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THE CORPORATE GOVERNANCE MODELS FOR BANKS: A COMPARATIVE STUDY

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Abstract:

An effective corporate governance system is vital in modern-day economics and firms. It can help to specify the distribution of roles, responsibilities, and resources among various stakeholders of an organization or society. The enhanced role of the banks in various economic systems demands a higher level of corporate bank governance for a stable and sustainable financial system. In this paper, four major corporate governance models of banks are compared and the financial outcomes of each model are analyzed to assess their alignment with expectations of an effective corporate governance system. The Continental corporate governance model found to be closer to the expectations of an effective corporate governance system compared to the Anglo-Saxon, Chinese, and Islamic banking. Banks under the Continental model charge lower margin to its customers, use bank resources more efficiently and create relative balance in the distribution of resources among all stakeholders compared to the other three models. Banks under the Anglo-Saxon model are charging higher margin to its customer, Chinese banks are under-utilizing the banks' resources, and Islamic banks are more favoring their shareholders and are riskier among banks of all selected models. Higher involvement of the more stakeholders in the decision-making process of the banks is key to effective corporate governance and sustainable banking system. Reforms in all corporate governance models are recommended while keeping in mind the prior research on corporate governance especially the Sir Adrian Cadbury report.

Key words: *Corporate Governance, Islamic Banking, Anglo-Saxon, Continental, Stakeholders*

1. Introduction

Most business models of modern-day enterprises are primarily based on the economic theory of Adam Smith (1723-1790). A dominant social, political, and economic system, first in Western Europe and later in most parts of the world, emerged from his thoughts over the period of the centuries. This system functions very differently from previous economic systems and named as "capitalism". The capitalist economic system redefines the roles and responsibilities of various stakeholders of society (Hunt & Lautzenheiser, 2015). The stakeholders of a society or enterprise are decided on the basis of their contribution to the production process which also called forces or factors of production. The number of these factors differ among various economic theories but most common are land, labour, and capital (Mankiw, 2014). The economic ideas of Adam Smith

provided the basis for the distribution of “The Wealth of Nations” among the forces of production (Hunt & Lautzenheiser, 2015). There are few other economic systems too which provided the framework of income distribution among the forces of production and other social partners. However, most of the world economies are based on some form of the capitalist system (Backhouse, 2004; Hunt & Lautzenheiser, 2015).

Most of the historical economic systems were labour and land extensive. The dominant role of capital came in the era of industrialization where a large number of machines were required to meet the need of the growing population. Innovations in transportation increase the trade among various regions and nations of the world which further increases the importance and need for capital. The workers or labour did not have sufficient money to meet the capital needs of their businesses growth as a result they acquired capital from various other stakeholders who were not physically participating in the production process. This separation provides managers/workers, who run enterprises, with the opportunity to pursue their own interests, which may not be aligned with the shareholder’s objectives. A governance system was required to protect the interest of capital providers in enterprises. The major reason for having a corporate governance structure is to reduce agency problems that are caused by the separation of ownership and control (Berle & Means, 1932). Therefore, the main focus of several corporate governance systems is the protection of the capital providers’ interests instead of other stakeholders of the enterprises or society.

The scarcity of capital enhanced the role of financial institutions in an economic system. One group of financial institutions is led by the banks which mobilize and allocate funds from savers to productive investment opportunities. The second group comprises of the financial markets where enterprises directly acquire funds from the savers. The economic system of each country is dominated either by one of these groups or balanced among both to form the financial system of an economy. The complexity of the financial institutions increases the asymmetry of information and diminishes stakeholders’ capacity to monitor the managers’ decisions. For all these reasons, financial institutions are subject to more intense corporate governance and regulations than other firms (De Andres & Vallelado, 2008; Ullah, 2020). Accordingly, the mechanism of corporate governance is formulated to meet the social, cultural, and economic needs of the country, institutions, and individuals. Regardless of the dominance of each group, the role of financial institutions is critical in every modern-day economic system.

The business model of banks or financial institutions is different compared to general business enterprises. The banking system of a country operates the payment systems, acts as a conduit for monetary policy, and plays an important role in financial intermediation. Banks have a higher level of leverage compared to other firms and responsible to maintain liquidity in the economy. The importance of the banking system in economic growth and human well-being is widely recognized by economists and policymakers (Beck, Demirgüç-Kunt, & Levine, 2009; Cecchetti & Kharroubi, 2012; Levine, 1997). Every healthy and vibrant economy requires a banking system that moves funds from savers to productive investment opportunities under effective government supervision and corporate governance (Mishkin, 2016; Schumpeter, 1912). An efficient financial intermediation ensures the availability of funds at a lower cost for household and business

consumers, which helps to accelerate economic growth and societal well-being (Mishkin, 2016; Wall, Reichert, & Mohanty, 1993). An inefficient financial intermediary will not necessarily be able to meet the commitments to all stakeholders in the long run, which may result in the failure of the intermediary. The failure of one intermediary may spread by contagion to the rest of the financial sector and the larger economy, which may ultimately lead to a financial crisis (Allen & Gale, 2000). Given the importance of banks, the governance of banks themselves assumes a central role. A sound governance system of a bank can assure an efficient allocation of capital and effective governance of the firms they fund.

Before reviewing the various corporate governance models of banks, it is better to review the concept of corporate governance articulated by various researchers and organizations. Following are the most prominent and in practice definitions of corporate governance:

"Corporate governance is holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations, and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for states is to strengthen their economics and discourage fraud and mismanagement" (Cadbury, 1992).

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structures specify the distribution of rights and responsibilities among different participants in the corporation and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance" (OECD, 1999).

These two definitions are the stepping stones for the development of the various corporate governance models and are adopted by several regulatory institutions. Discussion about the effectiveness and importance of the corporate governance revived after each financial crisis. A number of studies and researches are conducting to find the reasons behind each crisis but findings are about similar each time. The common findings of, either the Asian Financial Crisis (AFC) or Global Financial Crisis (GFC), are the weak financial structure of many companies, lack of transparency, lack of disclosure and accountability, little or ineffective laws to ensure fairness among all stakeholders of the companies (Beltratti & Stulz, 2012; Greenbaum, Thakor, & Boot, 2016; Hasannasab, Margaritis, & Staikouras, 2019). An effective governance includes safeguarding the interests of shareholders and stakeholders through transparency, accountability, trustworthiness, and responsibility. The corporate governance models of each country are overhauled after each crisis on the basis of these findings and guidelines of the international multilateral institutions. More emphasis is paid toward the corporate governance of the financial institutions which have a very critical role or epicenter of many financial crises. The motivation of this paper is to compare the various corporate governance models formulated for banks in different regions of the world and analyze their alignment with the true definition of the effective corporate governance.

2. Corporate Governance Models

A number of corporate governance models evolved over the time under the influence of the cultural and economic orientation of the country or region. These governance models are applicable to the corporations in general and specifically designed for the financial institutions. In this paper, four major corporate governance models of banks are reviewed which provides a basic framework of governance in most of the countries. These four basic corporate governance models are Anglo-Saxon, Continental, Chinese, and Islamic banking.

The salient features of each corporate governance model are given in Table 1. The Anglo-Saxon is the most dominant corporate governance model championed by the big economies of USA and UK, which is evident from being practiced in Canada, Australia, New Zealand, and many Asian and African countries. It is considered to be more business-friendly relative to the other models, due to lower government intervention, taxes, trade barriers, and capital friction. Developed financial markets and well-established banks are the backbones of this model. It is relatively easy in this model to raise business capital through financial markets and the banks. One of the most distinctive aspect of the Anglo-Saxon model is the structure of corporate ownership where the share ownership is widely dispersed and shareholders' influence on management is weak. Apparently, the central preoccupation of corporate governance in this model is to protect the interest and rights of the shareholders. Protection of shareholders' and creditors' rights, deregulation, the autonomous central bank, lower capital requirement, and enhanced management role are the salient features of this model.

The advocates of the Anglo-Saxon model claim that it encourages entrepreneurship and increases economic activities because it makes conducting business easier due to lower business barriers and higher protection of the investor's interest. Several research studies found that the Anglo-Saxon model has promoted more competition and flexibility in society through privatization and deregulation (De Bandt & Davis, 2000; Mitchell, Muysken, & Van Veen, 2006). Although, it reinforces profit-oriented behaviour and a struggle for material success by individual entrepreneurs and managers however this short-term, profit-oriented behaviour and individualism are combined with a set of appropriate institutions to enhance its effectiveness. The market phenomenon of a hostile takeover is another strength of this model, where management is taken over if shareholders are not satisfied with the current management of the firm (Cernat, 2004). The opponents of this model claim that it focuses too much on maximizing short-term profits, and therefore does not place enough emphasis on long-term planning, social well-being, and sustainability. It is difficult to find any representation of labour, social partners, and other stakeholders in the decision-making process of the banks following the Anglo-Saxon model. The level of government supervision is also insufficient to protect the rights of labour, social partners, and other stakeholders (Cuervo, 2002; Mitchell et al., 2006).

The Chinese model is opposite to the Anglo-Saxon corporate governance model. Higher government intervention, block shareholding, higher entry barriers, limited capital market role, and higher corporate taxes are salient features of the Chinese model (Li, Yue, & Zhao, 2009; Zogning, 2017). In recent years some reforms are introduced in the Chinese

model however it is still primarily based on the socio-economic ideology of Communism. This model is led by China along with Laos, Vietnam, Cuba, North Korea, and a few other countries. Ownership of all major banks in these countries is held by the state-owned enterprises (SOEs) and recently a small portion of shareholding is offered to foreign and common shareholders. Some reforms in corporate governance of banks are also introduced to accommodate the non-SOEs shareholders. The representation of non-SOEs shareholders and debtholders is available now, a supervisory board is introduced in many large corporations to represent labour, and the formal codes of corporate governance are also articulated (Hassan & Xie, 2013; Jiang & Kim, 2015). Like most other codes from around the world, China's code contains broad and vague language that describes merely guiding principles rather than explicit regulations (Zogning, 2017). The Critics of this model claim that the governance of Chinese banks serve the political agenda of government instead of workers, customers, social partners, and other stakeholders. The problem of financial tunneling by the large SOEs shareholders in China is widely reported in prior studies and proved to be destructive for the firm value. It is reported in prior studies that higher government intervention in corporate business may compromise the effectiveness of the corporate governance system and it is the key to the Chinese model (Levine, 2004; Zogning, 2017).

Table 1. Comparison of Corporate Governance Models

Feature	Anglo-Saxon	Chinese	Continental	Islamic
Geographical presence	US, UK, Canada, Australia, Ireland, etc.	China, Vietnam, North Korea, etc.	Most European Countries.	GCC, Malaysia, Indonesia, Pakistan, etc.
Government Intervention	Minimal	High	Moderate	Minimal
Influence of employees and social partners	Limited	Limited	Extensive and recognized at the national level.	Limited
Ownership Structure	Widely dispersed private ownership; dividend prioritized.	State-Owned Enterprises (SOEs) own the majority of stocks.	Mainly held by banks and corporate block-holders.	Financial institutions and corporate block-holders.
Board Structure	One-tier board of directors elected by shareholders.	Two-tier mixed board of directors nominated by the shareholder (SOEs) and nominated supervisory board.	Two-tier board of directors elected by the shareholder and nominated supervisory board.	One-tier board of directors nominated by shareholders. Advisory Sharia Board
The market for Corporate Control	Hostile takeovers are the "correction mechanism" for management failure	NA	Takeover restrictions	Hostile takeovers and acquisition activities exist
Trade Barriers	Low	High	Moderate	Moderate
Corporate Tax	Low	Moderate	High	Moderate
Role of Stock Exchange	A strong role in corporate financing.	Limited	Moderate	Limited

Source: (Cernat, 2004; Hasan, 2012; Li et al., 2009; Tobin, 2012)

The Continental model of corporate governance is based on the stakeholder theory of firms. It considers not only the interests of shareholders but also input from the other stakeholders of the business. More employee rights, social participation, government intervention, higher trade barriers, and corporate taxes are the main features of this model (Cernat, 2004). It is also called the European Social Model, which combines economic growth with high living standards and good working conditions. It dominates Germany, France, and a few other countries of Continental Europe (Aerts, Cormier, & Magnan, 2007). A two-tier administration is based on the board of directors and a supervisory board. The board of directors is elected by the shareholders and the supervisory board includes labour, social partners, and other stakeholder's representatives. It is a more regulated market compared to the Anglo-Saxon and less compared to the Chinese model however enforcement of the higher regulations is a challenge in most of these countries (Cuervo, 2002). The concentrated large shareholders assume the control of the firms therefore management did not face hostile takeover bids. The large shareholders are mostly institutional and are well-informed therefore it is assumed to be more useful to deal with the hazards associated with information asymmetries, investment in specialized assets, R&D, and long-term investments, and the agency problems of large organisations (Cuervo, 2002). Most of the large shareholders are financial institutions which mean banks are owned by banks and agents are managing agents. Moreover, the stock markets in these countries are less liquid due to concentrated shareholding and a "corrective mechanism" of a hostile takeover is also missing. Although it is more complex compared to other models but it ultimately reconciles the interests of different stakeholders.

The corporate governance model of the Islamic banks is primarily based on the Anglo-Saxon model with the addition of the Sharia Board. The size of the Islamic financial services industry (IFSI) was USD 2.19 trillion at the end of 2018 and spread over more than 100 countries. However, it is working parallel with traditional banking models in most of the countries. Prominent markets of IFSI are Gulf Co-operation Countries (GCC), Iran, Sudan, Malaysia, Indonesia, Brunei, Bangladesh, and Pakistan. The ownership structure is concentrated and mainly held by financial institutions. The Board of Directors (BOD) is mostly nominated by the block-holders along with some independent members. The Sharia compliance board makes sure that the Islamic products and services are compliant with Sharia Islamic law. Sharia board members have not any executive or supervisory role in the decision-making process of the BOD. Primarily, IFSI is based on a one-tier administration board. Although, the products and services of IFSI are compliant with Sharia law but the corporate governance model is not aligned with Islamic principles of corporate governance. Islamic corporate governance is based on principles of *Tawhid*, consultation, fair distribution of wealth, equality, and justice (Hamid, Haniff, Othman, & Salin, 2011; Slahudin, 2008). Prior studies propose, for the long-term interest of IFSI, the establishment of an independent Sharia board to oversee the implementation of the principles of Sharia in every process of the bank. These authors emphasize that if the Islamic banking system is not perceived as Islamic, existing IFSI will soon lose much of their market (Hamza, 2013; Iqbal, Ahmad, & Khan, 1998).

After a theoretical comparison of the selected corporate governance models, the next objective is to analyze the financial outcomes of each model. The analysis is based

on the objectives of the corporate governance system which stated earlier that it encourages the efficient utilization of resources and holds the balance between the economic and social goals of the individuals and corporations (Cadbury, 1992). A few financial outcomes of the banks from leading countries of each corporate governance model are given in Table 2.

The ratio of net interest margin is the difference between the rate bank pays to savers and charge to the borrowers. A higher margin means either bank paid lower rate to the savers or charged a higher rate to the borrower or both. In all three cases, the bank violated the principle of balance between in economic and social goals of individuals and corporations. A lower interest rate on loans is better for the economy and a higher rate on savings is better for the social well-being of the savers and vice versa. In case of a higher net margin, banks took more share of returns compared to the other two stakeholders of the banks which is not aligned with the basic principle of corporate governance. Moreover, the higher net margin is considered as a form of agency problem where managers have more money available to spend on operating activities which may not be aligned with other stakeholders of the bank (Bikker & Vervliet, 2018; Mishkin, 2016). As per the data reported in Table 2, the Anglo-Saxon countries are charging the highest net interest margin, followed by the Chinese and Islamic banking models, and the Continental countries are at the lowest. It implies that the Continental model, based on the stakeholder theory of the firm, is a better corporate governance model compared to the other three models in delivering the balance in the economic and social objectives of individuals and corporations.

The other major objective of corporate governance is the protection of the shareholders' interest, the ratios of ROA and ROE are given in Table 2 for this purpose. A consistent higher return on assets and equity is the ultimate objective of every bank and is considered as a sign of better financial performance. It is recognized in prior studies that a consistent good financial performance is not possible without satisfying the all major stakeholders of a firm (De Andres & Vallelado, 2008; Mergaerts & Vander Vennet, 2016). The highest return on equity is in Chinese model countries, followed by Islamic banks, and Anglo-Saxon model countries show that these models delivered beyond the protection of shareholder's interest. The assets of banks are usually financed by three parties; depositors, bondholders, and shareholders. An extremely higher return on equity compared to the return of the rest of the assets again proves that the balance between three financiers is ignored. Although, the shareholders bear more risk than the other two parties but the returns are far higher. A higher return for shareholders on the cost of other major stakeholders may not be sustainable in the long run. Justice and balance based on risk and returns can be observed in Continental model countries which is lower than the other three models. The Anglo-Saxon, Chinese, and Islamic banking models are favoring shareholders instead of protecting their interest which is not good for the long-term sustainability of the banking systems.

Table 2. Performance of Corporate Governance Models

Model	Interest Margin	ROA	ROE	Efficiency	Risk
Anglo-Saxon Model					
USA	3.28	0.85	7.60	59.25	2.76
UK	1.65	0.16	2.29	63.90	2.51
Chinese Model					
China	2.82	1.07	16.86	35.26	1.34
Vietnam	3.26	0.84	10.61	52.60	2.74
Continental Model					
Germany	0.92	0.08	1.82	81.46	2.58
France	0.89	0.27	7.20	67.22	3.97
Islamic Banking Model					
Global Islamic Banks*	2.50	1.71	15.92	53.17	5.14

Note: *INTEREST MARGIN* is average net interest margin, *ROA* is the average return on assets, *ROE* is the average return on assets, *EFFICIENCY* is the average cost-to-income ratio, and *RISK* is average non-performing loans to gross loans ratio for the period 2009-2017. *it is a global weighted average of all Islamic banks for the year 2017.

Source: (IFSB, 2019; WorldBank, 2018)

Another objective of banking and corporate governance is the efficient utilization of resources (Cadbury, 1992; Schumpeter, 1912). An efficiency ratio of Cost-to-Income of banks from each governance model is reported in Table 2. A higher efficiency ratio is considered as better firm performance and sustainable in the long run (Berger, 2007). The efficiency ratio of Chinese model countries is lowest and Continental model countries is highest among all selected models. The pattern of efficiency performance is very similar to the balance and equality performance among all four models. The involvement of more bank stakeholders in decision making and supervision can help banks to be more efficient. The efficient allocation of bank resources can bring growth in the economy, social well-being, and financial stability (Beck et al., 2009; Belke, Haskamp, & Setzer, 2016).

Another variable of bank performance reviewed in this paper is the level of risk, a lower financial risk is vital for the survival of a bank and sustainability of the banking system and vice versa (Beltratti & Stulz, 2012). The level of risk is highest in Islamic banks followed by the Continental and Anglo-Saxon model countries. The ratio of non-performing loans (NPL) to total loans is not significantly high in selected countries except Islamic banks. It may be concluded that the performance and approach of the Continental corporate governance model is better than other models which may be due to greater involvement of more stakeholders which is consistent with prior studies (Anginer, Demirguc-Kunt, Huizinga, & Ma, 2018). As discussed earlier that the Continental model has the representation of labour and social groups in the supervisory board to oversee the decisions of the board of directors and executives. Although the Continental model is not ideal however it is closer to the true definition of corporate governance therefore it is able to deliver performance for all stakeholders of the banks.

3. Conclusion

A need for an effective corporate governance system was felt in current economic models very long ago. The enhanced role of banks in the modern-day economic system

required more effective corporate governance for economic growth, stability, and social well-being. The concept of corporate governance evolved over the time with the contribution of various researchers and regulatory bodies. An effective corporate governance system assumed to promote the efficient utilization of resources and align as nearly as possible the interests of individuals, corporations, and society. Four major corporate governance models of the banks are compared in this paper and the reconciliation of these models with expectations of a corporate governance system is analyzed. Nine salient features of Anglo-Saxon, Chinese, Continental, and Islamic banking models are compared and five financial outcomes of each model are analyzed.

The Continental model found to be more aligned with expectations of the effective corporate governance systems compared to the other three models. It is charging a lower margin to customers, hold a balance in the rate of return among financiers and more efficient utilization of bank resources. The Anglo-Saxon model is charging the highest margin to the customers, the Chinese model banks are most under-utilizing the resources, and the Islamic banks are highly biased toward the returns for shareholders. Although, the Continental model is not an ideal corporate governance system however is better compared to other models due to the higher involvement of more stakeholders of the banks in the decision-making process. Some recent research and policy studies have recommended merging environmental, social, and corporate governance (ESG) in the business model of every organization for a sustainable future (Chevrollier, Zhang, van Leeuwen, & Nijhof, 2020; Sullivan, Martindale, Feller, & Bordon, 2015). Therefore, it is recommended that all corporate governance models need to be reformed for higher participation of more stakeholders of the banks for stable and sustainable banking systems.

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