International reports vary widely on what the prime objective of bank corporate governance should be, with one group recommending a shareholder-based approach, and the other a stakeholder-based one. Moreover, the focus of these reports is exclusively on risk avoidance, with little guidance as to how an acceptable level of risk should be defined. Drawing on insights from economics and finance, this paper is intended to contribute to the debate on bank corporate governance.

Understandably, the global crisis has generated a vast amount of emotion. What is needed is an efficient regulatory/bankruptcy system to promote stability and an efficient corporate governance system to promote economic development and risk taking.

The Financial Crisis and the call for better Bank Corporate Governance

The severity of the global crisis, the huge public costs of bailing out the banks, burgeoning budget deficits and the large losses incurred by private shareholders have prompted the chorus of ‘never again’. Bank corporate governance had failed in several cases; a view enforced by the fact that banking crises seem to be a recurrent phenomenon, with 11 major financial crises observed over the last 30 years. It is the succession of financial crises which has inspired the call for a review of corporate governance in the banking sector.

The international proposals for better banking highlight the division between two camps – shareholders-based focus and stakeholders-based focus. The Walker Report, which builds on the UK Companies Act, is resolutely based in the shareholder-based camp, but it does not imply that other stakeholders be ignored. However, according to this report, a single goal should be pursued by the directors, and that is to promote the welfare of the shareholders, the owners of the corporation.

In sharp contrast, the proposals for improved bank corporate governance by the Basel Committee and European Union favour the stakeholder view with multiple objectives, as can be seen in their report, after outlining the responsibilities, it says, “In discharging these responsibilities, the board should take into account the legitimate interests of shareholders, depositors, and other relevant stakeholders.”

In a market-based economy, several types of corporate governance mechanisms may exist and co-exist. Which form of corporate governance leads to the most efficient outcome for society? In an attempt to answer this question, this paper includes discussions on the governance of bank regulators and supervisors, and the corporate governance by the boards of banks.
Governance of Bank Supervision

Unlike CEOs of banks, very few heads of national supervisory authorities have been asked to step down over the past three years. In our opinion, the independence and accountability of banking supervisors, and appropriate legal mechanisms to privatise bank losses, are needed. Furthermore, the need to evaluate bank supervisors calls for the development of measures of performance, with a clear linkage between results and promotion/remuneration needed to build the correct incentive structure.

To reinforce financial stability, we propose tools to develop a legal mechanism that forces debt holders to bear bank losses. Appropriate mechanisms can be put in place to reduce the likelihood of a banking crisis and the potential consequences for the public finances.

Bank Corporate Governance

We present arguments on the stakeholder-based view which are centred on organisational efficiency, entrepreneurial innovation and economic welfare. We favour a dual-governance system based on clear objectives and accountability: the governance of banking supervision should insist upon a clear objective (stability of the banking system) and accountability of supervisors. The governance of banks should concern itself with the maximisation of the welfare of shareholders.

In promoting a pro-shareholder-based view, we believe that in a world where financial market reward short-term reported profits, it is the responsibility of the bank’s board to take care of long-term value creation, even if it means hurting reported revenue and the share price in the short term. We believe that conceptually, a long-term value-based approach should provide guidance on how much risk is acceptable.

Since the case for improved bank corporate governance rests in part on the perception of risk, we identify relevant stress tests; look at risk and uncertainty and the cognitive biases in risk assessment.

Another aspect that needs further review is the common perception among the public, press and many politicians, that compensation schemes have been, in part, responsible for excessive risk taking and the global banking crisis.

Our four main conclusions are as follows. The debate on bank governance should concern not only the boards but also the governance of banking supervision; biases for short-term profit maximisation are numerous and boards of banks should focus on long-term value creation; board members and banking supervisors should pay special attention to cognitive biases in risk identification and measurement; a value-based approach to risk taking must also take into account the probability of stress scenarios and the associated costs of financial distress. Mitigation of these costs should be addressed explicitly in the design of bank strategy.

Full publication available on: http://www.insead.edu/facultyresearch/research/doc.cfm?did=47338
Countering the widely held view that chief executive officer (CEO) succession is generally beneficial in turnaround situations, we adopt executive fit/refit logic, proposing that the implications of CEO replacement depend integrally on the incumbent’s degree of misfit and the successor’s degree of fit to the contextual conditions at hand. Drawing from prior turnaround research, we identify several prominent forms of CEO fit/misfit that are especially germane to troubled firms. In testing our hypotheses, we find substantial support for the fit/refit theory: troubled companies have substantially better performance to the extent that they replace incumbents who are poorly suited to the conditions at hand and when they appoint new CEOs who are well matched to those conditions. Further reaffirming the fit/refit model, we find that CEO replacement per se has no general effect on the improvement of troubled firms.

Conventional wisdom says that if a company is in trouble replace the CEO, but our research finds that the simple act of replacing the CEO of a troubled company has no effect on its performance. The implications of CEO replacement depend integrally on the incumbent’s degree of misfit and the successor’s degree of fit for the situation at hand.

We studied CEO replacement in turnaround situations by applying a fit/refit logic, which envisions that succession will be most beneficial to the extent that the predecessor is unsuitable and the successor is suitable. We are able to specify the characteristics that amount to a fit or a misfit before looking at the results, which is essential to the validity of the study.

We test the predecessor’s misfit and the successor’s fit for three different situations and after doing so, we conclude that a company still might want to replace the CEO but should think carefully about whether his or her qualities are really ill-suited for what needs to be done.

**Best CEO for the job: Insider or Outsider?**

In other words, the performance implication of CEO replacement depends on the actual characteristics of the incumbent and whether the new person really has the qualities now needed. The simple act of changing CEOs is not going to accomplish anything. However, if a company gets rid of their CEO who is ill-suited for the conditions at hand and brings in someone who is well suited for those conditions, then performance substantially improves.
For example, we find that if the industry is in bad shape and the incumbent CEO is a long time veteran of that industry, he won’t be able to think his way out. He’s too trapped by the baggage of the accumulated wisdom of that industry, so the longer the tenure of the industry incumbent, the more a company will benefit from getting rid of him. Meanwhile, we do not recommend turning to an industry-insider or someone else within the company as the new successor.

The direct implication of our studies is that boards should think carefully about whom they are getting rid of and whether the new person is really the right person for the job. The boards of troubled firms are often under pressure to make prompt leadership changes, thus lacking deliberateness or care in such actions. They may succumb to any number of well-known distortions in CEO hiring, including political compromises, an undue emphasis on executive charisma, or simply superstition that CEO replacement – in and of itself – is a cure-all, regardless of who is leaving and who is arriving.

We highlight the importance of alignment between managerial capabilities and contextual requirements, and as such it provides a corrective to the assumption that incumbents in troubled companies are inherently unsuited for their positions and the new CEOs will do better. Our study has implications for multiple research streams, most notably upper-echelons and corporate governance literature. We extend the centrally important idea that executives have finite, bounded repertoires, and that the value of a given executive’s repertoire depends on the business context.
The inner workings of the top executive team, and their importance for firm performance, are hard to observe or quantify. In this paper, we aim to contribute to the subject by introducing a new measure pertaining to the relationship between the Chief Executive Officer (CEO) and the other members of the top executive team, as well as studying the relation between this measure and the performance and behaviour of firms. Our new measure is CEO Pay Slice (CPS), which is defined as the fraction of the aggregate compensation of the firm’s top-five executive team captured by the CEO. By basing CPS on compensation information from executives that are all at the same firm, we control for any firm-specific characteristics that affect the average level of compensation in the firm’s top executive team.

The study looked at more than 2,000 publicly traded companies in the U.S. Such firms must disclose publicly the compensation packages of their five highest-paid executives. Our analysis focussed on the CEO “pay slice” – that is, the CEO’s share of the aggregate compensation such firms award to their top five executives. We found that the pay slice of CEOs has been increasing over time. Not only has compensation of the top five executives been increasing, but CEOs have been capturing an increasing proportion of it. The average CEO’s pay slice is about 35%, so that the CEO typically earns more than twice the average pay received by the other top four executives. Moreover, we found that the CEO’s pay slice is related to many aspects of firms' performance and behavior. It turns out that the bigger the CEO's slice of the pie, the lower the company's future profitability and market valuation.

The paper reveals a number of important correlations between what is known as “CEO pay slice” and various key measures of corporate financial performance. The study found that firms with a higher-than-average CEO pay slice were more likely to:

- Generate subpar returns for their shareholders.
- Produce lower profitability based on total assets and available capital.
- Make worse-than-average acquisition decisions.
- Reward their CEOs for fortuitous events (e.g., a rise in profits for an oil company due to an increase in worldwide oil prices) rather than for the outcome of their actual business decisions.
- Overlook poor performance, such that the probability of CEO replacement in the face of adverse earnings was lower than in comparable organizations where the CEO’s pay slice was smaller.
- Provide CEOs with favourably timed options grants, an indication of either deliberate backdating or the use of inside information.
Governance Correlation

What explains this emerging pattern? Some CEOs take an especially large slice of the top five executives’ compensation because of their special abilities and opportunities relative to the other four. But the ability of some CEOs to capture an especially high slice might reflect undue power and influence over the company’s decision-making. As long as the latter factor plays a significant role, the CEO pay slice partly reflects governance problems.

We should stress that a positive correlation between a CEO’s pay slice and governance problems does not imply that every firm with a high CEO pay slice has governance problems, much less that such firms would necessarily be made better off by lowering it. In some such firms, the large pay slice captured by the CEO may be optimal, given the CEO’s talents and the firm’s environment, and reducing the CEO pay slice might thus make the firm and its shareholders worse off.

Still, our evidence indicates that, on average, a high CEO pay slice may signal governance problems that might not otherwise be readily visible. Investors and corporate boards would thus do well to pay close attention not only to the compensation captured by the firms’ top executives, but also to how this compensation is divided among them.

Beyond our particular findings and their interpretation, our general conclusion is that CPS is an aspect of firm governance and management that deserve the attention of researchers. Future research on the effects of governance arrangements and management processes - as well as research on a wide range of aspects of firm behaviour and decision-making - could consider using CPS as a useful control or a subject of investigation. We hope that our work can provide a framework and a starting point for this line of work.

It turns out that the bigger the CEO’s slice of the pie, the lower the company’s future profitability and market valuation


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