The results of the econometric analysis also confirm that the financial experience is positively correlated with the crisis performance of a bank.[8]

Is the relationship between limited board competence and underperformance a result of political connections of bank board members? For this purpose we count the number of political appointees in each bank board and use this count as a so-called statistical "instrument" to infer a causal relationship. Such an instrumental variable analysis yields indeed very similar results, so that it is legitimate to interpret the above correlation between the financial experience and the crisis performance as a causal linkage where political connections first corrupts bank governance and in a second step leads to a dismal crisis performance.[9]

The analysis further reveals that pre-crisis operating profits were significantly lower in banks with supervisory boards of low financial competence. More risky investments

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could have been the consequence of poor operating performance, inducing higher losses in the current crisis.

We finally investigate the influence of executive pay on the crisis performance. There could be a positive effect on performance due to higher executive compensation, which we call the "efficient executive pay hypothesis". In particular, better paying banks could be able to attract better executives, thus yielding a better risk management and crisis performance. However, the results supply no evidence on the "efficient executive pay hypothesis". We rather find evidence on the contrary. In our sample higher executive pay was correlated with higher losses during the crisis. Thus large executive pay packages signal severe agency problems rather then a better management. The negative correlation between executive pay and the crisis performance could also indicate a suboptimal incentive-structure in executive pay and thus stronger requirements of financial experience in supervisory boards. Since executive payment contracts are approved by the supervisory board, a lack of board competence could thus create inefficient incentive structures, which encourage the executives to choose riskier investments.

Policy conclusions

The fragility of the banking sector poses a risk to the real economy. The pivotal role of banks in financing the investment activities of firms and housholds implies that financial distress by banks carries large macroeconomic costs. Banks should therefore be subject to a particular regulatory framework. Many voices advocate stricter bank regulation as the main solution to the current banking crisis. A political economy perspective casts doubts on such hopes. The lenient enforcement of existing bank regulation prior to the current crisis was largely a consequence of opportunistic political forces. The lenient regulation allowed the banks to reduce equity in order to benefit from returns induced by higher leverage, facilitating the shareholders to benefit from a higher rate of return and reducing their share in potential losses. Such powerful interests will continue to operate even if bank regulation appears to become tougher. In addition, the conglomerate structure of many international banks may yield banks, which are too large to be monitored by national regulators.

Nevertheless bank regulation needs to be tightened, but it is less clear how to shield national bank supervision from the weakening by political interference. Improving bank governance may therefore provide an additional and more robust policy objective to enhance bank supervision and thus reducing fragility of the banking sector. Our investigation of the German banking sector suggests that there is considerable potential for improving bank governance.

Improving bank governance is therefore a suitable policy tool in the pursuit of more bank stability. In particular, privatizing (profit-orientated) state-owned banks is likely to make a positive contribution to governance quality and indirectly to bank stability. This finding is important given that state-ownership is more prevalent in the banking sector than in any other industry. However, if state ownership of banks is unavoidable, the financial competence of the board members should be improved. Therefore the share of political representatives should be decreased in favor of an increased share of financial experts. A positive role of bank governance also implies that private institutions may similarly benefit from a more competent supervisory board. Hence it seems worth exploring whether prudential bank regulations should explicitly encompass criteria for board competence and quality.

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Notes

1. See Brown and Maloney(1999): "Exit, Voice, and the Role of Corporate Directors: Evidence from Acquisition Performance", unpublished script, Claremont McKenna College; and Yermack(1996): "Higher market valuation of companies with a small board of directors", Journal of Financial Economics 40, S. 185-211.

2. See Klein(1995): "Firm Performance and Board Committee Structure", Journal of Law and economics 41, s. 275 – 303; Mehran(1995): Executive Compensation Structure, Ownership, and Firm Performance", Journal of Financial Economics 38, S. 163-184; and Schellinger et al. (1989): " Board of Director Composition, Shareholder Wealth, and Dividend Policy", Journal of Management 15, S. 457-467.

3. The firm performance was therefore measured by Tobin's Q. See Hermalin and Weisbach(1991): "The Effects of Board Composition and Direct Incentives on Firm Performance", Financial Management 20, S. 101-112.

4. See Papakonstantinou(2008) : "Boards of Directors: The Value of Industry Experience",
Working Paper, Princeton University.

5. See Illueca Muñoz et al. (2008): "Liberalization, corporate governance, and savings banks", unpublished Working Paper.

6. For the complete article see Harald Hau and Marcel Thum: „Subprime Crisis and board (in-)competence: private versus public banks in Germany" in Economic Policy, October 2009, p. 701-752.

7. See the report "Das deutsche Finanzsystem: Effizienz steigern – Stabilität erhöhen" by the council of economic experts (Sachverständigenrat zur Beurteilung der gesamtwirtschaftlichen Entwicklung, 2008).

8. The statistical confidence-level of the correlation between the financial experience and the crisis performance is above 95%.

9. For the instrumental variable regression, we use the percentage of political representatives as an exogenous instrument (explaining the board competence); hence, we assume that CEOs of public banks cannot choose the number of political affiliated board members, which is quite realistic as the membership of political appointees is mostly defined by law.