

REGULATION, CORPORATE GOVERNANCE AND RISK MANAGEMENT IN BANKS AND INSURANCE COMPANIES

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ABSTRACT

Regulation may impact on financial risk taking by financial intermediaries by way of the decision-making process envisaged in the various possible legal structures set forth by the law. In Europe there are three different possible board structures: the one-tier board system, typical of the UK, Spain and many other countries, the vertical two-tier system, typical of Germany and of the Netherlands in the case of large companies and countries in which companies may choose between different models, such as France and Italy. The vertical two-tier system, was introduced in Italy with the company law reform in 2003. In the last eighteen months it was chosen in three of the most recent bank mergers in Italy (Intesa-Sanpaolo IMI, Banca Popolare di Verona e Novara-Banca Popolare Italiana, Banche Popolari Unite-Banca Lombarda) and also by Italy's largest investment bank Mediobanca.

It was also suggested for Assicurazioni Generali by international institutional investors. This re-fuelled the debate concerning corporate governance in Italy.

The adoption of the vertical dual system was appreciated by observers who pointed out the potential of the two-tier system in relation to the innovative role of the Supervisory Board and, especially, to its function as filter between ownership and management and in the definition of the risk appetite of financial intermediaries. Others alleged that there are no substantially innovative elements in its application compared to the traditional Italian horizontal two-tier system and underlined the risks of duplication of powers and responsibilities and the plethoric multiplication of seats on the boards.

This paper pursues a twofold objective of investigating i) the peculiarities of the corporate governance of financial intermediaries as concerns the size of the board and performance and ii), the role of committees in the risk acceptance process of European financial intermediaries considering also the type of governance system in place. Two international samples are used to conduct the analysis: the companies which make up the Eurotop 100 index and the top 40 European intermediaries by capitalization.

KEYWORDS

Corporate Governance, Board Structure, Two-tier Board Structure, Banks, Insurance Companies, Europe

INTRODUCTION

Corporate governance has become an increasingly-critical issue after the corporate scandals which occurred all over the world and its specific role in the stability of financial intermediaries was highlighted by the severe crisis which hit the financial markets from the summer of 2007. In fact, for financial intermediaries the governance system is all the more important not only because intermediaries are basically in the business of risk acceptance but also due to their special role within the economy in the aggregation and transfer of financial resources.

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This paper pursues a twofold objective of investigating i) the peculiarities of the corporate governance of financial intermediaries as concerns the size of the board and performance and ii), the role of committees (especially the audit committee and the risk committee) in the risk acceptance process of European financial intermediaries considering also the type of governance system in place.

The structure of the paper is as follows; the first paragraph is dedicated to a brief overview of the principles of corporate governance issued by various supranational entities, with particular attention paid to principles specifically devised for financial intermediaries. The second paragraph summarises relevant corporate governance literature. The third paragraph is dedicated to an empirical analysis which considers two different international samples of companies, the first is made up of the largest European companies which make up the Eurotop 100 index and the second is made of the top forty European financial intermediaries by market cap. Qualitative and quantitative elements on the governance of the companies in the two samples were drawn and their impact on performance assessed. International applications of the vertical two tier system confirm that financial intermediaries and two-tier companies have larger boards but this does not seem to impact negatively on performance. Paragraph 4 is dedicated to the analysis of the role of board committees especially as concerns the risk

acceptance and control process. Paragraph 5 concludes with certain *policy* suggestions also in light of a new vision of control which emerges from the analysis.

1. INTERNATIONAL CORPORATE GOVERNANCE PRINCIPLES

Though regulations vary worldwide general principles concerning corporate governance have been issued by various international agencies, such as OECD (Table 1), by the European Commission (Table 2) and specifically for banks by the Basel Committee (Table 3).

Table 1 – OECD Principles of corporate governance

1999	2004*
	<p>I. Ensuring the Basis for an Effective Corporate Governance Framework The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.</p>
<p>I. The rights of shareholders The corporate governance framework should protect shareholders' rights.</p>	<p>II. The Rights of Shareholders and Key Ownership Functions The corporate governance framework should protect and facilitate the exercise of shareholders' rights.</p>
<p>II. The equitable treatment of shareholders The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.</p>	<p>III. The Equitable Treatment of Shareholders The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.</p>
<p>III. The role of stakeholders in corporate governance The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.</p>	<p>IV. The role of stakeholders in corporate governance The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.</p>

<p>IV. Disclosure and transparency The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.</p>	<p>V. Disclosure and Transparency The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.</p>
<p>V. The responsibilities of the board The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.</p>	<p>VI. The Responsibilities of the Board The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.</p>
<p>Note: * New parts with respect to the 1999 version are highlighted.</p>	

Table 2 – The Commission Recommendation 2005/162/EC

Preamble	<i>18 considerations on the prior relevant discipline, on the importance of behaviour to promote trust in markets suggested in the Recommendation.</i>
Section I	<i>Scope and definitions</i>
Section II	<i>Presence and role of non-executive or supervisory directors on (supervisory) boards</i>
Section III	<i>Profile of non-executive or supervisory directors</i>
Annex I	<p><i>Committees of the (supervisory) board</i></p> <ul style="list-style-type: none"> • <i>Common features</i> • <i>The nomination committee</i> • <i>The remuneration committee</i> • <i>The audit committee</i>
Annex II	<i>Profile of independent non-executive or supervisory directors</i>

Table 3 – Principles of corporate governance for banks

Principle 1	<i>Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.</i>
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Principle 2	<i>The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation.</i>
Principle 3	<i>The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.</i>
Principle 4	<i>The board should ensure that there is appropriate oversight by senior management consistent with board policy.</i>
Principle 5	<i>The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.</i>
Principle 6	<i>The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.</i>
Principle 7	<i>The bank should be governed in a transparent manner.</i>
Principle 8	<i>The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (i.e. "know-your-structure").</i>

2. RELEVANT CORPORATE GOVERNANCE LITERATURE

Regulatory interventions on corporate governance stem from the fact that the market for corporate control often proves to be ineffective in ensuring that companies are run by the best managers in the interests of shareholders. Often companies, even listed companies, are not contestable (due majority shareholders, shareholders' agreements, and so on) and as such they are not subject to the disciplining effect of a possible hostile takeover bid.

There is extensive corporate governance literature, it focuses on internal governance mechanisms (structure of management bodies and ownership structure) and external mechanisms (market for corporate control and regulatory system). However, it often does not address the impact of such elements on performance. Studies often address a single country or there are international surveys of single governance aspects (board organisation, management compensation, ownership concentration).

Of this vast body of literature two areas are particularly relevant for the present paper: studies which address the relation between board size and composition and performance in general and studies which address the governance of financial intermediaries, which normally focus on banks.

The first set of studies which are relevant to the present analysis investigate the relation between board size (number of directors) and characteristics (independent vs. insider) and performance. From this viewpoint there are two opposite views: on the one hand, studies which address board size and composition considering **agency theory** and on the other hand studies that adopt a **resource-based view**.

Agency theory applied to the relation between **board size** and **performance** predicts that a smaller board should be more effective since it is more capable of reducing decision-making time and agency problems within the board. Empirical studies should find a negative correlation between board size and performance. Moreover, this approach emphasises the role of independent directors.

Instead, the second approach predicts that a larger board could favour better decisions since based on diversified competences and experiences and therefore a positive correlation between board size and performance. This approach suggests the importance not only of independent directors but also of directors with information on the company (insiders or executives) or with information on other companies.

There does not seem to be consistent evidence to support that board size or composition affect performance. Certain studies report negative correlation between board size and performance: studies quoted by Hermalin B., Weisbach M. (2003), and as concerns other countries a review of the literature see Denis D., McConnell J. (2003). More recently, de Andres P., Azofra V. e Lopez F. (2005), report no relation between independent directors and performance, and the negative correlation between board size and value of the company using a sample of international companies excluding financial institutions and the same effects are reported on a sample of Norwegian companies by Bøhren Ø, Strøm R. (2007). Other studies find that better performance seems associated to larger boards and in this case confirm the resource-based view, especially in the case of financial intermediaries as indicated below.

Another important issue concerns the relation between the board **composition** and performance: in theory, a wide number or a majority of **outside directors** could be associated with a better performance since it should reduce agency problems between shareholders and management. As concerns the presence of **executive directors** in the board two opposite effects have been identified. On the one hand, executive directors could positively affect performance since they provide a more in-depth understanding of the company and greater and better information on which the board may base its decisions. According to this approach, **more executive directors** may positively affect the quality of information which reaches the board, see Adams R., Ferreira D. (2007). On the other hand, the presence of executives may limit the board's effectiveness in controlling and disciplining top management.

Again empirical investigations of the relationship between board composition and performance do not lead to conclusive results: certain studies find that the presence of independent directors is positively associated with performance, Barnhart S. W., Rosenstein S. (1998), while others that report that a higher presence of external directors is not associated to better performance. Bhagat S., Black B. (2001), and the studies quoted in the surveys by Hermalin and Weisbach (2003), and Denis D., McConnell J. (2003), and more recently by de Andres P., Azofra V., Lopez F. (2005).

Studies on financial intermediaries tend to focus on banks. These studies are considered relevant for the purposes of the present study since banks and insurance companies are: i) active in the risk acceptance business, ii) strongly regulated and capital constrained and iii) over products which may be substitutes. There are Numberus studies which support the idea that **banks** should be subject to particular governance provisions due to their greater regulation compared to other sectors Levine R. (2003), Caprio G., Levine R. (2002), Busta I. (2007), or their operating characteristics, namely the deposit guarantee fund, deposit insurance and the systemic risks deriving from the management of payment systems and the transmission of monetary policy, Macey J., O' Hara M. (2003). Studies which in general show that governance is affected by industry also indirectly support the idea that intermediaries are different, Black B., Jang H., Kim W. (2006), Gillian S., Hartzell J., Starks L. (2003). Analyses which investigate the board characteristics for banks show that bank boards are larger and have a higher number of independent members, Adams R., Mehran H. (2003), that compare a sample of bank holding companies with a sample of US manufacturing companies and Schwizer P., Farina V.,

Carretta A. (2006) who find similar results for Italian companies and intermediaries which make up the S&P MIB 40 index. See also Gillian S.L., Hartzell J.C., Starks L.T. (2003), Adams R. , Mehran H. (2003, 2005) and Hayes R., Mehran H., Schaefer S. (2006).

Again there is mixed evidence on the relation of these elements with performance. There are studies on the US which do not find any significant relation between board size and composition and performance, Belkhir M. (2006). Other studies report that board size is positively correlated with performance (measured by Tobin's Q) and, even though the presence of independent members does not show a significant relation with performance, companies with boards dominated by outsiders show a better performance , Adams R., Mehran H. (2005).

Studies on a sample of European banks register a negative correlation between the size of the board and performance, while the percentage of independent directors seems to be positively correlated with performance measured by Tobin's Q, Staikouras C. K., Staikouras P. K., Agoraki M. K. (2006). Other research conducted on European banks identify a positive correlation between the presence of non-executives and performance in Continental Europe (France, Germany, Italy and Spain) and a negative correlation in the UK, Busta I. (2007).

The results of these analyses on banks confirm the difficulty of reaching univocal conclusions.

The lack of supporting evidence on "ideal" board size and composition could stem from the fact that there is no "one size fits all" in the field of governance. On the contrary, it seems likely that both outside and inside directors are necessary because of their complementary skills. Outside and independent directors which bring their insight from the outside and insiders with their in-depth information on the company on which to base decisions.

Even though empirical research does not lead to conclusive results, policy makers, supervisory authorities and institutional investors tend to consider governance important. In particular, institutional investors tend to prefer smaller boards.

Moreover, relevant literature in explaining possible reasons for the lack of conclusive evidence, provides interesting interpretations which permit a better understanding of the elements to be considered in board functioning mechanisms: the role of information and the board's two main duties control (explained effectively by agency theory) and the support of strategy (outlined more effectively with the resource-based view which highlights the contribution and importance of varied competencies within the board).

3. CORPORATE GOVERNANCE CHARACTERISTICS AND PERFORMANCE

Regulation defines the corporate governance systems which may be adopted by companies and therefore indirectly the way in which risk acceptance and risk control are attributed. This paragraph provides an original survey of the governance of the largest listed European companies which make up the Eurotop 100 index and the top 40 listed European financial intermediaries. Companies considered come from 16 different countries (12 in the case of the Eurotop index and 14 for financial intermediaries) and are therefore subject to different regulatory and self-discipline codes.

This paragraph analyses board characteristics and their relation with performance, with a particular focus on financial intermediaries, since as pointed out by Denis D., McConnell L. (2003), p. 8 , "Until recently there have been few published papers that study the effectiveness of European Boards of Directors. Despite this lack of evidence and despite the fact that the US evidence is somewhat open-

ended regarding the effect of board characteristics on firm value, various European commissions have embraced the idea that appropriate board composition is important to good corporate governance”.

The analysis was conducted on two different data sets extracted in January 2007 (market cap in Tables 4 and 5 also refers to 3 January 2007):

- companies in the Eurotop 100 index, representative of the largest European listed companies (Table 4), which includes 7 insurance and reinsurance companies (Allianz, Assicurazioni Generali, Aviva, Axa, Munich RE, Swiss RE, ZFS) and 4 banking and insurance companies (Fortis, ING Groep, KBC Group And Lloyds TSB);
- 40 European listed banks and insurance companies (30 of which are also part of the Eurotop 100 index), made up of the largest listed European financial intermediaries (Table 5). This second data set includes 8 insurance and reinsurance companies, the above and Aegon and the 4 banking and insurance companies, above.

The companies which are part of the Eurotop 100 index are all of significant size and complexity as well as a significant liquidity. Therefore, even though they are different in terms of industry, nationality and currency, companies considered are large and liquid and present significant similarities as concerns competition on capital markets which should be stimulated by the market to adopt the best governance system.

The size of the boards in the various governance systems (one-tier, vertical two-tier and horizontal two-tier, typical of Italian companies) are assessed and compared with three performance measures which are particularly suited (Tobin's Q, P/E, ROA) to data sets which present companies from different industries.

Table 4. Eurotop 100

<u>Country</u>	<u>Company</u>	<u>Market cap (Mln €)</u>	<u>P/E Ratio 2007</u>	<u>Governance system</u>
Switzerland	ABB	29,758.9	20.7	One-tier
Netherlands	ABN AMRO Holding	46,011.3	41.0	Two-tier
Netherlands	Aegon	23,808.3	8.2	Two-tier
France	Air Liquide	22,032.0	21.7	One-tier
Germany	Allianz	68,020.4	8.2	Two-tier
UK	Anglo American	54,486.6	15.1	One-tier
Denmark	AP Moller - Maersk	31,253.0	12.2	Two-tier
France	Arcelor Mittal	43,899.5	10.4	One-tier
Italy	Assicurazioni Generali	43,214.0	14.7	Italian horizontal two-tier
UK	AstraZeneca	63,269.8	11.5	One-tier
France	Axa	66,422.6	10.8	Two-tier
UK	Aviva	32,069.8	13.7	One-tier
Spain	BBVA	67,238.8	9.8	One-tier
Spain	Banco Santander	90,687.3	11.4	One-tier
UK	Barclays	73,651.5	7.3	One-tier
Germany	BASF	37,380.5	12.2	Two-tier
Germany	Bayer	31,689.6	20.7	Two-tier
Germany	Bayerische Hypo-und Vereinsbank	24,863.2	16.7	Two-tier
Germany	Bayerische Motoren Werke	28,736.8	8.9	Two-tier
UK	BG Group	35,114.3	22.3	One-tier
UK	BHP Billiton	33,773.8	12.2	One-tier
France	BNP Paribas	79,508.4	8.7	One-tier
UK	BP	164,615.1	11.2	One-tier
UK	British American Tobacco	45,099.5	18.7	One-tier
UK	BT Group	38,189.9	8.8	One-tier

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<u>Country</u>	<u>Company</u>	<u>Market cap (Mln €)</u>	<u>P/E Ratio 2007</u>	<u>Governance system</u>
France	Carrefour	32,778.0	20.0	Two-tier
France	Cie de Saint-Gobain	23,719.8	15.9	One-tier
France	Crédit Agricole	48,692.9	9.2	One-tier
Switzerland	Credit Suisse Group	64,878.9	9.2	One-tier
Germany	DaimlerChrysler	48,535.9	14.2	Two-tier
Denmark	Danske Bank	21,751.2	9.2	Two-tier
Germany	Deutsche Bank	53,665.8	6.6	Two-tier
Germany	Deutsche Post	27,754.5	20.3	Two-tier
Germany	Deutsche Telekom	61,893.9	115.6	Two-tier
Belgium	Dexia	24,881.3	7.9	One-tier
UK	Diageo	41,585.9	20.7	One-tier
Germany	E.ON	71,725.8	13.8	Two-tier
France	EADS	21,289.5	-	One-tier
France	Electricité de France	98,943.9	26.5	One-tier
Spain	Endesa	37,479.8	18.3	One-tier
Italy	Enel	48,636.2	13.1	Italian horizontal two-tier
Italy	ENI	102,056.5	9.2	Italian horizontal two-tier
Sweden	Ericsson	51,174.5	11.1	One-tier
Netherlands	Fortis	43,342.2	10.5	One-tier
France	France Telecom	55,653.4	10.2	One-tier
France	Gaz de France	34,317.5	15.9	One-tier
UK	GlaxoSmithKline	118,391.1	13.6	One-tier
France	Groupe Danone	30,495.1	33.0	One-tier
UK	HBOS	63,874.8	6.9	One-tier
Sweden	Hennes & Mauritz	31,436.8	24.3	One-tier
UK	HSBC Holdings	163,429.8	10.1	One-tier

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<u>Country</u>	<u>Company</u>	<u>Market cap (Mln €)</u>	<u>P/E Ratio 2007</u>	<u>Governance system</u>
Spain	Iberdrola	29,913.4	19.8	One-tier
Belgium	InBev	30,275.9	15.8	One-tier
Spain	Inditex	25,444.3	27.0	One-tier
Netherlands	ING Groep	75,147.2	6.5	Two-tier
Italy	Intesa Sanpaolo	74,788.6	21.1	Two-tier
Belgium	KBC Groep	34,802.9	10.2	One-tier
UK	Lloyds TSB Group	49,561.1	8.1	One-tier
France	L'Oreal	49,214.8	22.2	One-tier
France	LVMH Moet Hennessy Louis Vuitton	38,901.0	19.4	One-tier
Germany	Munich Reinsurance	30,201.3	7.4	Two-tier
UK	National Grid	29,993.4	16.6	One-tier
Switzerland	Nestle	107,881.8	18.7	One-tier
Finland	Nokia	64,776.6	14.3	One-tier
Sweden	Nordea Bank	32,041.8	9.5	One-tier
Norway	Norsk Hydro	29,373.9	10.8	Two-tier
Switzerland	Novartis	120,601.4	19.6	One-tier
Netherlands	Philips Electronics	35,453.0	7.0	Two-tier
UK	Prudential	26,243.3	22.3	One-tier
UK	Reckitt Benckiser	25,545.3	22.2	One-tier
France	Renault	26,385.2	9.4	One-tier
Spain	Repsol YPF	32,413.9	9.3	One-tier
UK	Rio Tinto	40,222.0	18.5	One-tier
Switzerland	Roche Holding	121,743.1	17.2	One-tier
UK	Royal Bank of Scotland Group	96,902.4	5.7	One-tier
UK	Royal Dutch Shell	173,290.1	8.4	One-tier
Netherlands	Royal KPN	21,040.5	8.8	Two-tier

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<u>Country</u>	<u>Company</u>	<u>Market cap (Mln €)</u>	<u>PE Ratio 2007</u>	<u>Governance system</u>
Germany	RWE	47,615.4	18.5	Two-tier
UK	SABMiller	26,546.0	19.9	One-tier
France	Sanofi-Aventis	95,508.1	16.1	One-tier
Germany	SAP	51,550.7	22.2	Two-tier
Germany	Siemens	67,205.8	23.3	Two-tier
France	Société Générale	60,625.3	50.0	One-tier
UK	Standard Chartered	30,903.9	18.0	One-tier
Norway	Statoil	42,764.4	12.3	Two-tier
France	Suez	50,614.0	15.1	One-tier
Switzerland	Swiss Reinsurance	24,152.8	6.7	One-tier
Italy	Telecom Italia	42,739.9	17.0	Italian horizontal two-tier
Spain	Telefonica	81,051.0	11.9	One-tier
Sweden	TeliaSonera	29,902.8	15.4	One-tier
UK	Tesco	48,265.0	18.9	One-tier
France	Total	132,277.9	9.7	One-tier
Switzerland	UBS	98,822.4	-	One-tier
Italy	UniCredito Italiano	71,915.2	10.6	Italian horizontal two-tier
Netherlands	Unilever	35,957.8	19.1	One-tier
France	Vivendi	34,798.6	13.9	Two-tier
UK	Vodafone Group	113,582.1	-	One-tier
Sweden	Volvo	22,430.9	14.7	One-tier
UK	Xstrata	33,781.7	12.3	One-tier
Switzerland	Zurich Financial Services	29,720.5	7.5	One-tier
	Average	53,935		
	Standard deviation	33,217		
	Standard deviation (%)	61.6%		

Source: Bloomberg. Market cap as at 3 January 2007. P/E Ratio 2007 is the last price for 2007 divided by the moving average of EPS in the prior twelve months.

Where P/E is not indicated, it means that the companies recorded losses for 2007.

Table 5. Top 40 financial intermediaries

<u>Country</u>	<u>Company</u>	<u>Market cap (Mln €)</u>	<u>P/E Ratio 2007</u>	<u>Governance system</u>
Netherlands	ABN AMRO Holding	46,011.3	41.0	Two-tier
Netherlands	Aegon	23,808.3	8.2	Two-tier
Germany	Allianz	68,020.4	8.2	Two-tier
Italy	Assicurazioni Generali	43,214.0	14.7	Italian horizontal two-tier
France	Axa	66,422.6	10.8	Two-tier
Spain	BBVA	67,238.8	9.8	One-tier
Spain	Banco Santander	90,687.3	11.4	One-tier
UK	Barclays	73,651.5	7.3	One-tier
Germany	Bayerische Hypo-und Vereinsbank	24,863.2	16.7	Two-tier
France	BNP Paribas	79,508.4	8.7	One-tier
France	Crédit Agricole	48,692.9	9.2	One-tier
Switzerland	Credit Suisse Group	64,878.9	9.2	One-tier
Denmark	Danske Bank	21,751.2	9.2	Two-tier
Germany	Deutsche Bank	53,665.8	6.6	Two-tier
Germany	Deutsche Post	27,754.5	20.3	Two-tier
Belgium	Dexia	24,881.3	7.9	One-tier
Netherlands	Fortis	43,342.2	10.5	One-tier
UK	HBOS	63,874.8	6.9	One-tier
UK	HSBC Holdings	163,429.8	10.1	One-tier
Netherlands	ING Groep	75,147.2	6.5	Two-tier
Italy	Intesa Sanpaolo	74,788.6	21.1	Two-tier
Belgium	KBC Groep	34,802.9	10.2	One-tier
Germany	Munich Reinsurance	30,201.3	7.4	Two-tier
Sweden	Nordea Bank	32,041.8	9.5	One-tier
UK	Prudential	26,243.3	22.3	One-tier

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UK	Royal Bank of Scotland Group	96,902.4	5.7	One-tier
France	Société Générale	60,625.3	50.0	One-tier
UK	Standard Chartered	30,903.9	18.0	One-tier
Switzerland	UBS	98,822.4	-	One-tier
Italy	UniCredito Italiano	71,915.2	10.6	Italian horizontal two-tier
Ireland	Allied Irish Banks	20,241.6	7.2	One-tier
Ireland	Anglo Irish Bank	11,199.4	9.9	One-tier
Portugal	Banco Comercial Portugues	10,147.8	18.7	Two-tier
Spain	Banco Popular Espanol	17,198.4	11.3	One-tier
Spain	Banco Sabadell	10,716.2	11.6	One-tier
Ireland	Bank of Ireland	16,803.0	9.4	One-tier
Italy	Capitalia	18,752.0	-	Italian horizontal two-tier
Germany	Commerzbank	19,627.6	9.0	Two-tier
Austria	Erste Bank der Oesterreichischen Sparkas	18,830.8	12.9	Two-tier
Greece	National Bank of Greece	17,241.7	14.5	One-tier
	Average	40,589		
	Standard deviation	24,512		
	Standard deviation (%)	60.4%		

Source: Bloomberg. Market cap as at 3 January 2007. P/E Ratio 2007 is the last price for 2007 divided by the moving average of EPS in the prior twelve months.

Where P/E is not indicated, it means that the companies recorded losses for 2007.

The one-tier system is the most widespread governance system (68%) in the Eurotop 100 index (adopted as the only model in Switzerland, UK, Spain, Belgium, Sweden and Finland). The horizontal two-tier system (in which both the Board of Directors and the Board of Statutory Auditors, in charge of control, are appointed by the Shareholders' Meeting) is adopted exclusively in Italy, while the two-tier model is the only one adopted in Denmark, Germany, Norway. In the Netherlands the two-tier system is mandatory for large companies

Corporate governance choices of the companies in the Eurotop index are strongly affected by the reference regulatory context: in only two countries two different models are simultaneously present (France, one-tier and two-tier, Italy, horizontal two-tier and two-tier).

Little over a quarter of companies in the Eurotop 100 index adopted the two-tier model, Dutch, Danish, French, German, Norwegian and one Italian (Intesa Sanpaolo).

The two-tier model confirms larger boards (Table 6).

Table 6. Board structures in Eurotop 100 companies

Eurotop 100	Total members *		Management body		Control body	
	Average	S.d.	Average	S.d.	Average	S.d.
<i>Eurotop 100</i>	16.81	5.91	12.28	4.38	7.48	5.87
<i>One-tier (68)</i>	14.07	3.13	14.07	3.13	4.30	1.06
<i>Two-tier (27)</i>	23.30	6.09	7.22	2.50	16.07	4.64
<i>Italian horizontal two-tier (5)</i>	19.00	6.60	15.20	5.72	3.80	1.10

* In the one-tier system the total members is the same as for the Management body (which appoints the control body among its members)

Table 7. Board structures in 40 European financial intermediaries

Financial intermediaries	Total members *		Management body		Control body	
	Average	S.d.	Average	S.d.	Average	S.d.
<i>Banks and insurance companies</i>	19.00	5.90	13.10	5.20	8.50	6.20
<i>One-tier (23)</i>	15.57	3.50	15.57	3.50	4.48	1.16
<i>Two-tier (14)</i>	23.86	5.74	7.64	2.65	16.21	4.06
<i>Italian horizontal two-tier (3)</i>	23.00	2.00	19.33	1.15	3.67	1.15

* In the one-tier system the total members is the same as for the Management body (which appoints the control body among its members)

Almost half of the companies in this second data set has adopted the two-tier model, namely Dutch, French, German, Portuguese, Austrian and one Italian (Intesa Sanpaolo). Again the two-tier model shows larger boards.

Furthermore, the comparison between the figures in Tables 6 and 7 confirm that financial intermediaries have larger boards and this is occurs irrespective of the corporate governance model adopted: for financial intermediaries with a one-tier board 15.57 (compared to 14.07), with a two-tier board 23.86 (compared to 23.19) and for the Italian horizontal two-tier model 23 (compared to 19).

The relation with performance is investigated considering the correlation between the size of corporate boards and performance (summarised with the three performance indicators) in 2005, 2006 and 2007 and the average for the three years

As concerns the **Eurotop index**, in 2005 and 2006 the relation between the **overall size of corporate bodies and performance**, showed a **negative correlation**, more marked for ROA and Tobin's Q and less marked for the P/E ratio. In 2007 correlation with P/E was positive, even though very low (0.073). Using the average over the three years for the performance measures basically confirm the negative correlation. Therefore, for companies in the Eurotop index smaller boards lead to an improved performance.

In the case of **European financial intermediaries** diverging results emerge: in 2006 and 2007 **correlation between overall board members and ROA and P/E is positive**, whereas it is **negative** for **Tobin's Q**. In 2005 correlation was negative for all three indicators. Larger boards lead to better

performance in terms of P/E and ROA. Using average figures a very low or positive correlation emerges. Therefore for financial intermediaries larger boards may lead to better performance.

The application of the three governance models is greatly affected by the regulatory framework of the home country of the company, in some countries, such as Italy and France it is possible to choose between different models, while in others there is only one model. In any case, the analysis has led to identify that the one-tier model is the most widespread and, that actually the two-tier model is applied quite differently by the companies which make up the two samples.

The companies organised according to the two-tier model show on average larger corporate bodies with respect to the other two models. Financial intermediaries, irrespective of the governance model chosen always present larger boards (presumably due to the wider competencies which are required in the board to operate in the business of risk acceptance which are typical of financial intermediaries).

Certain first indications have emerged from the empirical analysis, which require further research. For companies in the Eurotop index smaller and one-tier boards are associated to a better performance (perhaps as a result of the shorter decision-making chain) whereas the same does not occur for financial intermediaries in the second data set, for which the size of corporate bodies seems to have at most an uncertain effect. Even though this second result also suggests further research, considering it together with the fact that normally financial intermediaries have larger boards irrespective of the adopted governance model confirms, on the basis of an empirical survey that financial intermediaries are different.

This empirical analysis conducted on large listed companies permits to conclude that the two-tier model may show some potential for banks and insurance companies despite the fact that it is associated to larger boards. Moreover, the differences which emerge from the analysis of the articles of association of companies in the data set which have a two-tier board structure permit to identify different applications of the model present in Europe, which suggest that the model is well suited to mix the checks and balances which are at the basis of an effective governance. In short it is a model which shows an interesting potential provided that roles and competencies are clearly identified, especially as concerns risk acceptance and risk control. For this reason it is interesting to analyse the role of committees which are an important expression of self-governance of listed companies, even though as indicated in paragraph 1 certain committees have been strongly recommended.

4. ROLE OF COMMITTEES

As seen in paragraph 1 above the European Commission has issued a recommendation concerning the formation of three board committees: remuneration, audit and nomination for the listed companies in Europe. These committees have been extensively formed by companies within the two data sets (Tables 8 and 9). In addition to these committees a wide number of other board committees with different tasks have been formed by companies in the two samples and this provides first evidence of smaller groups of directors, presumably chosen on the basis of their specific expertise, to support the decision-making and control activities of the boards of large listed companies. Two-tier companies, both in the Eurotop 100 and in the financial intermediaries data set, tend to have a wider number of committees and this could be interpreted as a way to improve decision-making effectiveness of larger boards.

Table 8. Committees in Eurotop 100 companies

Number and average size of committees		Total			Recommended committees		Other board committees	
		Number of committees	Members	% of total board members	Number of committees	Members	Number of committees	Members
<i>Average</i>	One-tier	2.71	4.52	32%	1.57	4.13	1.13	5.10
	Two-tier	3.44	4.04	25%	1.78	3.51	1.67	4.70
	Italian horizontal two-tier	2.40	3.38	22%	2.00	3.83	0.40	2.25
	<i>Eurotop 100</i>	2.89	4.33	26%	1.65	3.95	1.24	4.83
	<i>Financial int.</i>	4.03	4.54	25%	2.40	3.89	1.63	5.21

Table 9. Committees in financial intermediaries

Number and average size of committees		Total			Recommended committees		Other board committees	
		Number of committees	Members	% of total board members	Number of committees	Members	Number of committees	Members
<i>Average</i>	One-tier	3.87	5.04	32%	2.61	4.26	1.26	6.16
	Two-tier	4.43	3.86	24%	2.07	3.10	2.36	4.61
	Italian horizontal two-tier	3.33	3.86	20%	2.33	4.72	1.00	1.67
	<i>Eurotop 100</i>	2.89	4.33	26%	1.65	3.95	1.24	4.83
	<i>Financial int.</i>	4.03	4.54	25%	2.40	3.89	1.63	5.21

As concerns more specifically risk acceptance and risk control activities it is interesting to note the committees which have been formed by companies in the two data sets. Again it is interesting to note the differences in the setting up of committees shown by financial intermediaries compared to Eurotop 100 companies (Table 10). In particular financial intermediaries have in 25% of the cases set up a risk committee (compared to 11% for Eurotop 100 companies) in addition to the audit committee, recommended by the European Commission and mandatory ex lege for one-tier companies. Financial intermediaries also set up corporate social responsibility committees to a greater extent than Eurotop 100 companies.

Table 10. Committees in the companies in the two data sets

Committees	Eurotop		Two-tier Eurotop companies		Financial int.		Two-tier financial intermediaries	
	Number	%	Number	%	Number	%	Number	%
Remuneration	85	85%	16	59%	30	75%	3	11%
Nomination	80	80%	19	70%	19	48%	1	4%
Audit *	30	30%	25	93%	15	38%	2	14%
Strategy	14	14%	3	11%	6	15%	1	7%
Finance	13	13%	4	15%	3	8%	-	0%
Mediation	11	11%	11	41%	4	10%	-	0%
Risk	11	11%	1	4%	10	25%	-	0%
Chairman's	10	10%	4	15%	2	5%	-	0%
Governance & Regulatory	9	9%	2	7%	3	8%	-	0%
Corporate Social Responsibility	8	8%	-	0%	5	13%	-	0%
Disclosure	7	7%	3	11%	0	0%	-	0%

* For one-tier companies the audit committee is mandatory.

5. CONCLUSION

Even though policy makers and institutional investors tend to attribute great importance to corporate governance there seems to be mixed evidence on the relation between board size and composition and performance. Financial intermediaries tend to have larger boards compared to other companies and size of the board does not seem to negatively affect performance.

The lack of conclusive empirical evidence on the relation between board size and performance probably means that there is no “one size fits all model” and that the two alternative views on board functioning (agency theory and resource-based theory) are complementary. From a purely theoretical viewpoint this seems the case if we consider the different duties which are attributed to boards. The first refers to the **control function** aimed at monitoring management, for which a lower number of (mostly independent) directors is probably best. The second approach better explains the board’s **strategic function**, that is its advisory role in helping management in defining strategy and risk appetite policies, and in this case a mix of outside and inside directors with diverse background is best. In general it is important that the key functions and processes of the board are clearly defined also as concerns the support which may be provided by board committees.

The two-tier model, which has been recently introduced in Italy, even though it leads to a higher number of board members, may in any case prove to be effective especially for financial intermediaries where board size may actually prove to be an advantage if complementary expertise and backgrounds are present on the board.

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