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Introduction

Few issues in the literature on corporate finance and organizational behavior have received as much attention in recent years as corporate governance. In the United States and in other countries, there is new interest in how firms' decision-making structures are organized, the priorities of these structures, and the structures' effect on shareholders. The term "corporate governance" essentially refers to the relationships among management, the board of directors, shareholders, and other stakeholders in a company. These relationships provide a framework within which corporate objectives are set and performance is monitored.

In the financial services industry, boards of directors face additional expectations imposed by their regulators. These are usually expressed in the form of laws, regulations, or guidance, and reflect the public interest in safe and sound financial institutions. This special public interest stems from the unique role played by financial institutions—particularly banks—in the U.S. economy: they are an important source of liquidity in times of crisis, they provide access to the nation's payment systems, and they maintain federally insured deposits. Yet surprisingly, the effect of corporate governance on the performance and overall health of firms in the financial services industry has typically received less academic scrutiny than it has in other industries.

After the thrift and banking problems of the 1980s and early 1990s, regulators and academics today agree that poor governance and poor management remain at the heart of most serious banking problems. The record number of savings-and-loan and bank failures in those years spurred legislative action—in the form of the Federal Deposit Insurance Corporation Improvement Act of 1991—to strengthen bank boards and board committees with the goal of holding them more accountable for performance. Supervisory guidance since then has further underscored the responsibilities of boards for fostering sound bank management. Institutional and functional consolidation in financial services—both within and across national boundaries—also heightens the importance of effective governance.

Accordingly, financial regulators are continuing to increase their emphasis on corporate governance as a crucial element in promoting sound institutions. Academic researchers, too, are stepping up their efforts to add insight to corporate governance.

The identification of key issues in governance is an important step toward achieving soundness. This special volume of the *Economic Policy Review* is designed to foster a better understanding of corporate governance—particularly as it applies to banking firms—among regulators, investors, researchers, and the interested public. The contributors to the volume, specialists in governance, analyze the topic from many perspectives, including law, financial accounting, and financial economics. As they summarize and synthesize a vast literature on vital governance issues, the authors present a framework for understanding corporate governance and identify key areas of future research.

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Critical Themes in Corporate Governance

The volume is divided into two complementary parts. The first consists of four articles that summarize the literature in several critical areas of corporate governance: the role of the board of directors, compensation issues, monitoring by outside blockholders (holders of large percentages of stock), and corporate disclosure. The framework of these articles follows the agency-theoretic literature—that is to say, the literature that argues that corporate managers may be self-interested, and, if operating independently, could make decisions that shareholders consider less than optimal. Boards of directors, compensation, and block ownership, according to this literature, are solutions that mitigate these conflicts of interest.

Researchers view the board of directors as the shareholder's first line of defense against potential conflicts of interest in firms. Accordingly, **Benjamin Hermalin and Michael Weisbach** begin the volume with an analysis of the corporate governance role of boards. The authors survey the wide range of economic studies that have centered on three key issues: the link between board characteristics and profitability, the effect of board characteristics on boards' observable actions, and the factors that influence board makeup and evolution. Among the empirical results documented by Hermalin and Weisbach are the findings that board composition does not seem to predict firm performance and that board size has a negative relationship to performance. However, the authors observe that because little theory exists to accompany the studies they examine, interpreting the empirical results—particularly with respect to possible policy prescriptions—can prove difficult.

Equity-based compensation and equity incentives are components of corporate governance that are of special interest to investors and regulators. **John Core, Wayne Guay, and David Larcker** synthesize the broad literature in this field and conclude that research on stock-based compensation and incentives has generated many useful insights. By the same token, they contend that the performance consequences of equity-based compensation, as well as of equity ownership, raise fundamental questions yet to be answered by the literature. For example, the authors find support for the proposition that performance-based compensation contracts, such as stock options, motivate top executives to enhance firm value. However, they also caution against making normative statements—such as option repricings are linked to weak governance—without fully accounting for the objectives of shareholders, the characteristics of managers, and other factors that influence the decision-making process.

Some researchers argue that investors with a large block of shares in a company have sufficient incentives to absorb the cost of monitoring its management team. Others, however, contend that these investors could benefit themselves to the detriment of minority shareholders. **Clifford Holderness** adds to this body of research by reviewing the empirical literature on blockholders in public corporations. He focuses on four key topics: the prevalence of blockholders; the motivation for block ownership; the effect of blockholders on executive compensation, leverage, takeover incidence, and a wide range of corporate decisions; and the ways in which large-percentage shareholders can affect firm value. Perhaps the most striking result obtained by Holderness is that most corporate decisions are unaffected by the presence of blockholders. In accordance with that finding, the author suggests that large-percentage shareholders are not likely to consume corporate resources to such an extent as to harm a firm. Thus, small investors and policymakers should have little cause for concern—or comfort—over the presence of blockholders.

Investors, regulators, and other corporate stakeholders value financial accounting information on firms because it enables them to monitor the actions of corporate insiders, thereby promoting enforceable contractual arrangements. The paper by **Robert Bushman and Abbie Smith** examines the central role played by credible financial accounting information in the governance of publicly traded firms. Bushman and Smith provide a basis for understanding how such information operates in an economy, discuss a range of research findings, and offer a conceptual framework for characterizing and measuring corporate transparency at the country level.

Taken together, these articles provide an essential context for the second set of studies in the volume, which focus on governance in the banking industry. The results in these studies shed light on why banks may differ in their corporate governance from firms in other, unregulated industries. These differences, in turn, present their own challenges for bank managers, regulators, investors, and depositors.

The challenges are first examined in the work by **Jonathan Macey and Maureen O'Hara**, who argue that commercial banks pose special corporate governance problems not only to managers and regulators, but also to claimants on the banks' cash flows. The authors contend that bank officers and directors should be held to a broader, if not higher, set of standards than their counterparts at unregulated, nonfinancial firms. Moreover, they recommend that the scope of the fiduciary duties and obligations of bank officers and directors be broadened to address the interests of fixed as well as equity claimants. Top bank executives, in the authors' view, should take solvency risk explicitly and systematically into account when making decisions.

Kose John and Yiming Qian consider another important theme in the corporate governance of banks: the effect of the

incentive features built into the compensation plans of bank chief executives. One theory popular in the literature is that shareholders want boards of directors to compensate CEOs with equity-based plans, such as stock options, because the plans strengthen the relationship between CEO pay and firm performance, known as pay-performance sensitivity. Stock options, however, can motivate CEOs to pursue riskier investment strategies. If a firm has debt in its capital structure, riskier strategies benefit stockholders at the expense of debtholders. This, in turn, gives rise to a debt premium. To reduce the cost of debt, leveraged firms are more likely to curtail their use of stock options. John and Qian find that, consistent with this economic theory, the pay-performance sensitivity for bank CEOs is in fact lower than it is for CEOs of manufacturing firms. They attribute the difference largely to the higher leverage of banks.

Renée Adams and Hamid Mehran focus on the differences between the corporate governance of banking firms and manufacturing firms. They find that the most significant differences relate to board size, board makeup, CEO ownership and compensation structure, and block ownership. These differences across banks and manufacturing firms, according to Adams and Mehran, support the theory that governance structures are industry-specific. The differences also raise the question of whether they arise more from the effects of regulation or from the particular characteristics of banks.

Conclusions and Implications

Several important conclusions—each with implications going forward—can be drawn from this collection of studies:

- Thus far, research on the corporate governance of public institutions has raised more questions than answers. In particular, the causes of problems and the consequences of governance structures remain elusive.
- One cannot evaluate the weakness or strength of an organization's governance by examining only a subset of factors affecting the governance structure. All corporate governance components are ultimately part of an interrelated system that determines the value of a corporation and the allocation of such value among various claimants. Empirical studies and regulatory changes need to consider these interrelationships in order to achieve their respective goals.
- The components of a firm's governance structure are determined by many factors: by the nature of the firm's assets, such as business risk, real assets, leverage, and cash-flow patterns, as well as by firm size, industry, and regulations. These complex interactions influence the equilibrium of firms' governance structures and give rise to different structures in different industries—and even in the same industry. Thus, reforms that do not take into account industry differences may not have the same intended effect across industries.

It is worth noting that most of the articles in this volume were completed before the many 2002 public and private initiatives for corporate governance reforms. Nevertheless, it is fair to say that the conclusions drawn remain fresh. Specifically, this volume focuses on economic or market-based solutions to a persistent problem inherent in the nature of corporations: the conflict of interest between managers and shareholders. The recent round of reforms and regulations aimed at addressing this problem will likely improve the governance of some institutions. However, only through an ongoing process can any universal benefits of reforms be realized.

It is also fair to say that researchers have further to go in explaining how governance works and in advancing the consensus on optimal corporate governance practices. Over the next few years, analyses of the effects of the 2002 governance reforms will likely contribute substantially to the understanding of corporate governance. We hope that this volume will assist practitioners and academics in those efforts.

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