Governance and banks

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Bank governance and the economy

• We care about bank governance in particular because of the peculiar role of banks in the economy: Bank governance and systemic risk

• But, one can have excellent governance and healthy banks and bank induced systemic events:
  - Spanish banks and the gigantic real estate bubble
  - They have yet to receive an euro of public capital.
  - S&Ls (“Cajas”) is another story; more below.
    - Competitive governance
  - The role of securitization
Governance and financial innovation

- Governance and risk management.
- Board are the first principal in a pyramid of principal agent problems.
- Leverage makes banks incredibly sensitive to “governance mistakes”
- One cannot think of governance independently of financial innovations:
  - Change in nature of principal agent problems.
  - Derivatives allow risk taking with little capital
  - Knowledge at the top (the board) and at the bottom (the trader)
Governance and supervision

• Governance and the role of the supervisor

• It is precisely because:
  - Of the special role of banks
  - Degree of obsolescence of corporate governance structure due to financial innovation:
    - Securitization
    - Off-balance sheet
  - Competition among financial intermediaries

that prudential supervision is essential.

• Governance and competition

• Example: Spanish banks and the Bank of Spain
The “cajas”: Bad governance? - 1

- The “cajas” (the Spanish S&Ls) are where the problem of the Spanish financial system is:

- Why?
  - “FDIC” insured
  - Evident implicit political guarantee by local governments
  - Ability to attract good management?
    - Some evidence that they were the lead in particularly bad (syndicated) loans but not overwhelming.
    - Profit maximization not an objective: Cajasur, intervened by the Bank of Spain last weekend, “owned” by the catholic church and run by a priest.
  - No market mechanism of discipline
• The political connection: Is it always bad?
  - Neither formal governance institutions (how the board is appointed) nor real ones (political connections in the board) correlate with portfolio composition or performance (Cuñat and Garicano, 2010):
    - The Basque “cajas” are the ones that have more political boards and yet they are the better run!

• It’s the chairman not the board: Loan composition and performance is worse
  - If the chairman was previously a political appointee.
  - If the chairman does not have an MBA or Ph.D.
  - If the chairman has no banking experience