

Corporate governance, regulation and supervision of banks

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1. Introduction

Ever since firms grew large and became funded by a variety of investors, they have had to deal with the separation of ownership and control and the associated agency problems. Various corporate governance arrangements try to limit these problems as efficiently as possible. Recently, corporate crises such as Enron and Worldcom in the US and Parmalat in Italy moved the corporate governance debate to the forefront of public policy on both sides of the Atlantic.⁽¹⁾

Most of the corporate governance debate has emphasised the governance of non-financial corporations, while little attention has been paid to the corporate governance of banks. Yet, corporate governance of banks differs from that of non-financial firms. In banks, debt holders are dispersed and non-experts, which limits the effectiveness of debt governance arrangements traditional in non-financial firms. In addition, the high proportion of debts in the total liabilities, and the resulting high leverage, facilitate risk shifting by shareholders. Hence there is a need for a representative of depositors to “mimic” the role taken by debt holders in non-financial firms. Typically, this role will be performed by a regulatory and supervisory authority (hereafter called the “RSA”).

The stance taken in this paper goes beyond the usual efficiency concern that underpins the corporate governance debate. Instead, we take a banking stability perspective. In particular, we stress that managers may be more risk averse than shareholders. Hence, it may be in the interest of the RSA to put more power in the hands of management vis-à-vis the shareholders. This is in contrast to traditional corporate governance recommendations for non-financial

firms. In some countries, managerial control is legally possible through structures such as trusts. However, in others it is associated with dispersed shareholder structures. Here, however, another concern may be the stability of shareholders when share ownership is dispersed. In this case, it may be difficult to oblige shareholders to bail-in⁽²⁾ ailing banks in the event of under-capitalisation. This raises some trade-offs between various shareholder structures and the relative power of managers vis-à-vis shareholders. In particular, shareholder structure, management incentives and the structure of the board of directors are evaluated with respect to their impact on a bank's risk.

The Belgian supervisory model tries to balance the respective power of shareholders and management by introducing the agreement on the autonomy of bank management.⁽³⁾ This agreement tries to combine the presence of strong reference shareholders with independent bank management. Initially, in 1959, it was meant to avoid shareholders' intervention in the credit policy of the bank (the risk of this kind of intervention was especially present in banks owned by an industrial holding company). The agreement was revised in 1992 to take account of a changing banking environment. However, the banking sector is still evolving. Capital markets and financial regulation are becoming more and more internationally oriented, and so are shareholders. The presence of industrial holding companies in the Belgian banking landscape is tending to decrease. On the other hand, we observe an increase in financial conglomerates.

(1) See Shleifer and Vishny (1997) and Becht et al. (2004) for surveys of the academic literature on corporate governance.

(2) We refer to a bail-in as a situation in which shareholders have to provide additional capital to the bank in case of problems and to a bail-out as a situation in which the bank is recapitalised by an external party (e.g. the state, the regulators, etc.)

(3) Protocole d'autonomie de la fonction bancaire/Overeenkomst over de autonomie in de bankfunctie.

In parallel with these evolutions, banks have also modified their governance structures over time. These modifications are to be seen as a response to pressures brought by the market to adapt to international standards and best practices. These observations raise several interesting questions. Is there still a need for an autonomy agreement? Is the agreement still optimal in the light of the recent developments in the banking landscape? Does it overlap with or contradict EU and national law? Is it still manageable in a changing environment where foreign shareholders predominate? These questions are very complex, as corporate governance mechanisms result from a subtle equilibrium. The goal of this paper is to present a framework which allows for the conceptualisation of these issues. Therefore, the paper will provide an answer to some of these questions although others will remain unresolved.

The paper is structured as follows. Section 2 presents the theory on corporate governance in banking. Departing from the general framework for non-financial organisations, it discusses why agency conflicts in banks are different and what the implications are for financial regulation. Section 3 analyses how the appropriate corporate governance structure can help to solve these agency conflicts. Shareholder structure, management incentives and the structure of the board of directors are evaluated with respect to their impact on a bank's risk. In addition, several boxes in Section 3 present evidence on the governance of Belgian banks at the end of 2003.⁽⁴⁾ Section 4 discusses and analyses the agreement on the autonomy of bank management in the light of Sections 2 and 3. Section 5 concludes.

(4) Bank governance is constantly evolving and some banks have announced their intention to change their governance structure. Therefore, as the evidence that is presented reflects the situation at the end of 2003, it may no longer be accurate at the time of publication.

2. Corporate governance and banking: theory

2.1 Corporate governance in general

The general "corporate finance" problem facing business undertakings is the one of raising finance efficiently. This means raising finance in a way that limits the *agency problems* arising from the separation between ownership and control. This separation, stressed originally by Berle and Means (1932), leads to classical problems identified for example in Jensen and Meckling (1976). For instance, when outside finance is needed, management efforts partly serve to repay outside investors. Thus, managers earn less than the full return on their effort, so that their incentive to exert effort is low. In a competitive capital market, managers end up bearing the cost of this distorted effort. Therefore, it is in both parties' interest to set up *governance mechanisms* that limit agency distortions.

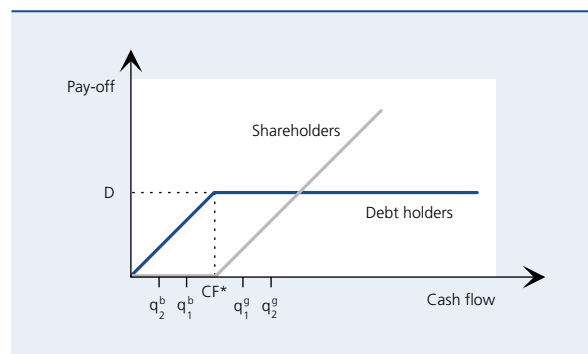
Governance mechanisms are associated with the different liabilities issued by the firm. They can be thought of as bundles of income rights as well as rights of control over the firm. In the real world, two standard liabilities are prevalent, with a variety of specific features in both cases: debt and equity. Debt implies a payment that is concave in the profit of the firm, and control of the firm is only given to debt holders in the case of lack of repayment (i.e. in "bad times"). The presence of debt leads to the possibility of excessive risk taking if management favours the interest of shareholders. Indeed, equity implies a payment that is convex in the profit of the firm; equity benefits from formal control (in the case of voting equity) unless debt is not repaid. This is explained in more detail in Box 1.

Box 1 – Risk Shifting

Figure 1.1 presents the pay-off of shareholders and debt holders under different outcomes of cash flow (CF) for a leveraged firm. There are two states of the world, i.e. b (bad, or bankruptcy) and g (good, or continuity), each with probability 0.5. As long as $CF < CF^*$ (bad state), there is not enough cash flow to repay all debt obligations D , hence the firm goes bankrupt and debt holders are in control. They receive CF . Shareholders receive nothing. From the moment $CF \geq CF^*$ (good state), the firm can repay its debt. Debt holders receive D , shareholders receive $CF - D$.

Now suppose the manager of the firm is also the owner or acts in the owner's interest and has to choose between two projects, 1 and 2. The CF of each project depends on the state of the world and equals q_i^j ($i = 1, 2$ and $j = b, g$). Both projects have the same Net Present Value (NPV), i.e. $0.5q_1^g + 0.5q_1^b = 0.5q_2^g + 0.5q_2^b$. However, $q_1^g < q_2^g$ and $q_1^b > q_2^b$. This means that $q_1^g - q_1^b < q_2^g - q_2^b$, implying that project 2 is riskier than project 1. Now look at the

FIGURE 1.1 PAY-OFF OF SHAREHOLDERS AND DEBT HOLDERS



pay-off of the two projects. The expected cash flow of the shareholder amounts to $0.5 [q_1^g - D]$ if project 1 is chosen and $0.5 [q_2^g - D]$ if project 2 is chosen. The debt holders' expected cash flow equals $0.5 [q_1^b + D]$ for project 1 and $0.5 [q_2^b + D]$ for project 2.

Hence, shareholders will prefer the riskier project 2, while debt holders prefer the less risky project 1. As the NPV corrected for risk is higher for project 1, project 1 is optimal for the firm. However, as shareholders are in command when choosing the project, project 2 will be the outcome. They engage in risk shifting.

The widespread coexistence between debt and equity can be rationalised if the "course of action" that management dislikes (e.g. restructuring) implies a reduction in the riskiness of firm profit (e.g. scaling down or closing some activities). Then, in order to give managers incentives, it is optimal to put in charge an investor who is risk averse in bad times (or risk loving in good times) (Dewatripont and Tirole, 1994a). However, for this scheme to work, one needs investors with *real control* and not just *formal control*.⁽⁵⁾ Here, we have to distinguish managers from investors as a whole, as well as the number of investors.

In Continental Europe, as far as debt governance is concerned, bank lending remains the cornerstone in financing most non-financial companies. In this case, debt is in the hands of a few specialised debt holders, and formal control in fact means real control. Therefore, the extent of control depends essentially on the *bankruptcy regime*. In the United States, this regime is widely considered as manager- or debtor-friendly, by allowing firms in financial distress ample opportunities to limit or delay creditor involvement.⁽⁶⁾ In contrast, in the United Kingdom the bankruptcy regime is creditor-friendly, with Belgium closer to the UK model.⁽⁷⁾ In "bad times", concentrated debt holders then have both the power and the incentives to protect their interest.

As far as equity governance is concerned, formal control is guaranteed by corporate law. This may operate directly through shareholder democracy or indirectly through the Board of Directors as the monitor of management. Real shareholder control depends, however, on the degree of shareholder dispersion (Barca and Becht, 2001; Franks and Mayer, 1994; and La Porta et al., 1998). The US and the UK typically have high shareholder dispersion, and therefore low incentives for individual shareholders to exert control. The main debate is thus *how to curb excessive managerial power*. In contrast, in Continental Europe, there is often the prevalence of big block-holders that have an incentive to monitor managers better but *may abuse small shareholders*. These two problems have to be kept in mind when analysing the features of equity governance, such as board composition (and in particular the notion of "independent director"), manager remuneration and appointment or dismissal, takeover rules, general voting rules at shareholder meetings, and so on.

(5) To follow the terminology of Aghion and Tirole (1997), who distinguish the *right* to take decisions (formal control) from the *ability* to take decisions (real control), which typically requires prior information acquisition about the consequences of potential decisions. See also Burkart et al. (1997), who use the Aghion-Tirole framework to argue that shareholder dispersion reduces shareholder incentives to acquire information and therefore to exercise real control.

(6) Through the "Chapter 11" procedure.

(7) One could see the recent introduction of the *concordat* regime in Belgium as an attempt to become somewhat more manager/debtor-friendly.

2.2 Corporate governance and banking⁽⁸⁾

What is special about banks that justifies they are regulated differently from other firms? First, “systemic risk” in case of failure is often invoked to justify regulation. Note that the same argument may hold in other strategic industries or in cases where failure of a big firm has important repercussions on an entire region because of cascade effects on suppliers, creditors and even small and medium-sized firms that do a substantial share of their business with the laid-off employees of the failing firm. Strategic industries (such as the electricity sector, for instance) are often regulated as well. Yet this is not necessarily the case for big firms whose failure could cause cascade effects. Therefore, systemic risk per se does not fully separate banks from these big firms. One could, however, argue that the nature of financial systems makes the occurrence of contagion effects more likely and the macro-economic consequences more widespread (for instance, interbank linkages and payment systems are natural channels for contagion).

A second element concerns the high leverage of banks. A higher percentage of debt used in the capital structure implies a higher possibility of risk shifting and debt overhang.

A third key specificity of financial institutions concerns their governance, because of the nature of its *claim holders*. In *non-financial companies*, debt holders are often banks themselves, which have the necessary expertise and play an important role in disciplining management in the case of financial distress, e.g. in order to avoid “gambling for resurrection”. By contrast, financial institutions have liabilities held by *dispersed non-experts*, namely depositors. In such cases, there is a need for a *debt holder representative*, which is a fundamental role for the RSA.⁽⁹⁾ The same is true for insurance companies or pension funds, two sets of institutions whose regulation shares many similarities with banking regulation (see Dewatripont and Tirole, 1994b). Exiting, however, is easier for depositors than for policy holders. Therefore, we can expect that depositors exert discipline by voting with their feet, while insurance policy holders have an incentive to control ex-ante.

The need for a strong depositor representative is especially great the more the credit institution is allowed to take risks. Such risks are prevalent in banking since, beyond their essential role in payment systems, another banking function is to provide liquidity for individuals, through demand deposits. Avoiding systemic risk through self-fulfilling panics has required at least partial deposit insurance, which further reduces depositors’

incentives to become expert in assessing the risks taken by their bank and creates moral hazard. This increases the need for regulation limiting the ability of shareholders to “play with the money of the deposit insurance fund”.

There are several ways in which the RSA acts as debt holder representative.

First, by imposing several sets of constraints on financial institutions, which serve to ensure their solvency and to avoid systemic externalities. (i) Regulation of market structure may limit competition and hence increase charter value and improve stability. (ii) Prudential regulation sets limits on the structure of financial institutions’ liabilities, in the form of “capital requirements” and limits on the riskiness of their asset portfolio. (iii) Additional “good practice” requirements aim at improving the governance of the financial institution. The paper mainly focuses on this last element. Second, ex-post, by threatening a “get-tough-policy” when these are not respected, with the RSA taking control and possibly closing or selling the financial institution. This broadly mimics the role of debt as a contingent control arrangement in non-financial firms, where control over the firm switches to creditors in bad times.

3. Bank Governance structures : implications for risk management and stability

Financial regulators increasingly acknowledge the importance of corporate governance. While Basel I determines capital requirements by defining capital weights for different categories of assets, Basel II allows some use of internal risk modelling techniques. This signals a partial move from a “regulatory” to a more “supervisory” approach by the RSA.⁽¹⁰⁾ In turn, the RSA needs to rely more on the supervision of the procedures having an impact on these internal models. The organisation of these procedures relies heavily on the specifics of the corporate governance of banks.

The need to focus on the corporate governance of banks is also partly the result of the gradual elimination of activity restrictions, limiting the scope of banking activities. While the 1930’s had seen the widespread introduction

(8) For details, see Dewatripont and Tirole (1994b) and Heremans (2000).

(9) While these regulators are civil servants, “private representatives” would be possible, in the same way that dispersed shareholders have representatives through the Board of Directors.

(10) A regulatory approach focuses primarily on the assessment of the quality of the bank’s balance sheet at a point in time, and then determines whether the bank complies with capital requirements and restrictions on asset holdings. A supervisory approach focuses more on the soundness of the bank’s management practices with regard to controlling risk (Mishkin, 2000).

of activity restrictions as a way to limit the possibility of contagion in the banking sector, many of these have been lifted since the 1970's and the subsequent deregulation. In Belgium this has resulted in a banking landscape where most banking activities are conducted as part of "bancassurance" conglomerates. The complex nature of potential spill-overs between business lines then calls for the supervision of internal risk procedures as a complement to more "standard" banking regulation and also suggests strengthened co-operation between RSA in banking and insurance industries.

The problem facing the RSA can be summarised as follows: while modern banking regulation of the Basel I type is the natural counterpart to the debt-and-equity governance of non-financial firms, it is not foolproof in a world of deregulated banks and accounting lags. Limitations on the effectiveness of regulation imply that excessive risk taking by banks remains a real problem. Hence, the goal of banking supervision is to complement regulations to further limit excessive risk taking. The supervision of banks' corporate governance structures can be analysed in this light. This implies that particular emphasis should be placed on the risk attitudes of the parties exerting real control over banking decisions and how these attitudes and relative powers can be influenced (through financial incentives, through "bail-in" obligations, etc.).

We now turn to the impact of corporate governance structures, such as ownership structure, board composition and management incentives, on risk taking and stability of the banking sector. In doing this, we follow Berle and Means (1932), Jensen and Meckling (1976), Aghion and Bolton (1992) or Hart (1995a, b). They view organisational decisions as being determined by the power and the incentives of the different parties involved. Corporate governance structures influence these incentives and powers. Beyond this, we should remember that, in banks, apart from managers and shareholders, the party potentially in control is the debt holder representative, the RSA, rather than debt holders themselves. Moreover, another difference in relation to the stance taken in the literature on non-banking organisations is that we do not discuss the organisation of corporate governance structures from the point of view of profit maximisation. Rather, we perform the analysis from the RSA's point of view, that is, the enhancement of financial stability. This being said, we shall draw both from the literature of non-financial firms and from the (much smaller) literature devoted to banking organisations.

3.1 Risk attitudes and the control of corporations

As stressed in Section 2, in non-financial corporations, formal control lies with risk-loving shareholders in good times and with risk-averse debt holders in bad times. In the banking context, due to the high leverage and dispersed debt holders, there is a concern that shareholders may face greater risk taking incentives than shareholders of non-financial firms. Indeed, in the absence of regulatory intervention, given the high leverage and the dispersion of debt holders, shareholders benefit from a higher potential for risk-shifting and gambling for resurrection.

But what about managers, when they enjoy real control? One could argue that, in a typical firm, managers would be intrinsically more risk averse than shareholders, for two reasons. First, they stand to lose invested specific human capital and, in some cases, invested wealth if the bank goes bankrupt. A second reason concerns the possibility of diversifying. Managers tie up all their human capital in the firm, so their degree of diversification is limited. Hence, they care about the total risk of the firm, i.e. systematic and idiosyncratic risk. *Diversified shareholders* on the other hand only care about systematic risk. Therefore, they could intuitively tolerate more risk than managers would be willing to accept.

The above argument implicitly assumes the absence of an RSA and the existence of a fixed compensation scheme for managers. Things can change when managers start receiving performance-based pay. With regard to the cash flow effect, managers face a trade-off between future cash flows generated by specific human capital invested in the firm and additional cash flows generated by increased performance resulting from increased risk taking. When linked to share prices, managerial incentives become more aligned with those of shareholders, even though the above considerations imply that the manager may remain more risk averse than shareholders. Things can, however, be different when managers are paid with stock-options, whose value can be very sensitive to the volatility of the underlying stock. In fact, above a certain threshold of option-based pay, managers may receive more incentives to take risks than shareholders. This is especially the case when options have a high exercise value and are out of the money.

From the RSA's point of view, one can thus say that, except for very high-powered incentive schemes, managerial control should reduce excessive risk taking. This may no longer be true when option-based pay is very significant. This type of remuneration is more likely the more diversified shareholders are, because diversification

increases their tolerance to risk. Banking stability concerns therefore provide an argument for:

- favouring managerial control over shareholder control when managerial pay is not too sensitive to share prices;
- limiting option-based managerial compensation.⁽¹¹⁾

In practice, several studies have found that regulatory frameworks influence the impact of both (i) managerial ownership and (ii) pay-performance scheme on risk taking and performance in banks.

Saunders, Strock and Travlos (1990) use a sample of 38 US bank holding companies over 1978-1985, a period of relative deregulation. They find that banks whose managers hold a relatively large portion of the shares exhibit a significantly higher risk taking behaviour. Anderson and Fraser (2000) use a panel of 150 US banks covering the period 1987-1994. They find that total and firm-specific risk are positively related to managerial ownership between 1987 and 1989. On the other hand, they also find that, after regulatory changes in 1989 and 1991 (which were designed to reduce risk taking and led to higher franchise values), bank risk was negatively related to managerial shareholdings (i.e. over 1992-1994). Systematic risk was unrelated to ownership in both periods. Lee (2002) uses a sample of 65 bank holding companies over the period 1987-1996 and finds that risk taking in banks where managers hold a large proportion of shares is more pronounced for banks with a relatively low probability of failure. This is in line with the diversification argument.

Houston and James (1995) use a sample of 134 banks covering the period 1980-1990. They find that, compared to CEOs in other industries, bank CEOs receive in absolute value less cash compensation (although their cash compensation is more sensitive to firm performance), are less likely to participate in a stock option plan, hold fewer stock options and receive a smaller percentage of their total compensation in the form of options and stock. They find no evidence that the total pay-performance sensitivity is higher in banking and no significant relation between the reliance on equity-based compensation and bank risk. They conclude that shareholders do not use CEO equity-based compensation to promote risk taking, but cannot rule out alternative mechanisms (e.g. cash-based compensation) as incentives for managers to increase risk taking. They attribute this to the fact that banks are regulated.

John and Qian (2003) use a sample of 123 banks over 1992-2000 and find that the pay-performance sensitivity of bank management seems to be lower than in other industries. They find that an increase of \$ 1000 in shareholder value triggers an increase of \$ 4.7 in the firm-related wealth of bank CEOs vs. \$ 17.5 for non-bank CEOs (i.e. a statistically significant difference of \$ 12.8). They attribute this result to the fact that the banking industry has high debt ratios and is regulated.

3.2 Equity governance

The real power of shareholders depends very much on its degree of dispersion. As long ago as 1932, Berle and Means called attention to the prevalence of widely held corporations in the US, in which ownership was dispersed among small shareholders, and real control was concentrated in the hands of managers. As stressed by Barca and Becht (2001), Franks and Mayer (1994) or La Porta et al. (1998), publicly-traded firms in Continental Europe are predominantly controlled by “block-holders”. This shifts the corporate governance debate away from a shareholder-manager conflict, as controlling shareholders face strong incentives to monitor managers and maximise profits when they retain substantial cash-flow rights in addition to control. A new concern arises however: the risk of expropriation of minority shareholders by block-holders.

As far as banking stability is concerned, the structure of ownership also matters for its impact on the riskiness of the bank. When shareholders acquire real control by holding substantial voting rights, it is easier for them to push managers to engage in risk shifting (Harm, 2002, Caprio and Levine, 2002) and increases the potential to extract private benefits (Bebchuk, 1999). However, in the case of financial distress, a bail-in may be easier to organise when there is a well-identified block-holder, which may in turn induce him to take less risk (Bolton and von Thadden, 1998 and Hagelin, 2003). As already stressed, shareholder dispersion thus has a potentially ambiguous effect on banking stability (see also Saunders, Strock and Travlos, 1990).

In the case of dispersed ownership, individual shareholders have little incentive to monitor managers and would rather free-ride on others. This means real control for managers who, except in the case of very high-powered incentive schemes, have less of an incentive to engage in excessive risk taking. However, dispersed ownership may also lead to potentially unstable ownership (i.e. shareholders voting with their feet when trouble is under way, or unfit shareholders gaining control over the bank by acquiring shares on the market). This may frustrate banking stability objectives.

(11) In practice, in a competitive managerial market, it may be difficult to limit option-based compensation. If the decrease in the option-based remuneration is not compensated by an increase in the cash remuneration, there is a risk that banks would no longer be able to attract good managers. On the other hand, if this decrease is compensated by higher fixed remuneration, banks may attract managers who would prefer higher fixed remuneration and lower variable compensation, i.e. risk averse managers.

Apart from the extent of shareholder dispersion, risk taking is also going to be influenced by the identity of the controlling shareholder. Risk incentives may differ if a bank is owned by another financial institution, a family, an industrial firm, or its own management. Indeed, these different owners have different opportunities to diversify their wealth and hence different attitudes to risk. Moreover, they differ in their information, expertise and monitoring

capabilities. As shown in Box 2, most Belgian banks are owned by other financial institutions. This may increase the possibility of contagion (through the direct impact on the balance sheet and financial links or through spill-over effects). On the other hand, banks may be effective monitors of other banks, especially if they have large exposures on the interbank market. Cross-shareholding may also be useful as an incentive to perform this monitoring role.

Box 2 – Shareholding structure in Belgian financial groups

TABLE 2.1 FIVE LARGEST DIRECT SHAREHOLDERS OF A SAMPLE OF BELGIAN FINANCIAL GROUPS ⁽¹⁾

	Assets (In millions of euro)	(In percentages)					Names
		1	2	3	4	5	
Listed ⁽²⁾							
Dexia	349,888	15.3	14.9	7.7	5.7	3.1	(1) Arcofin; (2) Holding Communal; (3) Caisse des Dépôts et Consignations (French State); (4) Ethias; (5) Deutsche Bank
Fortis ⁽³⁾	523,250	6.1	5.5	2.8	2.3	1.7	(1) Suez Groupe; (2) Stichting VSB Fonds; (3) Fortales; (4) Munchener Ruckversicherung; (5) Fortis
KBC bank and insurance ⁽⁴⁾	225,587	66.7	1.9				(1) Almanij; (2) KBC Group Companies
Keytrade ⁽⁵⁾	368	28.5	22.5	9.5	9.5	9.5	(1) Van Moer, Santerre et Cie; (2) Compagnie Centrale 1909; (3) De Streeel Grégoire; (4) Zurtstrassen Jean-Guillaume; (5) Zurtstrassen José-Charles
Not listed ⁽⁶⁾							
Axa Belgium	13,981	100.0					(1) Axa Group ⁽⁷⁾
Banque Degroof	2,550	36.5	16.3	13.2	11.9	4.0	(1) Guimard Finance SA and families Philippson, Siaens, Fontaine, Schockert, Haegelsteen; (2) Active Partners; (3) Compagnie du Bois Sauvage; (4) Management & Personel; (5) Parmafin (Family Theo Maes)
HSBC – Dewaay	343	100					(1) HSBC
Bank Corluy	102	62.5	37.5				(1) Group Corluy (family); (2) Mercator Bank en Verzekering
Bank Delen	846	100					(1) Finaxis ⁽⁸⁾
Bank J. Van Breda	1,901	100					(1) Finaxis ⁽⁸⁾
ING Belgium	121,045	99.6					(1) ING Group ⁽⁹⁾

Sources: Annual Reports, Banks' website, ING, Bankscope.

(1) An ultimate owner or controlling shareholder is a shareholder holding directly or indirectly more than 20 p.c. of the shares (La Porta et al. 1998). It is believed 20 p.c. of the shares is often enough to control a company.

(2) December 2003.

(3) On April 24, 2003, Suez issued a 3-year convertible bond which will be redeemed at maturity in a maximum of 70 million Fortis shares. Suez's potential voting rights (fully diluted) will then drop from 6.40 p.c. to 1.44 p.c. or more.

(4) See separate Box 3.

(5) Listed shareholders acting jointly.

(6) December 2002 except Banque Degroof and ING Belgium: December 2003.

(7) Ultimate owner is Mutuelles AXA.

(8) Owned by Ackermans & van Haaren (60 p.c.) and Groep J. Van Breda (40 p.c.).

(9) ING bank launched a squeeze-out procedure in April 2004.

The shareholding structures of the various Belgian banking groups differ widely (Table 2.1). The shareholding structure of Fortis, the largest Belgian financial group, is dispersed. However, Fortis has two reference shareholders: Suez Group and VSB Fonds. They both hold around 6 p.c. of the shares. KBC has a more concentrated ownership. The main shareholder of KBC is Cera Holding (through its participating interest in Almanij). As explained in Box 3, the shareholding is more or less similar to a pyramid. The shareholding structure of Dexia is relatively concentrated, as two shareholders each have more than 14 p.c. of the shares and 2 others both have more than 5 p.c. of the shares. Finally, ING Belgium is a subsidiary of ING group, a Dutch company. The smaller banks that are presented tend to have concentrated ownership.

Note also that although some large financial groups are listed, individual banking entities are not (the only exception being Keytrade). The fact that the banking activity is not listed has an impact on market discipline. Indeed, direct market discipline on bank entities through share price cannot be exercised, even though banks are generally monitored by rating agencies.

TABLE 2.2 OWNERS OF BELGIAN BANKS
(December 2003)

Major shareholder categories	Number of banks	Percentage of banks	Percentage of total assets
Foreign financial group	24	39.3	17.7
Belgian financial group	12	19.7	21.4
Listed banks with no shareholder owning more than 50 p.c. . .	2	3.3	56.6
Family structure	10	16.4	2.5
Professional credit associations	9	14.8	0.4
Other ⁽¹⁾	4	6.6	1.4
<i>Total</i>	<i>61</i>	<i>100.0</i>	<i>100.0</i>

Sources: CBFA, Bankscope, Schema A and own calculations.

(1) Other includes: (i) public authorities, (ii) consortium structure, (iii) Belgian or foreign non-financial groups.

Table 2.2 presents a breakdown of banks by the identity of their direct main shareholder. We observe that a large number (39 p.c.) of Belgian banks are owned by foreign shareholders, generally foreign financial institutions, yet they only represent 18 p.c. of the total assets of Belgian banks. Note that if we add to this the 20 p.c. owned by Belgian financial institutions, we find that 59 p.c. of Belgian banks are owned by another financial institution, accounting for 39 p.c. of the total assets of Belgian banks.

Shareholders exert power through their voting rights. In some environments, voting rights are directly proportional to cash-flow rights, so that it is enough to look at ownership concentration to have an idea of formal control rights of shareholders. In other environments, there is widespread use of technologies that give shareholders voting rights in excess of their cash-flow rights. Box 3 explains these mechanisms in detail. In most cases, these mechanisms are used to increase the power of the large shareholder, who may find such a strategy attractive when wealth constrained and only willing to invest if in control. As controlling shareholders value a voting premium as a form of private benefit, they will not sell their shares to small shareholders. This is

because small shareholders do not value these private benefits and hence will not be willing to pay for these voting rights (Grossman and Hart, 1998). These mechanisms may therefore lead to stable control.

Recently, however, there have been many debates about whether these mechanisms are a sign of bad corporate governance.⁽¹²⁾ This is because control rights that

(12) In its effort to draft a "takeover directive", the European Commission proposed to ban multiple voting rights. In Belgium, dual voting rights within one class of shares are not allowed and one-share-one-vote is the rule (art 541 corporate law). The OECD principles on corporate governance (2004) do not go that far, only stipulating that such arrangements should be disclosed. From a banking stability point of view, note that some of these arrangements may have some benefits when they lead to stable ownership structures.

significantly exceed cash-flow rights may distort incentives to the disadvantage of small investors. Bebchuk et al. (1999) show that this may cause considerable agency costs. Neither proxy contests nor hostile take-overs are possible, limiting the discipline of the external market and raising moral hazard concerns.

This analysis demonstrates that there is no clear answer to the question whether the RSA should favour dispersed or concentrated bank ownership. To some extent, there is an underlying trade-off between stable ownership and managerial autonomy, a trade-off that, as section 4 will show, the RSA in Belgium has tried to balance by introducing a special supervisory agreement.

Box 3 – Technologies separating cash-flow rights from voting rights

The trust office

One mechanism, frequently used in the Netherlands to separate cash-flow rights from voting rights is the trust office (“administratiekantoor”). A trust office holds the original shares of the company and issues “depository certificates”. Certificate holders, in addition to receiving dividends, retain the right to attend and speak at shareholders’ meetings, but they generally have no voting rights. Instead, the votes are cast by the trust office. Depending on its exact implementation, it may also serve as a mechanism to give real control to managers rather than shareholders. Trust offices very often represent large shareholders (if not all).

Often, trust offices serve as anti-take-over defences. As the supervisory board appoints the board members of the trust office and as the shareholders cannot exert their voting rights, it becomes impossible to take control of the firm through a hostile take-over. This mechanism also limits shareholder power and ensures managerial autonomy. On the other hand, the trust office has a lot of power and if it actually acts in the interest of (a subgroup of) shareholders, these are very well represented, whether they attend the shareholder meeting or not. This is in contrast with firms where uncast votes are handed over to the management.

When looking at the Netherlands, it seems that trust offices have been effective in protecting banks from foreign hostile take-overs without preventing company growth. These days however, the trend, at least in banking, is to gradually eliminate this Dutch peculiarity and to give more power to shareholders.⁽¹⁾

Preference shares

Preference shares constitute another widely used device. Unlike the trust office, preference shares do not increase the power of management, but affect the balance of power among shareholders. Preference shares may have several special features regarding dividend, seniority and voting rights. For example, the preference shares used by ABN-Amro give a right to a fixed guaranteed dividend of 5.5 p.c. of the face value, are senior to ordinary shares (but junior to debt) upon liquidation, and carry multiple voting rights. Hence, with respect to their pay-off, preference shares resemble subordinated debt. They differ solely in their attached voting rights and their indeterminate maturity. Hence, the use of dual-class shares is a way to endow some shareholders with incentives that are more debt-like.

ABN Amro uses preference shares accounting for 2.7 p.c. of the market value of the equity of the bank but with 47 p.c. of its voting rights. More than 80 p.c. of these preference shares are held by only 6 shareholders. This means that, together with the ordinary shares owned by these shareholders, 46 p.c. of the voting rights are in the hands of a group owning only 17 p.c. of the market value of the equity of the bank. Hence, ABN Amro has a

(1) ABN Amro announced its intention to dissolve its trust office (Stichting Administratiekantoor ABN AMRO Holding). The board of directors of ING proposed that the holders of depository receipts obtain a voting proxy for the full number of their depository receipts, whether it is “peacetime” or not. This means that Trust Office ING Shares will only exercise a vote at its own discretion for those depository receipts the holders of which are not represented at the Annual General Meeting and who have not given any voting instruction to the Trust Office ING Shares. Yet, the second trust office of ING, Trust Office ING Continuity retains its call option which gives the trust office the right to acquire cumulative preference shares. Fortis also has this kind of trust office (Stichting Continuïteit Fortis) which has been granted an option to acquire a number of Fortis preference shares. These two trust offices should be considered as anti-take-over devices. In order to prevent a hostile take-over, the trust is only given an option to buy cumulative preference shares in case of “wartime”. This so-called “poison pill” does not limit the power of shareholders in “peacetime”.



TABLE 3.1 CAPITAL STRUCTURE OF ABN AMRO
(Market value on December 31, 2003)

	Ordinary shares	Preference shares	Total	
	Percentage of shares		Percentage of market value	Percentage of voting rights
Aegon	0.4	13.5	0.7	6.5
Fortis	0.5	15.7	0.9	7.7
Delta loyd	0.7	9.9	1.0	5.0
ING	8.3	17.6	8.6	12.7
Rabobank	0.1	10.6	0.4	5.0
Zonnewijzer	0.0	14.2	0.4	6.7
Capital Group International, Inc.	5.2	0.0	5.1	2.8
<i>Total</i>	<i>15.2</i>	<i>81.6</i>	<i>17.0</i>	<i>46.3</i>
Other shareholders	84.8	18.4	83.0	53.7

Source: ABN Amro Annual Report 2003.

dispersed ownership, with concentrated voting rights.⁽²⁾ The figures are presented in Table 3.1, which details the major shareholders' investment and the attached voting rights.

Until now however, ABN Amro has combined these preference shares with a trust office which made management quite independent of these shareholders. In its 2002 annual report, ABN Amro announced its intention to change on this front, as with the trust office. The bank is planning to purchase all outstanding preference shares. This is because pressure from current corporate governance practice for non-financial firms discourages the use of dual class shares as it limits transparency. This measure will be accompanied by the dissolution of the trust office. From an RSA point of view, however, these dual class shares may in some cases be favoured, especially if they lead to stable shareholders with incentives that are closer to those of debt holders.

Pyramid structure

Pyramid structures represent an alternative to dual-class shares that also increases block-holder power without changing income rights. In a pyramid of two companies, consider a controlling shareholder holding a controlling stake (s_1) in a holding company that, in turn holds a controlling stake (s_2) in an operating company. Assume one-share-one-vote and assume first that it takes $s_i > 0.5$ ($i = 1,2$) to exert control over the assets. Then, the fraction of cash-flow rights required to gain formal control is only $s_1s_2 > 0.25$. With a cascade of n firms, control only requires a fraction of the cash-flow rights:

$$\alpha = \prod_{i=1}^n s_i .$$

where α is equal to the cash-flow rights held by the controlling shareholder

s_i represents the fraction of shares of firm i held by the controlling shareholder.

(2) However, it should be noted that in normal circumstances (i.e. peace time), as one ordinary share requires a significantly larger investment than one preference share, holders of depositary receipts for preference shares have the opportunity to acquire voting rights in the meeting of shareholders by proxy only, in proportion to the economic value of a preference share against that of an ordinary share. In addition, the trust office of ABN AMRO holding will exercise the voting rights in respect of preference shares for which no proxies have been issued.

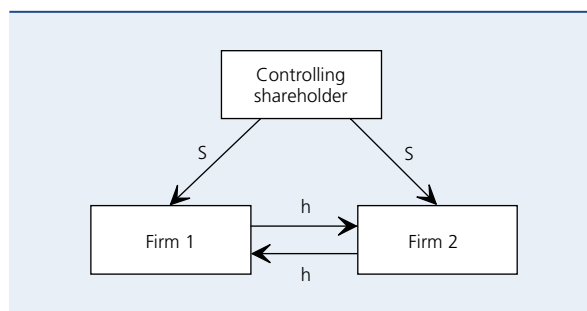
In the past, pyramid structures were common in Belgium. The shareholding structure of BBL, before it was acquired by ING, was an example of such structure. BBL was controlled by three shareholders acting jointly: Crédit Communal/Gemeentekrediet (12.5 p.c.), GBL (12.5 p.c.) and Royale Belge (12.5 p.c.).⁽³⁾ The other shareholders included ING (20 p.c.) and Winterthur (8.2 p.c.). Although the shareholders were acting jointly, the control was mainly exercised by GBL.⁽⁴⁾ GBL in turn was controlled by the Family Holding Frère-Bourgeois through a cascade of companies.⁽⁵⁾

A current rather atypical example in the Belgian financial sector is KBC holding, as it emerged in 1998 out of the merger of KB Bank, Cera Bank and ABB insurance. KBC holding, which is listed on Euronext, is 70 p.c. controlled by Almanij, another listed financial holding company, which in turn is more than 70 p.c. controlled by a group of major shareholders. Among these shareholders there is another listed financial holding company, Almancora holding 28 p.c. of the shares of Almanij.⁽⁶⁾ Almancora is 80 p.c. owned by Cera.

Cross ownership

The use of cross ownership to increase voting power is explained in the following figure.

FIGURE 3.1 CROSS OWNERSHIP STRUCTURE



In this symmetrical two company case, the controlling shareholder has a direct fraction of S shares, large enough to control both firms. Both companies have a cross-holding h . The indirect shareholding for the shareholder in each firm becomes $S + h$. The controller's fraction of the cash flow right (μ) is the ratio of its holding S over the total fraction of shares that is not cross-held $(1-h)$: $\mu = S/(1-h)$. For any μ it is in theory possible to set up a cross-ownership structure such that the controller has formal control over the assets but no more than a fraction μ of cash-flow rights.

In the financial sector, cross-holdings are commonplace. For example, Fortis currently directly owns 7.7 p.c. of the voting rights in ABN Amro and an interest of between 5 p.c. and 10 p.c. in ING. ING has a direct participation in ABN Amro representing 12.7 p.c. of the voting rights, while ABN Amro holds 5 p.c. to 10 p.c. in ING. Indirectly, Fortis has thus more power over ING and ABN Amro than would be expected from the direct shareholdings. This calls for two remarks. First, from what was discussed previously, we know that voting rights attached to ABN and ING shares are handed over to a trust-office. Because of this, the power of Fortis is limited. Second, Fortis is not a controlling shareholder in ING nor in ABN Amro. This means that Fortis has only partial control over the shares held in the cross-holding between ING and

(3) The ultimate owner of Royale Belge was Royale Vendôme (52 p.c.), partly owned by UAP (75 p.c.) and GBL (25 p.c.).

(4) See e.g. Delvaux and Michielsens (1999).

(5) In 1995, GBL was controlled by Pargesa Holding (47.4 p.c.) which in turn was controlled by Parjointco (55 p.c.). Parjointco was jointly controlled by Power Corporation (a Canadian holding company controlled by Paul Desmarais, owning 50 p.c. of the shares of Parjointco) and by Agesca Nederland (50 p.c.). Agesca Nederland was controlled by the Compagnie Nationale à Portefeuille/Nationale Portefeuille Maatschappij (89.5 p.c.). The Compagnie Nationale à Portefeuille/Nationale Portefeuille Maatschappij was controlled by Fibelpar (46.2 p.c.) which in turn was controlled by Erbe (54.1 p.c.) which was controlled by the Family Holding Frère Bourgeois (54.5 p.c.). For more information, see e.g. Chapelle and Szafarz (2002) or Becht et al. (2001).

(6) Almancora, was set up after a legal dispute, in order to allow mutual shareholders of Cera holding, a cooperative and formerly the owner of Cera Bank, to make their stakes in Cera more liquid by converting them into Almancora shares.

ABN Amro. Hence, there may be other reasons for these cross-holdings, e.g. strategic, financial (in a bankinsurance model, cross ownership can also result from the investment portfolio of the insurance company. In that case, investments are not made for control purposes but may serve a strategic purpose), historical or cross-monitoring reasons. Yet the last reason could also present some drawbacks. Indeed, if a bank acquires a significant participating interest in a competitor, and a seat on its board of directors in order to monitor that firm, this creates potential conflicts of interests which may in the end considerably weaken the role of the board and undermine its supervisory function.

3.3 Structure of the board of directors

Voting rights in the general meeting of shareholders are not the sole source of power. Influence in the board is important too. Of course, voting rights and influence in the board are related. However, the power of the board over the firm's decisions may differ, depending on the board structure, i.e. the number of independent, executive and non-executive members, shareholder representatives, appointment procedures, committees, nomination period, etc. Box 4 presents some evidence on the current functioning of boards of directors in Belgium.

The monitoring function of the board is especially important for banks, where monitoring by depositors is non-existent. The complexity of operations impedes monitoring by those sparse, uninsured creditors, and banking regulation often makes take-overs (and thus market discipline) more difficult. In addition, one can also argue that the role of the board is different from its role in non-banking organisations. Normally, the board acts in the interest of the shareholders. Besides the fact that this is a legal obligation, this can also be justified by the fact that shareholders are the only stakeholders that can credibly contract with the other stakeholders, as they have the strongest incentives at the margin (Easterbrook and Fischel, 1983). In banks, however, shareholders cannot credibly commit to an implicit contract with debt holders. As the latter are not represented, shareholders will not internalise the interests of debt holders. (Macey and O'Hara, 2003). A solution may be to give bank boards of directors fiduciary duties not only towards shareholders

but also towards debt holders. Hence, bank boards should comprise more independent members and fewer representatives of the shareholders. Bank directors should also receive less equity-based compensation. The latter idea is confirmed by Becher, Campbell and Frye (2003). They compare a sample of 700 observations from 81 US banks with 13147 observations from non-banks over the period 1992-1999. They find that, on average, bank directors' remuneration consists of 18.72 p.c. equity-based pay compared to 31 p.c. for non-bank directors. This difference declines over the sample period.

Gillette et al. (2003) show that having a majority of independent board members (outsiders) is not enough to guarantee efficient board performance. What also matters is the way in which board members consult each other. They simulate the functioning of a board of directors comprising insiders and outsiders in laboratory experiments with human subjects. Their experiments provide support for the hypothesis that boards dominated by outsiders tend to produce the outcome which maximises firm value. In addition, allowing for communication between outsiders (whatever the communication protocol used), favours the adoption of the socially efficient outcome. Hence, in order to foster efficiency⁽¹³⁾, coordination between outsiders should be enhanced. This implies that boards where the outside members can consult one another in private will be more efficient. This is an argument in favour of a two-tier board structure.

(13) Efficiency refers to the fact that decisions of the board pursue firm value maximisation

Box 4 – Board structure of Belgian banks

Board composition

Table 4.1 presents the structure of the board of directors of several Belgian banks. A breakdown is made between executive and non-executive members. Among the non-executive members, we distinguish between independent and non-independent directors. This distinction is based on information provided in annual reports and is thus based on a self-assessment of each board of directors.



TABLE 4.1 COMPOSITION OF THE BOARD OF DIRECTORS OF SEVERAL BELGIAN BANKS

(Independence distinction is based on information provided in annual reports of banks and is thus based on a self-assessment of each board of directors)

	Level	Executive members	Non-executive members			Total	Separation chairman / CEO?
			independent	not independent	not classified		
Listed							
Dexia ⁽¹⁾	Group	1	8	9		18	yes
Fortis ⁽²⁾	Group	1	11			12	yes
KBC	Group	8	4	11		23	yes
Keytrade	Bank	4			7	11	yes
Non listed banking entity of listed Belgian financial group							
Dexia	Bank	7			19	26	yes
Fortis ⁽³⁾	Bank	10			11	21	yes ⁽⁴⁾
KBC	Bank	5			8	13	yes ⁽⁵⁾
Not listed							
Axa Belgium ⁽³⁾	Bank	6			7	13	yes
Banque Degroof	Bank	9	3	5		17	yes
HSBC – Dewaay	Bank	4			6	10	yes
Bank Delen	Bank	5			7	12	yes
ING Belgium ⁽⁶⁾	Bank	6			10	16	yes

Source: Annual Reports 2003 and Bankscope.

- (1) On March 4, 2004, the board of directors of Dexia appointed Anne-Marie Idrac as a provisional replacement for Paul Louis Halley, who died on December 6, 2003. On December 31, 2003, there were thus 8 independent directors instead of 9.
- (2) The board of directors of Fortis appointed 5 new non-executive directors in 2004, in replacement of 4 non-executive directors who had reached the end of their term of office. The board of directors of Fortis now counts 12 non-executive directors. Fortis also announced other changes including the replacement of the co-chairmanship structure by a single chairmanship and the end of the parity between Belgian and Dutch directors.
- (3) December 2002.
- (4) Chairman of the board of Directors at the bank level is CEO at the group level.
- (5) Same chairman at the group and at the bank levels.
- (6) ING Belgium modified the composition of its board in April 2004. The board of directors of ING Belgium now counts 9 non-executive directors and 6 executive directors.

With regard to the board structure, there are some significant differences among Belgian banks. There is no (implicit) rule with regard to the composition of the board or to the number of directors.⁽¹⁾ The number of directors in Belgian banks ranges from 10 to 26. The number of independent directors also varies. The majority of directors in Fortis and Dexia are independent. In KBC, only a minority of the non-executive members are independent.

(1) Yet note that the Report of the Belgian Commission on Corporate Governance recommends limiting the size of board of a firm in general to no more than 12 directors.



TABLE 4.2 COMPOSITION OF COMMITTEES OF KBC, DEXIA AND FORTIS (GROUP LEVEL)

Committees	Fortis	Dexia	KBC
Audit	Composition : 6 independent board members. Meetings in 2003:5.	Composition : 4 board members (two of whom are independent). Meetings in 2003:4.	Composition : 9 non executive board members (3 of whom are independent). Meetings in 2003:6.
Appointment / Nomination	1 appointment and compensation committee consisting of 7 board members, including 6 independent board members and the CEO. Meetings in 2003:3.	Composition : 6 board members (comprising the Chairman, the CEO and 2 independent directors). Meetings in 2003:4.	The Agenda committee acts as an appointment committee.
Remuneration / Compensation		Composition : 3 non-executive directors (the Chairman and 2 independent directors). Meetings in 2003:2.	Composition : 3 non-executive directors (including 1 independent director and 2 representatives of the principal shareholder). The committee meets on an ad hoc basis.
Strategy	NA	Composition : 6 board members (comprising the Chairman, the CEO and 2 independent directors). Meetings in 2003:1.	NA
Agenda	NA	NA	Composition : 6 members (including the Chairman and Vice-President of the executive committee and 3 non-executive directors). The committee meets prior to each Board meeting.
Risk and Capital	Composition : 5 board members (of whom the CEO). Meetings in 2003:3.	NA	NA

Source : Annual Report 2003.

The three large Belgian banks use a different definition of independence, although they all comply with the new legislative act of August 2002. Therefore, the figures in Table 4.1 are not totally comparable. KBC relies only on the definition of independence given in the Corporate Law. The board of directors of Fortis uses its own definition of independence. For instance, Fortis' definition of independence does not take account of a maximum term of office. Banque Degroof used the recommendations of Euronext Brussels.⁽²⁾ Finally, Dexia uses criteria that are even more stricter than those of the Bouton White Paper⁽³⁾ and the Belgian Corporate Governance Law. This illustrates how difficult it is to define independence.⁽⁴⁾

(2) Belgian Commission on Corporate Governance (1998), Report.

(3) MEDEF, "Pour un meilleur gouvernement des entreprises cotées : rapport du groupe de travail présidé par Daniel Bouton, président de la Société Générale", September 2002.

(4) Criteria for independence refer to directors with no ties with shareholders or managers. The latter criterion tend to be emphasised in the Anglo-saxon corporate governance model relying upon dispersed shareholder, the former is more relevant for the Continental corporate governance model with concentrated ownership. Although there is no single definition of independence, it is at least possible to identify some dependence criteria. The list of criteria given here is based on the Dutch Corporate Governance Code (Corporate Governance Committee, "The Dutch Corporate Governance Code: principles of good corporate governance and best practices provisions", December 2003. This report is also known as the Tabaksblat report) and on the Bouton White Paper. They combine both criteria from the Anglo-Saxon and the Continental model. A director may not be considered as independent if one of the following criteria applies to him, his wife, or child or relative up to the second degree:



At the bank level, managers seem to have an important say in the board. This is because the Agreement on the autonomy of bank management stipulates that members of the managing board must be chosen from among the members of the board of directors.⁽⁵⁾ Executives, however, may not be in the majority. In addition, the total number of board members seems to be quite large. This might raise difficulties in board decision-making, as there may be moral hazard in teams. Therefore, it is important to establish subcommittees. This is addressed in the next paragraph.

Board organisation

The board of directors may delegate some of its responsibilities to committees made up of a limited number of directors. Table 4.2 summarises committees created by Dexia, KBC and Fortis. There is no universal definition of the scope of competencies of each of these committees. The prerogatives of the committee and its members are determined at the board level.

All the banks represented in the table make use of several specific committees. It seems that there are large differences in board structure between banks. An audit committee and a remuneration committee are nowadays commonplace in a lot of firms across many industries. Yet, their composition varies widely. For instance, the audit committee of Dexia contains 4 members but 9 members in the KBC case. The existence of a strategy committee or a risk and capital committee is maybe less frequent. Codes of best practices recommend that the board of directors establish rules that define the roles and responsibilities of each of these committees. With regard to the composition of the audit committee, the Bouton White Paper recommends that, if such a committee exists, it should comprise at least two-thirds independent members and no current or former managers. In addition, members of the committee should be finance or accounting experts. The audit committee should supervise the internal control, the internal and external audits, and check compliance with their recommendations.

The Bouton report defines the optimal composition of the remuneration committee. The committee should comprise a majority of independent members and no executive directors. The remuneration committee should make proposals with regard to the remuneration package of directors, members of the managing board and high level employees of the firm. A crucial element of this package is the importance of the variable element (cf. supra).

(5) Note that the agreement applies at the bank level and not at the group level. Therefore, we see that banks such as Fortis or Dexia only have one executive member on the group board while the whole managing committee is represented at the bank level.

4. A special supervisory instrument: The agreement on the autonomy of bank management

The fact that the agency conflict in banks differs from the agency conflict in non-financial firms creates a need for an RSA. The exercise of the RSA function is facilitated by sound corporate governance structures in banks. Therefore, the RSA may try to govern the relationships between shareholders, directors and managers. The Belgian supervisory model makes use of an original instrument to govern these relationships: the Agreement on the autonomy of bank management. To the best of our knowledge, this instrument is rather specific to Belgium. First, the instrument itself is original, in the Belgian tradition of developing rules and regulations by way of soft law. Supervisory intervention served mainly as a substitute for formal regulation and formed a body of informal company law aimed at policing the conduct of major companies (see e.g. Wymeersch, 1994). Second, the content of the agreement is not necessarily included in the legislative framework of neighbouring countries.⁽¹⁴⁾

Although the stated purpose of the autonomy agreement is to guarantee the stability and the continuity of the banking function, the historical background lends itself to a more limited interpretation (for an historical overview of the agreement on the autonomy of bank management, see Appendix 1). Indeed, the agreement on the autonomy of bank management has its roots in the desire to avoid conflicts of interests within group structures (in mixed banks or in industrial holding companies). As structural regulation failed to fully solve conflicts of interests in credit policy, the CB⁽¹⁵⁾ started to negotiate agreements with bank shareholders to ensure the independence of bank management in credit policy. As such, it focused on credit risk and did not target the general problem

(14) One should, however, note that the Italian legislation contains a provision pointing out that the Bank of Italy may request a sort of "declaration of independence" from the participants in the capital of a new bank in the occasion of its setting up (see also Lombardo, 1993).

(15) The Commission for Banking (CB), the Belgian RSA, was set up in 1935. In 1990, it was renamed the Commission for Banking and Finance (CBF). In 2003, the CBF merged with the OCA/CDV, the agency in charge of the control of insurance companies, to form the Commission for Banking, Finance and Insurance (CBFA). The text thus uses the abbreviations CB, CBF and CBFA, depending on the period it is referring to.

of banking risk. To this end, the agreement establishes a clear distinction between the managing board of a bank and its board of directors. In addition, it tries to reinforce the independence of a bank's management and to protect it from any external influence.⁽¹⁶⁾ The goal of this section is to present this special and unique feature of the Belgian supervisory model, i.e. the agreement on the autonomy of bank management.⁽¹⁷⁾ This subsection first retraces the tradition of autonomy agreements in Belgium. Subsequently, it investigates the future for a (revised) autonomy agreement.

4.1 The Belgian autonomy agreement

The current agreement rests on two pillars. Its first pillar is based on a clear distinction between management and supervision:

- The managing board is in sole charge of the banking function and should pursue the interests of the bank to the fullest. The managing board manages the credit institution according to the general policy defined at the board of directors' level. The managing board is composed of members of the board of directors and constitutes a collegial body.
- Supervision of the management is the prerogative of the board of directors. The latter also defines the general policy of the bank and has the power to appoint and dismiss members of the managing board. The scope of the general policy includes planning, budgets, important structural reforms, and relationships between the bank and its shareholders.

The second pillar of the agreement specifies the rights and duties of significant shareholders.⁽¹⁸⁾ First, the agreement clearly states that, despite their specific role, significant shareholders have the right to expect a normal return on their investment. In addition, they are actively represented in the board of directors and subsequently play a role in the definition of the general policy and the supervision of the bank. Significant shareholders, however, may not use their influence to interfere with the business management. They also undertake to support the credit institution, to guarantee its stability and to ensure the autonomy of its management. They agree to inform the managing board, the board of directors and the CBFA prior to any changes in the size of their participating interest. The CBFA may recommend suspending the disposal operation for a period of three months if this operation threatens the stability of the bank or the independence of its management or if shares are transferred to an unsuitable shareholder.⁽¹⁹⁾ Table 1 provides a summary of the content of the agreement. The information presented in Table 1 is based on a standard agreement on the autonomy of bank management. However, the

agreement provides that any party may request a modification of the agreement, although the modification needs to be accepted by all the other parties (including the CBFA) and by the shareholders meeting.

Each bank ratifies voluntarily the agreement after negotiations with the CBFA. One of the incentives that the banking industry may find to ratify the agreement is to avoid the development of a formal *one-size-fits-all* legislation containing the provisions of the agreement.⁽²⁰⁾

The agreement is essentially a compromise that tries to combine the advantages of a stable shareholder structure with the advantages of autonomous management. Section 3 showed that there is typically a trade-off between the existence of a reference shareholder and managerial autonomy. The agreement thus tries to impose management autonomy in every shareholder structure by limiting the intervention of shareholders in the management of the bank. It ensures the autonomy of the banking function by the introduction of a structure similar to a two-tier board of directors. Instead of structurally breaking up the group, it introduces a governance solution reminiscent of Chinese walls. In addition, through its second pillar, the agreement tries to ensure stability of ownership by placing restrictions on the disposal of shares. Indirectly, restrictions on the sale of shares also constitute recognition that concentrated ownership provides more stability and hence better protection for parties that have contractual relationships, such as depositors. The agreement thus implies an uneasy compromise, as significant shareholders have to give up control and at the same time accept additional responsibilities, such as supporting

(16) This, however, also results in a great need for internal and external control, as the monitoring function of shareholders is weakened. Banks are therefore subject to a cascade of control. This cascade of control is often symbolised by four concentric circles. The inner circle represents the internal control, the second circle, the internal audit, the third circle the external audit and the outer circle the CBFA. Note that the role of the external auditor and the nature of the auditor's contact with the supervisory authority are rather special in Belgium. The external auditor function in fact combines a private mandate (defined in the corporate law – this mandate relates to the protection of shareholders) and a public mandate (co-operation with the CBFA – this mission relates to the protection of debt holders). The co-operation with the supervisory authority not only encompasses a signalling function (i.e. the auditor reports directly to the CBFA any decisions, facts or developments that could significantly influence the position of the credit institution or that are in conflict with corporate law, with the articles of association or the banking law) but also a supervisory function based on compliance forms. The auditor must thus perform a number of additional tests for a supervisory purpose.

(17) A similar agreement, the agreement on the autonomy of insurance management, also exists for the insurance industry. This instrument resulted from negotiations between the CDV-OCA and insurance companies.

(18) Note that there is no formal definition of a significant shareholder. The agreement specifies that "insofar as the voting rights attached to a participating interest may have a de facto influence on [general] shareholders' meetings, such a participating interest will imply an institutional role for the shareholders concerned, a role which, considering the powers they have, imposes corresponding duties to support the credit institution's stability, development and autonomy".

(19) However, the agreement does not define "unsuitable shareholders".

(20) Yet, although the banking industry as a whole has an interest in the approval of agreements, this is not the case for each of the significant shareholders of individual banks of the system. Therefore, it opens the door to free-riding types of behaviour, in which some banks might decide to refuse to negotiate the agreement.

TABLE 1 CONTENT OF THE AGREEMENT ON THE AUTONOMY OF BANK MANAGEMENT

	Managing Board	Board of Directors	Shareholders
Role	<p>The managing board is responsible for the business management of the credit institution. This management is to be carried out without external interference in the context of the general policy laid down by the board of directors.</p> <p>The board of directors confers on the managing board powers to take decisions and represent the bank with regard to its staff, its customers, other credit institutions, other economic and social entities and the authorities. The CBFA is to be consulted with regard to the scope of powers delegated to the managing board.</p> <p>The managing board will constitute a collective body with collective responsibility.</p>	<p>The board of directors defines the general policy (on its own initiative or following a proposal by the managing board). The general policy includes the definition of the bank's strategic direction, the approval of plans and budgets, significant structural changes and restructuring, and the definition of relationships between the credit institution and its shareholders.</p> <p>The board of directors exercises effective supervision over the management and the business. To this end, the managing board and the external auditor regularly report to the board of directors. In addition, the board has a right of investigation. The board may call upon the assistance of an audit committee consisting of directors who are not members of the managing board.</p> <p>The chairman of the board of directors will ensure that powers are correctly distributed between the board of directors and the managing board.</p>	<p>Significant shareholders undertake to support the credit institution, to guarantee its stability, to ensure the autonomy of its management and to create the conditions necessary for ensuring sound, objective and prudent management of the bank. They accept that the bank is not merely an instrument for serving their own interest, but also has other interests which must be taken into account in banking.</p> <p>They undertake not to vote during the general meeting for the removal from office or the non-renewal of the director's mandate of a member of the managing board or of the chairman of the board of directors without having sought the opinion of the board of directors and the managing board and the approval of the CBFA.</p> <p>They play an active role within the board of directors in defining the general policy, supervising its activities and management, and appointing the members of the management committee.</p> <p>They communicate the size of their participating interest each year to the CBFA and the board of directors.</p>
Composition	<p>Members of the managing board must be under 65 and must have the required professional integrity and experience.</p> <p>The managing board is composed of members of the board of directors. After consultation of its board, the chairman of the managing board must advise the chairman of the board of directors of the candidates proposed for nomination as chairman and as members of the managing board. If the chairman of the board of directors approves the proposal, he submits it to the board of directors. Otherwise he makes a counter-proposal to the chairman of the managing board. If the managing board disagrees, both chairmen try to reach a consensus on a single candidate. Otherwise, each chairman submits his proposal to the board of directors. The approval of the CBFA is required before any proposal to the board of directors.</p> <p>The board of directors may decide whether to revoke or not to renew the mandate of a member of the managing board only after obtaining the opinion of the managing board and of the CBFA.</p>	<p>The board of directors ensures that shareholders' interests are adequately represented and includes the members of the management board. The board may have a majority of representatives from those shareholders who have signed the agreement.</p> <p>Members of the managing board may not form a majority on the board of directors.</p> <p>Independent directors may also be appointed as directors in order to diversify the composition of the board.</p> <p>The credit institution ensures that the number of directors is limited.</p> <p>The chairman of the board of directors is appointed by the board of directors from among those directors who are not members of the managing board. The CBFA is to be consulted beforehand on the appointment and departure of the chairman of the board of directors. The appointment and removal from office of the chairman of the board of directors is subject to the prior approval of the CBFA.</p>	<p>In order to protect the credit institution's autonomy, arrangements are to be made to prevent an unsuitable shareholder from acquiring a significant participating interest in the credit institution. Any change which would directly or indirectly result in a significant increase or decrease in the relative size of the participating interest of a significant shareholder is subject to the opinion of the board of directors and the managing board of the credit institution and to prior consultation with the CBFA. If such change would be likely to affect the stability or the autonomy of the institution, the CBFA may recommend implementation to be suspended for a maximum of three months. This recommendation may be made public.</p>

Remuneration	<p>The board of directors sets the remuneration of the managing board, after seeking the opinion of the chairman of the managing board. The remuneration covers all functions performed by the members of the managing board within the credit institution, including their functions and mandates in companies where the credit institution has a participating interest.</p> <p>Where this remuneration includes a variable element, it may not be calculated on the basis of items classified as operating expenses.</p> <p>The allocation of remuneration among members of the managing board is subject to internal rules approved by the board of directors.</p>	<p>The remuneration of the board of directors consists solely of attendance fees or fixed remuneration, to be decided upon by the general meeting and, where appropriate, an annual fee laid down in the credit institution's articles of association based on the dividend paid or a portion thereof.</p>	<p>The particular role of the shareholders in no way impairs their right to expect the credit institution's management to generate a normal return on their investment.</p>
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the credit institution and guaranteeing its stability. Yet, shareholders can still exert influence through the board of directors. This influence is limited, as the prerogatives of the board of directors are restricted to the definition of the general policy and the supervision of the bank. Managing the bank is the exclusive competence of the managing board and must be carried out without any external interference, in the context of the general policy defined at the board level. So, solving the first agency problem (i.e. the potential abuses by controlling shareholders) may result in reintroducing another problem of governance, namely, the separation of ownership and management.

4.2 What future for an autonomy agreement ?

The agreement on the autonomy of bank management is a special instrument to be situated between regulation and corporate governance codes. However, due to this special position, the agreement is challenged as, on the one hand, bank regulation has changed and, on the other hand, the corporate world is increasingly focusing on governance codes. More importantly, structural changes in the banking landscape might call for changes in the agreement. We discuss here the emergence of financial conglomerates, the move towards foreign and dispersed ownership, and the changes in regulation. These all have an effect on the functioning of the agreement on the autonomy of bank management.

4.2.1 Bank ownership after the merger wave of the 90's

The ownership structure of Belgian bank holding companies has considerably evolved over the last 20 years. This may call into question the efficiency and the usefulness of the autonomy agreement. First, compared to 1974, when the agreement was applied to 50 banks, shareholding structures of bank holdings seem to be less stable, as changes in ownership structure are becoming more frequent in Belgium (see e.g. the M&A waves of the 90's). However, the stability of the ownership structure is essential for the effective application of the agreement. Too frequent significant changes in the ownership structure might become difficult to manage, as each significant change in ownership composition demands a renegotiation of the agreement. Second, we observe that the traditional industrial holding group structure, as well as the pyramid structure, are tending to disappear. Several large Belgian banks are now owned by foreign financial groups with a more dispersed ownership structure⁽²¹⁾, although large differences still persist (see Box 2). In principle, dispersed ownership increases the power of managers, while foreign owners may be difficult to control. This changes the nature of agency conflicts and subsequently decreases the need for the first pillar of the agreement, while the second pillar becomes more important.

4.2.2 Banking structures

While the former industrial holding structure was disappearing, another structure emerged, namely the financial conglomerate structure, combining banking, insurance and securities activities (National Bank of Belgium, 2002). At the top of the conglomerate is the financial holding company, which is often listed. The holding company may

(21) At the holding company level.

have a banking statute, but this is not necessarily the case. Each sector of activity is placed under a subsidiary. The subsidiaries are not listed, but are owned by the holding company. Hence, the bank has a concentrated ownership, while the holding company may have a dispersed ownership (see Box 2).

The introduction of this structure changes the nature of the conflict of interests. The main sources of conflicts of interests in these structures are no longer the relationships between majority and minority shareholders but the contagion between several sectors of activity and the consequences for the claimholders of the institution. Indeed, risks taken in one sector of activity (e.g. insurance) can influence another sector of activity (e.g. banking), and vice-versa. This may lead to the cross-subsidisation of one category of claimholders (e.g. insurance policy holders) by another category (e.g. bank depositors). Hence, although the conglomerate structure may improve risk management and efficiency, it reintroduces the risk of contagion between the different sectors of activity. In this context, it also changes the problem of the RSA. In particular, it raises the question of what would happen if the financial conglomerate comprised a weak insurance activity and a strong bank, and how would it be possible to protect bank debt holders in that situation. Increased transparency of the structure of the conglomerate and of the flows between sectors of activity is in any case needed. In addition, particular attention should be paid to general risk policy, as the risk of contagion depends on how the general risk policy (and not only the credit risk policy) is conducted.

Risk policy may be defined at the level of the sector of activity. This is especially the case when the subsidiaries operate at arm's length in relation to the holding company. In that case, each business line defines and manages its own risk plan. Consequently, the risk of the conglomerate is the combination of the separate risk plans of the sectors of activity. Yet, there is a tendency to define and manage risk at the group level in order to benefit from synergies and diversification effects.⁽²²⁾ How does the autonomy agreement cope with this trend? Currently, two separate agreements are concluded at the bank level and at the insurance company level, ensuring that the management of both the bank and the insurance company are independent (from each other and from their direct and indirect shareholders). Therefore, risk management remains the competence of the managing board of the bank or insurance company, whereas the board of directors may only define the general risk policy and supervise risk management. However, when the risk policy is defined at the group level, one might question the actual level of autonomy of the bank/insurance

management.⁽²³⁾ On the other hand, is the autonomy of bank/insurance management desirable or is it better to allow risk management at the holding company level? It is also interesting to note that the agreement does not impose restrictions on the management of the holding company, whereas a lot of decisions are made at the holding company level. This may create the need for a special agreement at the holding company level. It must also be noted that the present regulation imposes separate regulations on the different sectors of activity.⁽²⁴⁾

4.2.3 Legislative developments

Some rules of the autonomy agreement are now covered by several legislative acts. At the Belgian level, one can cite, for instance, the Banking Law of 22 March 1993, the law of 3 May 2002 implemented by the Royal Decree of 19 July 2002 concerning the exercise of external functions by directors and managers of credit institutions⁽²⁵⁾ and the Law of 2 August 2002 on corporate governance; at the European level, the new European Company Statutes regulation, and the European Directive on Financial Conglomerates.⁽²⁶⁾ Following these new developments, one could ask whether some elements of the agreement are not redundant, or worse, incompatible with current regulations.⁽²⁷⁾

With regard to the first pillar of the agreement, article 26 of the banking law authorises (but does not oblige) the board of directors to delegate some of its competences to a managing board constituted by directors. However, if such delegation occurs, the definition of the general policy of the bank must remain the responsibility of the board of directors. The corporate governance law adds that, if a managing board is constituted, the supervision of this managing board is the task of the board of

(22) E.g. traditionally, the duration of a bank's assets is longer than the duration of its liabilities. The reverse is traditionally true for insurance companies. The interest rate risk of the insurance business is then negatively related to the interest rate risk of the bank business. See also National Bank of Belgium (2002).

(23) A similar problem arises in the relationships between a daughter company and its parent company when both are subject to the agreement on bank management autonomy, and raises the issue of consolidated prudential control. Indeed, the fact that the management of a daughter is autonomous does not exempt it from adhering to the strategy of its parent as regards risk control and management or internal audit. Conversely, the agreement on the autonomy of bank management may not be used by the bank parent company to gain exemption from any kind of control or responsibility.

(24) There has recently been some tendency towards convergence in the regulation of banks and insurance activities, although it is limited to regulatory techniques for capital requirements. This requires the co-ordinated supervision of banks and insurance companies. The move from CBF-OCA/CDV to CBFA can be seen in this light.

(25) To guarantee the separation of the managing and supervisory functions, non-executive directors may not hold executive functions in companies in which the bank has an interest.

(26) Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

(27) For instance, this is particularly true with regard to sanctions and arbitration. The legislation generally punishes an infringement by a sanction, while for the same infringement the agreement will favour consultation and arbitration (this is of course due to the characteristics of this instrument).

directors.⁽²⁸⁾ Note here that, very clearly, the agreement on the autonomy of bank management sets up a stricter organisation and division of powers. In addition, articles 18 and 19 of the banking law stipulate that directors and members of the managing board must have the required professional integrity and experience, although the law does not establish any *ex ante* control by the CBFA. The Royal Decree of July 2002 also stipulates some incompatibilities in the exercise of external functions by the director or the manager of a bank.

With regard to the second pillar of the agreement, articles 17 and 24 of the banking law stipulate that the identity of shareholders owning more than 5 p.c. of the shares must be communicated to the CBFA in order to obtain a bank licence. Afterwards, communication is mandatory if the shareholding structure is modified. The CBFA has the right to refuse the licence if the CBFA judges that shareholders do not present enough guarantees with regard to the sound and prudent conduct of the bank. The law is even stricter than the autonomy agreement. For instance, the CBFA has the right to oppose the acquisition of shares by a shareholder that would threaten the sound and prudent conduct of the bank. The CBFA can also suspend the shareholder's voting rights and force this shareholder to dispose of his shares.

Although some elements of the agreement are redundant given the current legislation, the agreement still remains relevant. In particular, the agreement defines very precisely the separation between the supervisory function of the board of directors and the management tasks of the managing board. It also details the scope of intervention of the board of directors and the managing board. In addition, appointment and dismissal procedures are established so as to offer more guarantees for the independence of management. Moreover, a remuneration philosophy is defined, limiting the variable elements that can be taken into account in the remuneration.

There is also still the problem of financial conglomerates. The Financial Conglomerates Directives recommends co-ordination and additional supervisory review with respect to capital adequacy, risk concentration at the level of the financial holding company, internal control and risk management procedures and intra-group transactions. Indeed, article 8 of the Financial Conglomerates Directive stipulates that significant intra-group transactions (i.e. transactions that exceed at least 5 p.c. of the total amount of capital adequacy requirements at the level of the conglomerate) are subject to supervisory review. In addition, article 9 introduces adequate procedures to guarantee that the risk surveillance systems are integrated and that the systems are compatible so as to allow the

risks at the level of the financial conglomerate to be measured, monitored and managed. However, one might wonder whether it sufficiently addresses the potential problem of internal conflicts of interest and of potential contagion between the sectors of activity. In Belgium, in particular, a new type of banking agreement could probably address more thoroughly the problems of transparency in risk accounting and efficient capital allocation among the sectors of activity in order to avoid excessive cross-subsidisation.⁽²⁹⁾

4.2.4 Best practices in corporate governance

Corporate governance codes have become very fashionable in recent years.⁽³⁰⁾ These codes generally aim at establishing goals, guidelines and best practices for the effective governance of listed firms, and are thus not specific to banks. Yet, they may cover some aspects of corporate governance relevant for financial stability. In particular, some of these codes identify best practices linked to some issues dealt with by the autonomy agreement. First, these codes very often cover best practices with regard to the role of the managing board, the (disclosure of the) remuneration of the managing board, potential conflicts of interest, etc. In addition, current codes also address the functioning, the composition and the remuneration of boards of directors and of some of its sub-committees. Among the other issues addressed by these codes, the most frequent recommendations relate to shareholders, financial reporting and the internal and external audit function. While there is clearly some overlap between such codes and the agreement, this overlap is only partial, and codes do not necessarily make the agreement superfluous. Yet, it would be possible to envisage framing recommendations relating to bank stability within a revised agreement.

(28) Under the European Company Statute, defined by the Council in 2001 (Council Regulation No 2157/01 of 8 October 2001 on the Statute for a European Company), a company may have either a two-tier system with a supervisory board and a management board, or a one-tier system with an administrative board that manages the company. In the two-tier system, the management board (the members of the management board are appointed by the supervisory board) is responsible for managing the company. In the two-tier system, no person may be at the same time a member of both the management board and the supervisory board of the same company. The agreement seems thus to favour a hybrid (one and a half-tier ?) system where the members of the management board are members of the supervisory board. This raises the question whether the agreement should adopt a stricter definition or continue to promote hybrid structures (especially as some banks might want to adopt the European Company Statute).

(29) Internal discipline can be reinforced by the introduction of internal cost of capital allocation schemes, as they complement the weak external market discipline of conglomerates (Boot, 2000).

(30) See e.g. the Bouton White Paper in France, the Code on Corporate Governance of the Financial Reporting Council in the U.K., the Tabaksblat Report in the Netherlands or the OECD Corporate governance principles. In Belgium, the Corporate Governance Committee, established in January 2004 and chaired by Maurice Lippens, was set up at the initiative of the CBFA, the Federation of Belgian Enterprises and Euronext Brussels. The Committee has published a draft code on June 18, 2004. The Committee will publish the final version of the code on December 9, 2004, after a public consultation.

5. Conclusion

This paper has reviewed the corporate governance of banks and its implications for supervision. Banks are special, as banks' debt holders are dispersed non-experts, and this impairs the proper exercise of debt governance. In addition, banks are subject to potential risk shifting by shareholders. Therefore, bank depositors are in need of a representative. This role is generally endorsed by a regulatory and supervisory authority (RSA).

When managerial pay is not too sensitive to share prices, managerial control should reduce excessive risk taking. Under these conditions, the RSA may favour managerial control (requiring management autonomy). In addition, the RSA may find it advantageous to promote concentrated ownership, because of the potential to bail-in and the higher stability of ownership that is associated with concentration. In practice, however, managerial control and ownership concentration are difficult to combine.

The Belgian supervisory model is based on an instrument – the agreement on the autonomy of bank management – that tries to reconcile concentrated ownership with management autonomy. The initial goal of the agreement was to avoid conflicts of interest within group structures. It aimed at limiting the abuse of the banking function by holding companies to promote their own financial interests. Gradually, it also became an instrument to promote banking stability.

The agreement was last revised in 1992. In the meantime, changes have occurred in the financial and legal environment. On the legislative front, new developments have taken place in terms of both company law and banking law. Moreover, corporate governance codes have been introduced. While these initiatives overlap with some of the main ideas of the agreement, they are not a perfect substitute for its insistence on managerial autonomy or its desire to promote shareholder stability.

More challenging are the market developments that have led to a new banking landscape in Belgium, with increased foreign ownership, less stable shareholding structures and the rise of financial conglomerates that now control the main banks in Belgium. The conflicts of interests that were at the heart of the initial agreement, namely the granting of loans to troubled industrial shareholders of banks, are now largely irrelevant. On the other hand, banking stability concerns are possibly more important than ever, for two reasons. First, because the reduced stability of ownership makes potential bail-in (the second pillar of the agreement) problematic. And second, and more importantly, because the conglomerate structure of banking and insurance groups increases the potential conflicts between a centralised risk management at the holding level and the autonomy of bank management. Therefore, governance structures implemented by banks should remain a key issue in supervision.

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Appendix 1 – Historical perspective on the agreement on the autonomy of bank management in Belgium :

In Belgium, banking autonomy concerns were first raised early in the thirties during the mixed banks crisis. The *mixed banks* were shareholders of firms that they financed with the deposits they had raised. However, as they had been hit by the crisis that had started in 1929, these firms suddenly needed refinancing. At that time, mixed banks faced a clear conflict of interests. Indeed, they had to find a balance between the interests of their depositors and the interests of the companies they owned. The mixed banks decided to provide assistance to the ailing firms they owned. As depositors subsequently started to withdraw their deposits, the liquidity of mixed banks became a serious concern. Therefore, mixed banks were banned by a Royal Decree in 1934. The existing mixed banks were divided into holding companies and pure deposit banks.

This split, however, did not entirely solve the potential conflict of interests, as holding companies continued to exert their influence on the banks they were holding. Indeed, the holding companies were not only major shareholders of the new banks, but in many cases, boards of the two entities met together. In addition, in some cases, the holding company continued to intervene in lending decisions and sometimes was even informed of the bank's results before the board of directors of the bank. Therefore, the newly established CB drew attention to the autonomy of bank management on several occasions (see e.g. Annual Report 1936 and 1937).

In this context, the CB tried to negotiate with the Société Générale de Belgique (then shareholder of the Banque de la Société Générale de Belgique) and with Brufina (then shareholder of the Banque de Bruxelles), two holding companies, in order to decrease their participating interest in the credit institution they owned so as to limit it to 10 p.c. of the capital of the bank. In exchange for the forced disposal, the holding companies demanded exemption from taxation on the capital gains resulting from the sale. As this demand was rejected by the Ministry of Finance, the agreement was never applied.

The CB then approached the problem in a radically different way. Instead of trying to force holding companies to reduce their stake, in 1959 the Commission negotiated agreements with the holding companies in order to institutionalise their stakes in the bank. In other words, banks were no longer allowed to sell their stake without first consulting the CB. In addition, the agreement comprised three other clauses. First the chairman of the bank was no longer allowed to hold a position in the holding company and had to guarantee the independence of the bank. Second, individual members of the management committee no longer reported to the board of directors but to the managing board. This provision was supplemented by the introduction of the concept of the collective responsibility of the managing board. Third, the agreement revised the composition of the board of directors and included mandatory independent members.

In 1969, Brufina breached the agreement and sold a substantial share of its participating interest in the Banque de Bruxelles to Algemene Bank Nederland without informing the CB. This caused major political debates and fears of potential foreign control over Belgian banks. After lengthy discussions, the government agreed that the CB had to negotiate a new, stricter agreement that would apply in general to a large number of banks. In 1974, the agreement was extended to about 50 banks. The standard agreement was based on the two following pillars. First, the agreement implicitly set up a dual (two-tier) board system (the members of the managing board were chosen from among the members of the board of directors) in order to guarantee the independence of the management board. The managing board, in charge of the management of the bank, carried collegiate responsibility and its members were on equal footing. The board of directors was in charge of the definition of the general policy of the bank and of its supervision. With regard to its composition, neither the managers nor the representatives of significant shareholders were allowed to represent a majority of the directors. Second, the agreement recognised a quasi-institutional role for significant shareholders, which implied limitations on the transfer of ownership, in order to avoid the transmission of shares to an undesirable shareholder.

The content of the standard agreement was revised in 1992 for several reasons. First, a new regulatory context had emerged. The first (1977) and second (1988) Banking Co-ordination Directives incorporated some elements of the 1974 agreement such as the collegiality of the management board, the control of the status of shareholders, and the definition of sound and prudent policies. The Directives also gave formal legal power to the CB. Another change in the regulatory context was brought about by Basel I (1988), which obliged shareholders to strengthen the capital base if the regulatory

capital fell below a certain threshold. Second, certain developments in the banking sector highlighted the need for some revisions of the agreement. The increasing presence of foreign shareholders, as well as some limitations on the effective role played by the board of directors, forced the CBF to amend the 1974 agreement. Indeed, some shareholders were concerned about the fact that, in practice, the board of directors of most banks limited the scope of its intervention to a supervisory function. This problem threatened the stability of the shareholding structure as some shareholders would have incentives to dispose of their shares, since they were unable to effectively exert their responsibilities.

Although the spirit of the agreement remained unchanged, the agreement was therefore amended in 1992. The role of the board of directors and of its chairman was explicitly spelt out. The board of directors was in charge of the definition of the strategy, the plans and budgets, the structural reforms, and the definition of the relationship with the shareholders. In addition, the role of its chairman was to ensure the proper allocation of powers. The composition of the board of directors also changed, as limitations with regard to majority were abolished so that representatives of shareholders were allowed to cast a majority of the votes, increasing the power of major shareholders. The procedure for appointing the members of the managing board was also redefined and appointment required the approval of the CBF. With regard to major shareholders, their role and obligations remained unchanged, although their power increased.