Bank Governance and Financial Stability in CESEE: A Review of the Literature

Sándor Gardó[1]

This article explores the interrelationship between bank governance and financial stability in general and in the ten Central, Eastern and Southeastern European EU Member States (CESEE MS) in particular. Agency theory is used to illustrate that banks are engaged in multiple agency relationships. Within a conceptual framework, five main dimensions of bank governance are identified and analyzed, namely internal, external, corporate, institutional and international governance. Based on the pertinent literature, we subsequently review the agency problems the CESEE MS faced in their banking sectors on their way to installing efficient and sound banking systems in the 1990s. Their experience holds important lessons for the completion of banking reform in less advanced transition economies. Most importantly, banking sector restructuring should go hand in hand with a redesign of the incentive structures for all the relevant actors in the system. This seems to be a prerequisite for achieving and maintaining financial stability and improving the efficiency of capital allocation and economic growth prospects. Overall, the CESEE MS experience also provides useful insights for dealing with the ramifications of the current global financial crisis.

JEL classification: G01, G14, G28, G34
Keywords: Governance, financial stability, transition economies

> *"Since perhaps the only meaningful distinction between man and machine is moral hazard, it may be too much to ask that banking reform eliminate all self-interested ... behavior. However, the mere recognition of the possibility of self-interest ... is a useful start."*[2]

1 Introduction

Financial intermediaries play a key role in the functioning of market economies, with their mode of operation critically depending on prevalent governance standards and practices. In fact, recurrent episodes of banking sector distress, such as the U.S. savings and loan crisis (1980s), the Nordic banking crisis (in the early 1990s), the Asian crisis (1997) or the Argentine crisis (2001), highlighted the importance of good governance for financial and banking institutions. Governance failures have also been cited as one of the underlying causes of the current global financial crisis. In the same vein, the ten Central, Eastern and Southeastern European EU Member States (CESEE MS)[3] were plagued by severe banking sector distress during the first decade of economic transition, i.e. in the 1990s. Poor governance practices were among the root causes.[4] Phenomena such as "too big to fail," "bank insolvency," "nonperforming loan problem," "bad bank" or "lender of last resort" allow for numerous analogies between the current global financial crisis and the banking crises of the 1990s in the CESEE MS.

[1] *Oesterreichische Nationalbank, Foreign Research Division, sandor.gardo@oenb.at. Substantial research for this study was conducted during a research stay at the Bank of Finland (BOFIT) in June 2008. The author would like to thank Peter Backé and David Liebeg (both OeNB), Prof. Laurent Weill (Université de Strasbourg) and two anonymous referees as well as Ingrid Haussteiner for valuable comments.*

[2] *Boot and Thakor (1993), p. 212.*

[3] *The CESEE MS comprise Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.*

[4] *See e.g. Lindgren, Garcia and Saal (1996), Caprio and Klingebiel (1996), Honohan (1997), Tang, Zoli and Klytchnikova (2000), Enoch, Gulde and Hardy (2002), Bonin and Wachtel (2004) and Gandy et al. (2007).*

Governance of nonfinancial firms has been examined widely, both in developed and in developing (including transition) economies.[5] Yet, research on bank governance in general and in developing and emerging economies in particular has been limited to date even though the topic is highly relevant.[6] The even smaller body of pertinent research on transition economies focuses on very specific issues, such as the role of banks in the governance of other firms (e.g. Baer and Gray, 1995; Dittus, 1996; Grosfeld, 1997) or the link between banks' ownership structure and bank efficiency (e.g. Weill, 2003; Bonin, Hasan and Wachtel, 2005a).

Against this background, this article is meant to – by way of a structured literature review – shed light on how distortions in banks' governance arrangements were linked to banking fragility in the CESEE MS. The focus is on the 1990s, when most CESEE MS revamped their banking sectors and broadly completed transition-related banking reform. First, drawing on the available literature, we identify all the major dimensions of bank governance. In a second step, the related literature on transition economies is reviewed to show how bank governance practices have developed in the CESEE MS.

The subsequent section 2 addresses the question of why the quality of bank governance matters in general and during economic transition in particular. Section 3 deals with agency theory, which normally underpins the governance debate. By stressing the special nature of banks, section 4 discusses the questions if and why the governance of banks differs from that of nonfinancial firms. Based on Lindgren, Garcia and Saal (1996), section 5 breaks down the various dimensions of bank governance, focusing specifically on transition-related issues. It also sketches a comprehensive "governance nexus"[7] in transition banking that brings together all major dimensions of bank governance in a unified conceptual framework. Section 6 explores the efficacy of these governance arrangements during transition. Finally, section 7 examines the lessons learned from the experiences of the CESEE MS and presents policy implications for banking reform in less advanced transition economies, where in most cases governance issues have yet to be tackled in a comprehensive manner. This section also discusses in how far the experiences of the CESEE MS provide useful insights for dealing with the ramifications of the current global financial crisis.

2 The Importance of Governance Quality

Governance impacts on financial stability and economic development through various channels (see chart 1).

Given their fundamental functions of intermediation and monitoring, banks mitigate information and transaction costs and thus contribute to an efficient allocation and use of resources, thereby promoting economic growth (Levine, 1997). Levine (2004) argues that banks operating along the lines of sound governance

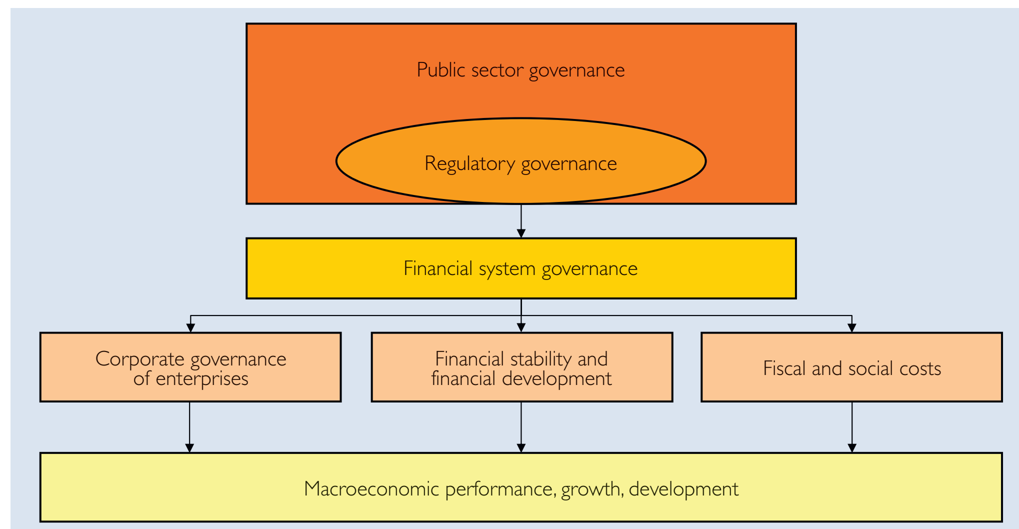
[5] *For research on transition economies, see inter alia Pistor, Reiser and Gelfer (2000), Crotty and Jobome (2004), Berglöf and Claessens (2006), Fox and Heller (2006) as well as Heinrich, Lis and Pleines (2007).*

[6] *For general reviews, see Prowse (1997), Caprio and Levine (2002), Macey and O'Hara (2003), Adams and Mehran (2003) and Levine (2004); for details on developing economies, see Arun and Turner (2004), Das and Ghosh (2004), Allen (2005) and Gandy et al. (2007).*

[7] *See also Quintyn (2007). For an overview of agency relationships and governance structures, see Gelauff and Broeder (1997).*

Chart 1

Governance and Economic Development



Source: Quintyn (2007; slightly adapted).

principles are more likely to allocate capital efficiently and to monitor borrowers properly than banks that are subject to weaker governance practices.

Empirical research both on banks and nonfinancial corporations has shown that governance quality matters for efficiency at both the firm and country level.[8] De Nicolò, Laeven and Ueda (2006) find that improvements in governance quality result in higher output, investment and productivity growth at the level of the aggregate economy. The benefits are particularly high for industries which rely predominantly on external financing.[9] On this note, Claessens (2006) stresses easier access to external financing, lower cost of capital and better operational performance as the main channels through which good governance fosters economic growth and development. In addition, Oman (2001) and Meón and Weill (2005) underline the relevance of improved governance structures for constraining the misallocation of scarce resources, particularly in developing economies with low capital stocks. De Nicolò, Laeven and Ueda (2006) also find a significant positive relationship between the degree of financial development and the favorable impact of improved governance on economic development. In particular, financial development and economic growth hinge on the strength of property rights as well as the quality and effectiveness of the legal and regulatory system, two important elements of the corporate environment.[10] These findings are critical for banks, as a better quality of governance in banking is expected to contribute to economic

[8] *For details, see Gompers, Ishii and Metrick (2003), Knack and Keefer (2005), Meón and Weill (2005) and Quintyn (2007).*

[9] *This finding seems consistent with the view in the academic literature that debt financing serves as an important corporate governance device by increasing the likelihood of financial distress, reducing free cash flows and fueling creditors' monitoring efforts.*

[10] *See Levine (1997), La-Porta et al. (1998), Beck, Levine and Loayza (2000), Claessens and Laeven (2003) and Meón and Weill (2005).*

growth both directly via higher bank efficiency and indirectly via stepped-up financial development.

The literature on transition economies largely supports these findings.[11] Koivu (2004), based on a sample of 25 transition countries, argues that higher banking sector efficiency translates into stronger economic performance. Brissimis, Delis and Papanikolaou (2008) provide evidence that banking reform in the CESEE MS positively influences bank efficiency, while Fries and Taci (2002) argue that reform progress in banking is even a conditio sine qua non of banking sector development in transition countries. Pistor (2006) shows that financial market developments in transition economies benefited from improved law on the books as regards shareholder and creditor rights, while highlighting the need for better law enforcement. In a similar vein, De Haas (2002) finds that bank privatization per se does not automatically lead to improved financial sector development and economic growth in transition economies. Rather, it should be accompanied by a sound legal and institutional environment, because without an effective legal system, banks continue to face perverse incentives even when they have been privatized.

Banks moreover play a pivotal role in exercising corporate governance over other firms (see chart 1).[12] This is particularly true for bank-based financial systems, which are the norm in the CESEE MS. Sound governance practices increase banks' screening and disciplining powers, thereby creating incentives for corporations to improve their internal governance arrangements. This in turn enables corporations to obtain easier access to financing and/or lower the cost of capital.[13] Vice versa, improved governance practices of corporations tend to contribute to better loan portfolio quality, higher profitability, efficiency and stability of the banking sector and stronger economic dynamics.

Poor governance practices in the financial sector contribute to individual or system-wide bank failures and thus entail considerable fiscal (and social) costs. Among others, Tang, Zoli and Klytchnikova (2000) estimate that the total fiscal and quasi-fiscal costs of banking distress (including costs related to the government, central bank and depositor compensation), as cumulated from 1991 to 1998, amounted to some 25% of GDP in the Czech Republic and to 42% of GDP in Bulgaria. Not only does such an additional fiscal burden weigh on public finances for many years, but it also slows the catching-up process by wasting scarce resources and entailing output losses.

Finally, the quality of governance arrangements matters for financial stability. From the financial stability perspective, the "governance view" should be seen as complementary to the quantitative view: The timely identification of governance problems can serve as an early warning system for pinpointing financial vulnerabilities (Chai and Johnston, 2000). Good governance practices underpin the soundness and stability of the financial system by reducing informational asymmetries and increasing the shock-absorbing capacities of the financial system through

[11] *De Haas (2004) notes some shortcomings in the "legal view," which to some extent limit its applicability on transition economies.*

[12] *See Macey and O'Hara (2003), Claessens (2006) and Quintyn (2007).*

[13] *See e.g. De Nicolò, Laeven and Ueda (2006) and EBRD (2009).*

a well-functioning legal, regulatory and supervisory framework.[14] In this regard, banks' predominant role as major source and provider of financial funds in CESEE MS financial markets might entail adverse systemic implications of governance-related bank failures via contagion effects. This could impact the whole financial system, the real economy and the pace of the catching-up process. Yet another factor is the dominant market position that foreign-owned banks hold in the CESEE MS, which is traceable to banking reform and bank privatization strategies in most transition economies. Such cross-border linkages underscore the importance of governance issues that arise from the increasing globalization of banking.

3 The Principal-Agent Problem

Agency theory is frequently used to explore governance issues. The starting point of standard agency theory is the modern ("publicly" owned) corporation characterized by an agency relationship that results from the separation of ownership and control. In such a contractual relationship between two parties, the principal (e.g. owner of a firm) instructs the agent (e.g. manager of a firm) to conduct certain transactions on his behalf.[15] Agency relationships are, however, not necessarily problem-free and the parties involved may well encounter conflicts. The principal delegates not only multiple tasks to the agent, but also certain discretion in decision making. This in turn raises the question to what extent the agent – against the background of information asymmetries – acts in the principal's interest or engages in moral hazard.[16]

The challenge is thus to find the most efficient governance mechanisms, which decrease the likelihood of agents' self-interested behavior and reduce the uncertainty resulting from informational asymmetries between principal and agent, thereby aligning the interests of the two counterparties involved. In this sense, the ultimate objective of agency theory is to minimize the agency costs. They are the sum of (1) the expenses taken on by the principal (incentive, monitoring and enforcement costs), (2) the agent's costs in signaling that he or she acts in the principal's interest ("bonding expenditures"), and (3) a residual loss capturing the remaining difference between the actual outcome of the agent's decisions and the desired outcome maximizing the principal's welfare.[17]

Depending on whether governance mechanisms are designed to protect only shareholders' interests or also those of stakeholders,[18] two strings of literature have emerged. The Anglo-Saxon (outsider) model, which rests on a mainly market-based financial system, holds that governance should first and foremost aim at maximizing shareholder value. By contrast, the European (insider) model, which is based on bank-dominated financial markets, states that the firm is a "complex web or nexus of contractual relationships" (Macey and O'Hara, 2003), giving sim-

[14] *See Chai and Johnston (2000), Halme (2000), Das, Quintyn and Chenard (2004) and Heremans (2007).*

[15] *See Jensen and Meckling (1976), Fama (1980) and Fama and Jensen (1983).*

[16] *See Arrow (1985), Pratt and Zeckhauser (1985) and Shleifer and Vishny (1997). According to Tirole (1999), moral hazard can take the form of insufficient effort, excessive risk taking, managerial entrenchment and/or self-dealing.*

[17] *See Jensen and Meckling (1976), Pratt and Zeckhauser (1985) as well as Eisenhardt (1989).*

[18] *The term "stakeholder" refers to individuals, groups or institutions (e.g. shareholders, creditors, customers, employees and suppliers) that are directly or indirectly attached to and affected by the actions and objectives of a corporation.*

ilar weight to the interests of stake- and shareholders. While the first concept focuses on "firm level" governance, i.e. corporate behavior, the second also accounts for the corporate environment, i.e. the normative business framework.[19] These two models are in fact to a large degree interrelated, as the quality of firm level governance largely depends on the quality of the business environment, i.e. the political, institutional and legislative framework, and vice versa.[20]

Governance practices address multiple agency problems mainly with a view to bridging the gap between the different interests of various share- and stakeholders. Governance can thus be understood as a complex system of control and incentive mechanisms, which (1) enhances corporate efficiency by helping an enterprise effectively manage scarce resources and (2) aligns corporate behavior with stakeholders' (more broadly speaking, society's) interests by mitigating the misallocation of existing resources.[21] The existence and quality of governance arrangements determine market participants' "net risk taking behavior" (Chai and Johnston, 2000). Enforcement by the private and the public sector plays a key role in this context, in particular, when we also take into account potential resistance by various interest groups to applying and improving available governance mechanisms.[22]

4 The Specifics of Bank Governance

Initially, researchers of bank governance mainly argued along the lines of standard agency theory and treated banks in the same way as nonfinancial corporations. More recently, however, research on bank governance has started to stress banks' uniqueness and their special functions and features: their special capital structure, specific nature of activities and degree of regulation.[23]

Standard agency theory focuses on the owner-manager relationship in firms, where owners provide (nearly) all of the firm's capital (equity finance). Banks, however, operate predominantly on a (strongly dispersed) debt basis and are highly leveraged (Macey and O'Hara, 2003). This differentiation between debt and equity finance is not only important because, in the case of bank insolvency, debt holders (all put together) have much more at stake than equity holders, but also because under such circumstances risks and control rights are transferred from the equity to the debt holders.[24]

Moreover, the literature tends to argue that banks are more "opaque" than nonfinancial firms given the intertemporal divergence of effort and reward, the special nature and growing complexity of bank products (Heremans, 2007; Llewellyn, 2007) and the limited observability of loan quality. In fact, as the current financial crisis has patently proven, banks can often mask emerging problems for a longer period of time than nonfinancial firms.[25] First, this lower degree of trans-

[19] *See Shleifer and Vishny (1997), Berglöf and Thadden (1999), Macey and O'Hara (2003) as well as Claessens (2006). Micro- and macro-governance concepts are also common in the literature, with the former mostly referring to ownership and board issues, while the latter refer to legal and regulatory standards, creditor rights, enforcement and other stakeholder issues (Crotty and Jobome, 2004; Ciancanelli and Reyes-Gonzales, 2000).*

[20] *See Oman (2001), Arun and Turner (2004), Claessens (2004) and Quintyn (2007).*

[21] *See Tirole (1999), Allen (2005) and Claessens (2006).*

[22] *See Oman (2001), Berglöf and Claessens (2006) as well as Claessens (2006).*

[23] *See Ciancanelli and Reyes-Gonzales (2000), Adams and Mehran (2003) as well as Llewellyn (2007).*

[24] *See Shleifer and Vishny (1997), Tirole (2001) and Heremans (2007).*

[25] *See Fink and Haiss (1999), Caprio and Levine (2002), Levine (2004) as well as Király, Mérő and Száz (2007).*

parency[26] can aggravate the agency problem by providing managers and/or block holders (large shareholders) with more room for opportunistic behavior. Second, it can also make it more difficult for dispersed equity and debt holders to control managers and/or block holders, in particular when we also consider their ability (lack of expertise) and willingness (associated pecuniary and/or nonpecuniary costs, free rider problem) to do so.[27] Several disciplining mechanisms can mitigate these agency problems, even though they may not always be very effective (Levine, 1997; Allen and Gale, 1999). They include competition in the product market, the market for corporate control (e.g. takeovers), the managerial labor market as well as other (internal) mechanisms like ownership and board structures or incentive-compatible remuneration.[28]

Finally, standard agency theory is based on the assumption of perfect and competitive markets. By contrast, banks (given their opacity and economic importance) are highly regulated. This not only reduces competitive pressures, but also weakens the efficacy of the above-mentioned market forces as governance mechanisms.[29] Safety nets, such as (explicit or implicit) deposit insurance schemes or central banks' lender of last resort function, have been put in place to deal with systemic risk concerns. These safety nets are designed to protect depositors in case of bank failures to avoid bank runs and possible contagion effects and thus to ensure the stability of the financial system. On the flip side, such arrangements can, however, create new incentives to moral hazard, either via curbing monitoring efforts (by depositors) or triggering excessive risk taking (by managers). This in turn leads to further regulation, e.g. on capital requirements, asset diversification, ownership structure or competition.[30]

Given these specific features, the governance of banks is not only different from that of nonfinancial firms, but it is also more complex. Hence, for banks, there is a clear case to take a broader view of governance. Some research has already been conducted that – in line with the tenets of the continental European model of corporate governance – takes into account depositors and/or borrowers and/or regulators and supervisors.[31]

5 Dimensions of Bank Governance

In light of banks' above-mentioned special features and functions, standard agency theory does not lend itself fully to examining bank governance. To get a grasp of the agency problems faced by banks during economic transition, taking a multidimensional view of bank governance seems to be more appropriate.

[26] *Transparency is an essential element of good governance. However, there are certain limitations to it in banking given competition issues and (regulatory) confidentiality requirements (Sauerzopf, 2008). Moreover, relevant information is revealed mostly only to authorities, but not to the market (Leechor, 1999), which contributes to the persistence of informational asymmetries.*

[27] *See Mishkin (1997), Caprio and Levine (2002), Das and Ghosh (2004) as well as Berglöf and Claessens (2006).*

[28] *See Prowse (1997), Allen and Gale (1999), Tirole (2001), Levine (2004), Adams and Mehran (2003) as well as Llewellyn (2007).*

[29] *See Ciancanelli and Reyes-Gonzales (2000), Caprio and Levine (2002), Levine (2004) as well as Allen (2005).*

[30] *See Leechor (1999), Macey and O'Hara (2003), Das and Ghosh (2004), Levine (2004) as well as Heremans (2007).*

[31] *On different governance concepts for banks, see Harm (2002), Adams and Mehran (2003), Macey and O'Hara (2003), Arun and Turner (2004), Quintyn (2007) and Lindgren, Garcia and Saal (1996).*

Governance problems in banking, namely incentives to moral hazard, are largely affected by the environment under which financial market actors operate (Lindgren, Garcia and Saal, 1996; Fries, Neven and Seabright, 2002). The regime change from a centrally planned to a market economy is accompanied by a wide array of "external" uncertainty. This encompasses macroeconomic and political instability, institutional, legislative and judicial loopholes and bottlenecks as well as the "governance gap" (Chai and Johnston, 2000) created by financial liberalization, decentralization and deregulation.[32]

In such a setting, incentives are particularly distorted and behavior is governed by factors other than market forces, which leads to "internal" uncertainty. To capture these features, it makes sense to take a broad view of bank governance. In other words, akin to the stakeholder approach outlined above, one should include all actors involved, namely depositors, borrowers, regulators and supervisors, and their agency relationships with banks.

A simplified bank balance sheet is a good starting point for identifying the most relevant agency relationships and governance issues banks face during transition (chart 2). On the liability side, two main agency problems emerge: (1) between bank owners and managers, as implied by traditional agency theory (internal governance), and (2) between the bank and its creditors (mainly depositors) and/or bank supervisors (usually central banks) in their capacity as guardian of both the depositors' and the general public's interests (external governance). The existing literature views bank governance mainly from the liability side and thus deals with the issues of internal and external governance.

However, the asset side of banks' balance sheets involves another dimension of the agency problem, namely that between the bank and its debtors (mainly corporations) (corporate governance). Again, this is crucial given banks' prominent role in the governance of other firms and the mutually reinforcing character of the qualities of governance arrangements in the financial and corporate sectors.

Moreover, two additional important dimensions come into play. Banks do not operate in a vacuum, but have relationships with multiple stakeholders who not only shape banks' business environment, but also influence the decision-making process within banks (institutional governance). Such stakeholders include political groupings, central banks, privatization agencies or competitors, and more recently also other institutional entities, such as mutual/pension/hedge/sovereign wealth funds and private equity firms.[33] The list could be extended to include auditors and rating agencies. Especially the latter's disciplining role is, however, limited given the prevalent conflict of interest between their role as (independent) external monitoring devices and (financially dependent) bank consultants.[34]

Finally, financial globalization requires banks to adopt and adhere to international legal and regulatory standards. They represent both a framework for the operation of financial institutions in an international context and the highest level

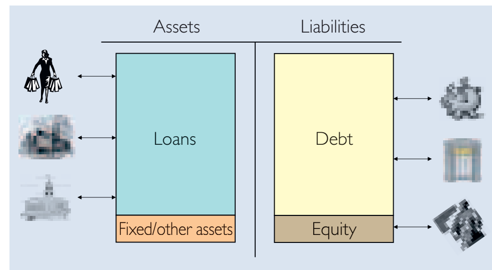
[32] *Crotty and Jobome (2004) find that governance problems in transition economies are a function of the design of regime change, i.e. the pace and sequencing of reform measures. On this note, the "shock therapy" is regarded as inferior to the "gradual approach."*

[33] *For further details on the governance role of private equity firms, see Boot and Thakor (2009). For possible interdependencies and interactions between multiple stakeholders, see Balling's (1998) governance matrix.*

[34] *See e.g. Leechor (1999) and Boot and Thakor (2009).*

Chart 2

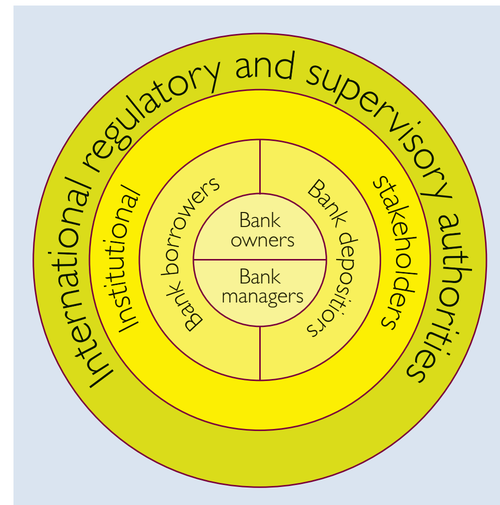
Bank Governance: A Balance Sheet Approach



Source: Compiled by author.

Chart 3

The Bank Governance Nexus



Source: Compiled by author.

of "monitoring" of their activities (international governance). On the one hand, financial globalization has had positive effects on competition, corporate governance and the availability and cost of funding. On the other hand, international financial integration has increased the complexity of the banking business, informational asymmetries and systemic risk at both the European and the global level, while at the same time challenging bank supervisors' monitoring efforts.[35] Again, this is crucial for the CESEE MS, as their banking systems were largely sold to internationally active foreign banks.

When we put all of these five governance dimensions together, a complex nexus of internal, external, corporate, institutional and international governance emerges. This framework helps understand and assess banking sector developments during transition toward a market-based financial system (chart 3).

6 Bank Governance in Transition: What Went Wrong (or Right)?

In transition economies in particular, the design and efficiency of governance arrangements matter for at least three reasons:[36] (1) Banks play a crucial role in economic development, i.e. the catching-up process of transition economies, (2) banks are the major source and provider of financial funds in the CESEE MS and thus largely determine the efficiency of aggregate capital allocation, and (3) the regime change after the fall of the Iron Curtain in 1989 made far-reaching banking reforms and the introduction of market-based banking structures necessary. At least during early transition, such a general overhaul, including financial liberalization, implied a lack of strong governance mechanisms and thus more leeway for bank owners' and managers' self-interested behavior.

How has bank governance therefore developed in transition economies? To explore this issue in more detail, we look at each of the five governance dimensions and provide a synopsis of the evidence reported in the literature.

[35] *See e.g. Lindgren, Garcia and Saal (1996), Schüler (2003) and Alexander and Dhumale (2006).*

[36] *For general considerations on developing and transition economies, see Levine (2004), Arun and Turner (2004), Das and Ghosh (2004) as well as EBRD (2009).*

6.1 Internal Governance

As set out in section 3, internal governance problems mirror conflicts of interest resulting from the separation of ownership and control. Aligning owners' and managers' diverging goals and interests requires well-functioning internal and market mechanisms of control.

In the CESEE MS, the question arose of how to contain in a new and transforming environment the resurfacing problems of insider control in the absence of traditional control mechanisms.[37] This was particularly relevant, as important control devices like the disciplining role of market forces mentioned above did not deter managers from moral hazard for several reasons.

First of all, at the early stage of transition, human capital in banking and management know-how were scarce, with (nonindependent) bureaucrats and government officials with poor banking expertise filling many senior management positions.[38] Combined with rather limited competition in the managerial labor market, this meant that the labor market was all but nonexistent as a control mechanism. Later on, when foreign banks entered the region (and foreign managers took posts in the newly acquired or established subsidiaries), management know-how in banking was gradually upgraded in the CESEE MS.

Second, capital markets were underdeveloped (both in terms of depth and structure), while the information required for company evaluation was distorted given high macroeconomic uncertainties, inadequate disclosure and lax accounting practices. At the same time, infant capital market structures coupled with regulatory impediments and widespread state ownership undermined the credibility of potential takeover threats. This corresponds with Revoltella's (1998) observation that capital markets in the CESEE MS were initially seen as instruments for ownership change (privatization) rather than as a traditional source of finance and a governance device.

Finally, given oligopolistic market structures, as reflected by high market and (state) ownership concentration, competition in the market for final bank products was low.[39] In fact, this noncompetitive nature of the banking business, combined with a lack of transparency and infant capital market structures, also undermined the role of market discipline as a governance device during most of the first decade of transition.

The more market mechanisms fail to ensure prudent behavior by managers, the more owners depend on internal control mechanisms (e.g. the board of directors) and incentive schemes (e.g. incentive-compatible remuneration). Board efficiency primarily depends on board size, independence and composition, but also on the underlying know-how. However, control expertise in bank boards was a rather scarce good in the CESEE MS especially in the early stages of transition. In light of strong personal links among managers (originating from central planning times), "cross-control" structures were not uncommon.

Also, high external uncertainty put the efficacy of incentive schemes and sanction mechanisms (such as firing incumbent management) into question. Owners

[37] *For further details, see Revoltella (1998), Lewis (2002) as well as Fox and Heller (2006),*

[38] *See Király, Mérő and Száz (2007), Enoch, Gulde and Hardy (2002) as well as Gandy et al. (2007).*

[39] *According to Levine (2004), product market competition is in general less pronounced in banking than in other sectors, since long-term relationships with clients represent barriers to competition.*

were hardly in a position to verify whether good (or bad) performance was a result of managerial effort (or slack) or simply a consequence of improving (or deteriorating) external conditions (Grosfeld, 1997). Jones and Kato (1998) are among the very few to investigate the determinants of managerial compensation in transition economies. They use data from Bulgaria and find a strong relationship between pay and firm size but none between pay and profitability. This implies that executive compensation schemes were designed to provide managers with incentives to increase size (or resist downsizing) and to pay less attention to profitability. The magnitude of the too big to fail and the bad debt problems in banking during early transition suggests that these findings might well apply to banks, too. In another study on the Czech Republic and Slovakia, Eriksson (2005) confirms a strong firm size effect in executive compensation. Yet, he also finds first evidence of a positive influence of corporate performance on managerial pay in the Czech Republic, which implies rather strong managerial incentives to increase corporate profitability.

As to banks' ownership structure, internal governance problems in the CESEE MS were aggravated by dominant state ownership. From a theoretical point of view, a concentrated ownership structure lends itself to mitigating governance problems.[40] However, state ownership also has some drawbacks, which can, but do not necessarily have to, hamper governance quality. State banks do not operate solely on commercial terms, as their operations are often tilted toward achieving economic and political objectives. This results in a conflict of interest between the state's capacities as bank owner and guardian of public interest.[41] State ownership might therefore distort competition and managerial incentives, and restrain corporate innovation. It is thus associated with a higher degree of inefficiency, misallocation of scarce resources (given the interference into the day-to-day management of banks and widespread related/directed lending) and slower financial development and economic growth.[42] Moreover, the state often lacks credible disciplining mechanisms, because in the event of financial distress, it rather tends to soften budget constraints and to take a "too political to fail" stance. As a result, bank managers' weak performance fairly often remains without consequences. Finally, monitoring mechanisms such as the market for corporate control or monitoring through the final principals (taxpayers) are likewise absent.[43]

For emerging economies, Gandy et al. (2007) pinpoint the ownership issue as the "primum mobile" of the quality of bank governance. Most of the empirical literature on transition economies finds that the type of ownership is also relevant for bank efficiency.[44] Private ownership is found to be superior to state ownership,

[40] *The agency problems related to concentrated ownership, i.e. the expropriation of minority shareholders by controlling owners should, however, not be neglected. For more details, see e.g. Shleifer and Vishny (1997) and Levine (2004).*

[41] *See Caprio and Levine (2002), Nollen, Kudrna and Pazdernik (2005) as well as Quintyn (2007).*

[42] *See Saal (1996), Meagher (2002), Ferri (2003), Crotty and Jobome (2004), Levine (2004), Andrews (2005) and Haselmann, Marsch and Weder di Mauro (2009).*

[43] *See Lindgren, Garcia and Saal (1996). According to Király, Mérő and Száz (2007), diverse state (i.e. government, public agencies, state enterprises) ownership might pose an obstacle to proper governance of banks. However, according to Ferri (2003), a plurality of public sector shareholders, in light of the different interests represented, might offer some degree of shelter from capture of state banks by large (state-owned) firms.*

[44] *For further details, see Meón and Weill (2005).*

even though differences prevail between various forms of private ownership. Majority domestically-owned banks are considered to be least efficient (Fries and Taci, 2005). However, the issue of state and private ownership is more complex. In an empirical study based on a sample of 11 transition countries, Bonin, Hasan and Wachtel (2005a) find that denationalization is not a sufficient precondition for higher bank efficiency. This is consistent with the observation that domestic private strategic owners in transition economies were often linked to certain industries or politics. Also, there have been cases when banks were founded by corporations to achieve better access to (cheap) financing of other business interests. Coupled with opaque cross-ownership structures, in many instances this entailed a high level of related party influence, in particular during early transition.[45]

Overall, the view is well established in the literature that the design of ownership change and the resulting ownership structure are relevant for governance quality and consequently bank efficiency. But according to Bonin, Hasan and Wachtel (2005b), the timing of privatization seems to be of utmost importance as well, with earlier-privatized banks being more efficient than later-privatized ones, which suggests that the realization of efficiency gains is time dependent.

As to the methods of ownership change, Meagher (2002) and Andrews (2005) point out that bank privatization via initial public offerings (e.g. in Poland) and voucher privatization (e.g. in the Czech Republic) led to dispersed ownership structures, which – apart from neither generating revenues for the government (in case of voucher privatization) nor providing fresh capital for the privatized bank – often reinforced insider control and preserved prevalent incentive problems. Similarly, Bonin, Hasan and Wachtel (2005b) argue that voucher privatization does not result in increased efficiency given continued state interference in voucher-privatized banks.

In contrast, foreign bank entry is widely seen to be beneficial for improving bank governance and efficiency in transition economies,[46] with the most efficient institutions being foreign greenfield banks (Bonin, Hasan and Wachtel, 2005b). As for banks with foreign participation, a higher foreign stake is associated with less inefficiency (Hasan and Marton, 2003).

After initial strong resistance to foreign ownership, more and more CESEE MS allowed foreign banks to enter the market toward the latter part of the 1990s, mainly in view of increasing fiscal and external financing constraints. Foreign presence contributes to ownership diversification (not only by complementing state and domestic private ownership, but also owing to foreign investor plurality), to enhanced competition, product innovation, improved risk management practices, better governance of banks as well as a more advanced human and technological capital base. All of this promotes bank efficiency and, ultimately, banking system stability.[47] Given the "import" of foreign regulatory and supervisory practices and a loosening of political ties, which implies a lower probability of regulatory and political capture, foreign bank entry also speeds up regulatory reform (Meagher, 2002).

[45] *See Meagher (2002), Nollen, Kudrna and Pazdernik (2005), Király, Mérő and Száz (2007) as well as Gandy et al. (2007).*

[46] *See e.g. Weill (2003), Hasan and Marton (2003) as well as Bonin, Hasan and Wachtel (2005a).*

[47] *See Ferri (2003), Weill (2003) as well as Arun and Turner (2004).*

6.2 External Governance

External governance problems are based on informational asymmetries arising between banks and their debt holders, in particular depositors. They are closely related to the problems of internal and corporate governance. Bank managers' opportunistic behavior toward bank owners, and both parties' inability and/or unwillingness to enforce hard budget constraints in the corporate sector are already an indication for banks' moral hazard behavior vis-à-vis their depositors. Who then should monitor banks' behavior?[48] Obviously, depositors should play a critical role in monitoring. However, as pointed out before, the individual depositor is neither able (due to lack of knowledge, prohibitive costs) nor willing (free rider problem) to supervise the bank he deposited his money with. This is one of the factors behind the rationale for the prudential regulation and supervision of banks.

The efficiency of bank regulation and supervision largely depends on the availability and quality of laws and regulations, and on the degree of enforcement. It is widely accepted that ill-designed laws and regulations, by offering discretionary room for maneuver, aggravate agency problems in banks (Quintyn, 2007). Thus, it is of crucial importance that banking reform is supported by proper laws and regulations. Nevertheless, evidence in the CESEE MS shows that regulations designed to prevent banks from governance failures (e.g. capital requirements, licensing, asset diversification, deposit insurance) were among the first to give rise to moral hazard (Király, Mérő and Száz, 2007).

Capital requirements are a case in point. They play a vital role in preventing owners and managers from excessive risk taking, so that the amount of capital at stake determines owners' incentives to exercise management control and shape managerial behavior (Halme, 2000). During early transition, capital requirements had been low and were increased only gradually to the level of international best practice. Inadequate capitalization, however, increased the likelihood of soft budget constraints and banks' incentive to gamble for resurrection.[49]

Bank recapitalization might help overcome such incentive problems. However, in order to be successful, capital injections have to be conditional, well defined (e.g. differentiating between old and new bad debt), appropriate (in terms of volume) and credible especially with a view to their frequency, so as to imply a "once and for all" solution. Only under such conditions is it possible to break the "vicious cycle of repeated recapitalizations" (Andrews, 2005), which was common in some transition economies (e.g. in Hungary).[50]

Apart from initially low minimum capital requirements, highly liberal bank licensing during the early 1990s – to spur competition in the banking sector – and inappropriate asset diversification rules in many instances seem to have contributed to increasing the moral hazard problem in banks.[51]

In order to cope with these legal deficiencies and to close moral hazard loopholes, banking laws were gradually upgraded to best practice. Sound laws and regulations are, however, fruitless without enforcement (Berglöf and Claessens, 2006).

[48] *For further details, see e.g. Diamond (1984) and Holmstrom and Tirole (1997).*

[49] *See Dittus (1994), Berglöf and Roland (1995) and Fries, Neven and Seabright (2002).*

[50] *See Berglöf and Roland (1995), Saal (1996), Meagher (2002), Bonin and Wachtel (2004) as well as Király, Mérő and Száz (2007).*

[51] *See e.g. Reininger, Schardax and Summer (2002) and Bruckbauer, Gardó and Perrin (2004 and 2005).*

In fact, enforcement posed a great challenge to authorities in the CESEE MS in the early stage of transition. Because of transitional circumstances (e.g. missing legal authorization, lack of information, inadequate staff qualifications, staff shortages, wage competition from the private sector) supervisory authorities were often not able to appropriately fulfill their duties (Fink et al., 1999). Moreover, supervisors themselves often operated under perverse incentives and acted in their own interest (e.g. reputation, financial interests, power) or the interest of large stakeholders, such as the state, various interest groups or supervised institutions ("regulatory capture"),[52] thereby undermining the credibility of the supervisory process. The related "regulatory forbearance" – particularly in the case of state-owned banks – may represent an obstacle to effective bank governance.[53]

Moreover, in response to recurring banking (sector) crises, authorities in the CESEE MS at an early stage aimed at creating relevant safety nets to regain confidence and foster banking system stability. Before, costly implicit guarantees (primarily for state banks) had been common, which distorted competition and increased moral hazard on both banks' and depositors' part (Tang, Zoli and Klytchnikova, 2000). Against this background, creating a credible explicit deposit insurance system was seen as vital, with the timing of establishment and the design of the scheme (premiums, coverage, level) being particularly important for determining risk-taking behavior and the quality of bank governance. Getting things right was challenging in transition economies, as the moral hazard problems related to deposit insurance were pressing during transition, given a higher degree of informational asymmetries and the bad debt problem (Hermes and Lensink, 2000). As to the design of deposit insurance schemes, Nenovsky and Dimitrova (2008) argue that in the CESEE MS overinsurance (largely a consequence of harmonization with EU standards), weak coinsurance practices and the limited use of risk-adjusted premiums increased the risk of moral hazard.

6.3 Corporate Governance

Corporate governance, or the monitoring of borrowers, is – apart from mobilizing and allocating funds – the third main function of banks (Diamond, 1984). The elimination of moral hazard on the part of debtors requires not only information, but also sanction mechanisms whenever scarce funds are used inefficiently. If none of this is available easily and at nonprohibitive costs, bank owners' and managers' incentives might change. Thus, the quality of banks' internal governance not only depends on the strength of available corporate governance arrangements, but to a large extent also on banks' ability and willingness to fulfill their corporate governance functions.

In the early phase of transition, both banks' ability to gather information on clients and the use of sanction mechanisms were subject to limitations. First, an important consequence of the regime change was that banks lost proprietary information. Information on clients accumulated over decades of central planning became useless overnight in a rapidly changing environment. On the other hand, acquiring reliable (future-oriented) information was impaired by high macroeconomic uncertainty, missing credit registries, inadequate disclosure practices, lax

[52] *For a general overview on regulatory capture in banking, see Hardy (2006).*

[53] *See Leechor (1999), Halme (2000) and Andrews (2005).*

and "creative accounting standards" (Király, Mérő and Száz, 2007; Enoch, Gulde and Hardy, 2002) and unclear and fluid ownership structures in the corporate sector (Meagher, 2002). Moreover, reputation could not act as a source of information or governance device. Existing firms had a rather poor reputation and newly-founded enterprises none at all, and reputation building was difficult given the surrounding uncertainty.[54]

Second, the credibility of sanction mechanisms, such as the use of collateral[55] or the initiation of bankruptcy proceedings, was often affected by unsettled creditor rights, inappropriate legal frameworks and ineffective debt collection procedures (Baer and Gray, 1995; Hainz, 2003).

Finally, in order to properly execute their corporate governance functions, banks would have required adequate risk management systems, which were another scarce good in the early stages of transition (Meagher, 2002). Apt risk management in banks is a prerequisite for good governance (in both enterprises and banks) and has to comprise both proper risk assessment and effective risk monitoring. But the reverse causality appears to hold, too, with good corporate governance mechanisms contributing to better risk management.

From the bank governance perspective, it is, however, more important to note that the lack of ability was also accompanied by a lack of willingness. In fact, it is widely argued that during early transition banks often had no interest in hardening budget constraints in the corporate sector.[56] First, high costs and lengthy procedures frequently made creditor rights enforcement unattractive. Second, banks hoped that future macroeconomic conditions would be more favorable and help borrowers to recover (wait and see attitude). Third, through inactivity and passivity, banks fearing a run or immediate action by supervisory bodies also tried to conceal their own financial distress.[57] Fourth, in the case of multiple creditors, the problem of free riding prevailed. Fifth, the lack of alternative high-quality projects and the "too many to fail" problem (Berglöf and Roland, 1998) induced banks to continue lending to established and troubled borrowers. This in turn deterred firms from initiating restructuring measures despite pressing adjustment needs (Berglöf and Thadden, 1999). Finally, in order to increase the probability of a government bailout, banks were also prone to soft budget constraints. Thus, banks' failure to exert proper corporate governance of firms is not only the outcome of, but also the reason for a lack of good governance in the corporate sector. On this note, Berglöf and Roland (1995, 1998) find that the likelihood of soft budget constraints (and bank bailouts) is negatively correlated with loan quality, collateral availability and the level of bank capitalization.

[54] *See Baer and Gray (1995), Berglöf and Claessens (2006) as well as Fox and Heller (2006).*

[55] *According to Baer and Gray (1995) and Hainz (2003), problems related to collateral during transition include unclear property rights, a narrow definition of property qualifying as collateral, multiple use of collateral, over-collateralization, an unfavorable hierarchy of liens and a low marketability of collateral. In this context, Weill and Godlewski (2009) find no empirical support for banks using collateral to mitigate ex ante informational asymmetries (adverse selection) in transition economies. This suggests that other considerations, i.e. minimizing loan losses and/or reducing ex post information asymmetries (moral hazard), play a more important role for collateral use.*

[56] *See e.g. Mitchell (1992), Begg and Portes (1993), Saunders and Sommariva (1993), Saal (1996) and Dittus (1996).*

[57] *For a case study on the Czech Republic, see Hanousek and Roland (2002).*

As transition proceeded, it became ever more evident that without an adequate legal and regulatory framework for claim enforcement and proper incentive structures, monitoring efforts would not be successful and misallocation of capital would continue. The soft budget constraints prevalent in the banking and enterprise sectors, a distorted debt repayment culture as well as weaknesses in transparency, enforcement and risk management led to the accumulation of a huge burden of nonperforming loans (both inherited and newly originated). This in turn affected the conduct of management (Meagher, 2002; Enoch, Gulde and Hardy, 2002), which often resulted in "lemming behavior" by banks and a high degree of short-termism in banks' business strategies (Fink and Haiss, 1999).

The incentive-distorting bad loan problem requires first and foremost that the magnitude of the underlying problem is ascertained. This is a challenging task given bank managers' interest to stay in office and their ability to easily mask emerging problems (Fink and Haiss, 1998). Aghion, Bolton and Fries (1996) argue that transition banks' incentive to reveal the true dimension of their bad loan problem largely depends on the rigor of the government. If the authorities are tough (if managers are fired, insolvent banks are shut down, etc.), banks will tend to underreport bad loans (and thereby contribute to a softening of the budget constraints in the corporate sector). On the other hand, if they are too soft (insolvent banks are fully bailed out and managers remain unpunished), banks will be inclined to overstate their problems. Aghion, Bolton and Fries (1996) also argue that the optimal amount of information will be revealed in a soft approach (reducing banks' incentives to conceal bad loans) in combination with the transfer of bad loans at an adequate price (i.e. less than the minimum value of a performing loan) to a hospital bank (reducing banks' incentive to overstate bad loans).

In order to be able to take appropriate measures to clean up bank balance sheets, it is also crucial to understand the link between managerial performance and bad loans. In this respect, empirical evidence is mixed. For example Rossi, Schwaiger and Winkler (2005), based on a sample of 278 banks in nine CESEE MS economies for the years 1995 to 2002, find evidence for the bad luck hypothesis: A high volume of bad loans and a low level of bank efficiency are the result of external factors outside management control. However, Podpiera and Weill (2008), based on data for Czech banks covering the period from 1994 to 2005, report empirical support for the bad management hypothesis: Low efficiency and a high level of bad loans are a sign of poor management performance.

Once the issue of management responsibility is addressed, attention has to be paid to the design of an incentive-compatible strategy for the workout of bad loans. In this context, debt cancelations and debt-equity swaps can send wrong signals toward managers (Meagher, 2002) and may even increase the risk of management misbehavior. In addition, banks – aware of the high skill- and cost-intensity of an active shareholder role and the related moral obligation to extend financing in times of trouble – may not even be interested in exercising corporate governance via debt-equity swaps (Dittus, 1996).

The literature also differentiates between state-led (often taking the form of a "bad bank") and bank-led workouts. The former is centralized (and was taken e.g. in Hungary, the Czech Republic and Slovakia), while the latter is decentralized (e.g. in Poland), depending on who is responsible for dealing with the bad debt problem. Both strategies have pros and cons. In particular, the centralized ap-

proach is seen to provoke the problem of moral hazard, while the decentralized approach is viewed to prolong ties to bad customers and thus to delay the recovery of banks (Bonin and Wachtel, 2004). Hence, a mixed strategy is often regarded as the best solution. In fact, Berglöf and Roland (1995) state that, depending on the loan portfolio quality, a partial transfer of nonperforming loans to a "bad bank" is preferable to a full transfer, which would release banks from their responsibility to participate in the costs of the balance sheet cleanup. In any case, the repair of banks' balance sheets has to go hand in hand with the restructuring of the corporate sector, preferably with some bank involvement, in order to account not only for the stock (inherited bad loans), but also the flow problem (newly generated bad loans).[58]

6.4 Institutional Governance

Sound institutions are vital for bank governance. In fact, institutional stakeholders – comprising public organizations responsible for legislation and law enforcement, and private (non- or for-profit) entities actively shaping banks' business environment – with all their multiple interests exert substantial influence on financial markets and institutions. They therefore to a large extent determine the timing and intensity of banking reform (Fink et al., 1999).

Most CESEE MS inherited weak institutional and legal systems, which made institution building a cornerstone of transition (Bonin and Wachtel, 2004). Thus, functional and credible institutional arrangements, both formal and informal, were crucial for hardening budget constraints in transition economies (De Haas, 2001). Reininger, Schardax and Summer (2002) as well as Berglöf and Pajuste (2005) found that the CESEE MS – encouraged by the need to adopt the acquis communautaire in the course of EU membership negotiations – have in little more than a decade made good progress in bringing their institutional and legal systems closer to Western standards (see chart 4 based on World Bank governance indicators).[59] However, they still spotted room for improvement mainly as regards the effectiveness of laws (i.e. implementation and enforcement).

However, in a weak environment not only bank owners and managers, but also institutional stakeholders might be inclined to make use of their bargaining power to influence the decision-making process in banks, in order to secure some "control and cash-flow rights" (Claessens, 2006). A stakeholder's bargaining power is thereby a function of his standing and legitimation (legitimate power), special expertise (expert power) or ability to reward conformity (reward power) and to penalize nonconformity (coercive power) (Fink and Haiss, 1999).

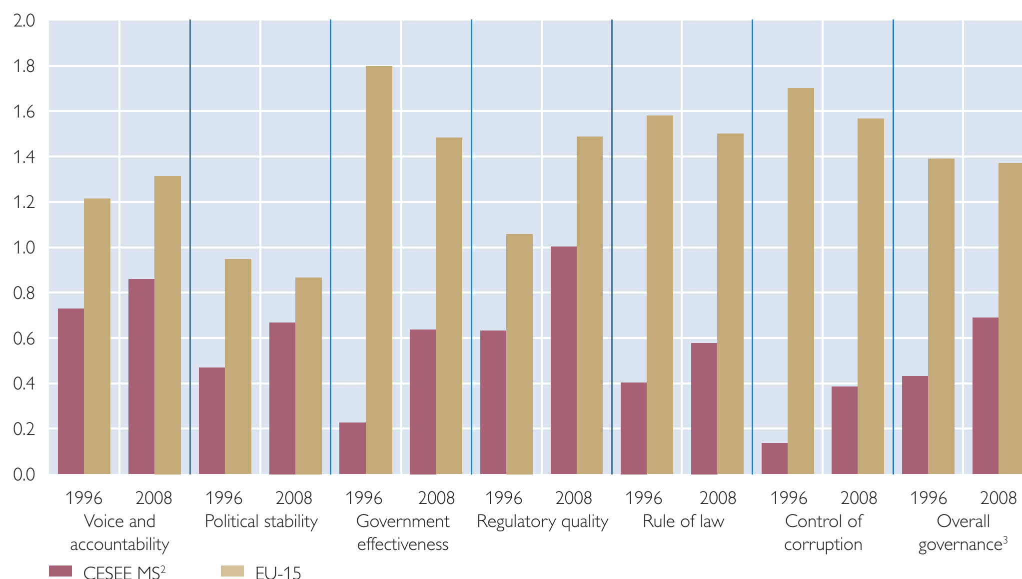
In fact, these agency relationships between banks and institutional stakeholders proved to be an obstacle to banking sector reform in the CESEE MS in the earlier stages of transition. There are two reasons for this: First, the general economic and political turmoil accompanying the transition process presumably also amplified institutional stakeholders' moral hazard behavior. Hoarding of compe-

[58] *For a comparison of the Czech and Polish approaches with a view to bank and corporate restructuring, see Weill (2002).*

[59] *In this respect, Pistor (2006) notes a high level of convergence between legal systems throughout the CESEE MS (despite differences in the pattern of legal change), which was most likely driven by the import of similar external legal solutions and foreign technical assistance.*

Chart 4

Development of Governance Indicators[1] in the CESEE MS



Source: Kaufmann, Kraay and Mastruzzi (2009), OeNB.

[1] The governance indicators are measured in units ranging from about −2.5 to 2.5, with higher values corresponding to better governance outcomes.

[2] The CESEE MS aggregate is the arithmetic mean of the data published for the individual CESEE MS.

[3] The overall governance indicator is the arithmetic mean of the six subindices.

tences, reputation concerns or simply financial interests may have led to "bureaucratic forbearance" and the pursuit of the "as little trouble as possible" strategy (Fink and Haiss, 1999). Second, difficulties may have also arisen out of intra-stakeholder relationships. Conflicting goals or discord over the scope of competences may delay banking reform and the recovery of weak banks.

6.5 International Governance

Financial liberalization, rapid development of information technology and financial innovation have brought about far-reaching globalization of banking services in the last few decades (Alexander and Dhumale, 2001), both via direct foreign lending/borrowing and via cross-border mergers and acquisitions. At the same time, banks have become more integrated with financial markets (Boot and Thakor, 2009). The CESEE MS were a key target region in this process, as they opened up their banking sectors in the run-up to EU membership. The market presence of foreign banks in the region soared and more recently several CESEE MS banks have started to enter foreign markets (mostly with an intra-regional focus).

To overcome the governance problems related to the internalization of the banking industry, efforts have been undertaken to harmonize regulatory, supervisory and corporate governance standards internationally under the leadership of the Basel Committee for Banking Supervision. These standards provide not only a broad regulatory framework and disciplining mechanism for the CESEE MS, but also the regulatory guidelines for CESEE MS policy makers and an important transmission channel of institutional and regulatory innovations (Ivaschenko and Brooks, 2008).

The applicability of these international norms to transition economies was initially limited, however, as these standards were developed for sound financial institutions operating under stable macroeconomic conditions. In particular, the use of the same standards (especially as regards capital requirements) in transition economies, which have displayed a higher level of risk and macroeconomic volatility than advanced economies, does not provide the same level of protection as in developed markets. During economic transition stricter regulations were thus regarded as preferable (Lindgren, Garcia and Saal, 1996; Arun and Turner, 2004) and were, indeed, applied in many countries. Furthermore, as Alexander and Dhumale (2006) argue, international standards are no panacea and have to be complemented by national regulations in order to account for differences in political, economic and legal environments. Finally, some of these standards potentially give rise to moral hazard (Schüler, 2003) and thus challenge bank regulation and supervision in countries, such as the CESEE MS, whose banking systems are dominated by internationally operating foreign banks.

On this note, Basel II seems to be an important tool for fostering prudent banking policies by increasing risk awareness and creating a level playing field for internationally operating banks. However, the Basel II debate has mainly focused on the risks associated with the first pillar, i.e. capital requirements, and not (yet) on those related to the second and third pillars, which, however, lie at the core of the governance debate, namely market discipline and the supervisory review process. This is presumably going to change now as the global financial turmoil has put the spotlight on these issues.

7 Concluding Remarks

This survey of the literature argues that the efficiency and soundness of banking systems critically depend on the design and quality of banks' governance arrangements. Failures within the different dimensions of the "governance nexus" are often a major factor behind banking distress. Thus, effectively restraining agency problems will have a considerable impact on the efficiency of capital allocation and economic growth prospects. Hence, to be successful, banking reforms have to go hand in hand with a redesign of the incentive structures for all the relevant actors in the banking system, and also have to take due account of the special characteristics of banks.

As revealed by this literature survey, considerable progress has been achieved in all the CESEE MS since the onset of transition to overcome prevalent shortcomings in bank governance. The European integration process and the increased market presence of foreign banks in the region have driven this development. The steadily growing number of governance codices at both the individual bank and the banking sector level, indicates that the CESEE MS have recognized the importance of good governance. As such codices are, however, often nonbinding ("soft law"), implementation seems still inadequate in some countries (Gandy et al., 2007). In fact, as the current crisis has shown, implementation of such mechanisms has proved far from adequate in mature markets as well.

The experiences of the CESEE MS economies provide important lessons for banking reform in less advanced transition economies. Based on a comprehensive notion of bank governance, which incorporates internal, external, corporate, in-

stitutional and international governance issues, the experience of the CESEE MS shows that any incentive-compatible banking reform should focus on:

- Creating a conducive business framework ("macro level") by (1) ensuring sound and credible monetary and fiscal policies, (2) strengthening the institutional, judicial and legal infrastructure, (3) increasing transparency via better disclosure practices, (4) introducing proper accounting and auditing standards, and (5) fostering capital market development with a view to improving and deepening complementary governance structures;
- Promoting banking sector developments ("meso level") by (1) adopting risk-sensitive and cycle-proof bank regulations, (2) establishing profound supervisory structures, which are aware of the risks associated with financial globalization and (3) enhancing market discipline;
- Enabling a recovery of individual banks ("micro level") by (1) quickly solving the bad debt problem and restructuring bank balance sheets, (2) recapitalizing banks (if necessary) in a well-defined, transparent and credible manner, (3) privatizing banks early and mainly (not necessarily exclusively) with the involvement of reputable foreign banks as strategic investors, (4) hardening budget constraints in the corporate sector as well as (5) improving financial literacy and management know-how to allow for a better understanding of risks and the importance of business leadership.

It takes time to create operational business frameworks, functioning regulatory and supervisory systems and efficient banking market structures. This makes the proper sequencing and timing of reform measures even more important to avoid micro governance problems. Developments in the CESEE MS in fact confirm that banking distress was often the result of mistakes in banking reforms. Also, there is no "one size fits all" approach for the proper governance of banks in the CESEE MS. After all, the applicability and effectiveness of governance arrangements also depend on cultural and historical factors, but likewise on the regulatory, institutional and political setting. Consequently, policy recommendations have to take into account country-specific factors (Berglöf and Thadden, 1999; Oman, 2001).

The strength of the governance reforms carried out so far in the CESEE MS is now being seriously put to the test in a fragile global economic and financial environment. As governance problems are among the root causes of the current global financial crisis, the traditional mechanisms of bank governance are being challenged. This implies that governance failures are an endogenous source of financial instability. But there are also many other open issues regarding the agency relationships and interactions between various stakeholders and the different dimensions of the governance nexus, the directions of causality or the role of newly emerging stakeholders in banks' governance.

In this context, it is critical to stress the dynamic aspect of bank governance, which not only calls for greater transparency, but also for a continuous adaptation of the regulatory and supervisory framework (regarding both the sectoral and the individual bank level) to the needs of a rapidly changing business environment. This is certainly not an easy task, especially in light of financial globalization, i.e. the increasing role of globally active financial conglomerates/holding companies, and financial and technological innovation of recent decades. In fact, as the experience from the current global financial turmoil shows, rapid financial innovation (resulting in ever more complex financial markets and sophisticated financial

products) and increasingly complex financial holding structures may fundamentally challenge bank governance practices, from the point of view of both insiders and outsiders. As to future academic work on these issues, it will be worthwhile to revisit some of the findings of the literature analyzed in this paper in order to see to what extent they still hold (or need to be modified), when the recent financial crisis experience is taken into account.

Dynamic aspects are critical for bank governance in the CESEE MS for at least three reasons. First, the changing nature of bank refinancing in the CESEE MS challenges banks' governance. The increased reliance on external (mainly parent bank) financing that was observed earlier in this decade in many CESEE MS highlights the relevance of parent banks in the governance of CESEE MS banks.

Second, recent years saw a change in banks' lending behavior in the CESEE MS, with lending for consumptive (and real estate) purposes gaining more weight. This challenges the corporate governance role of banks, which according to the prevalent literature primarily targets the relationship between banks and their corporate borrowers, and shifts attention to "retail governance." This in turn may be more challenging given the heterogeneity of retail borrowers and fairly low individual loan sizes, which not only limits information "reusability," but also possibly puts limits on monitoring efforts.

Third, potential future disintermediation – against the background of gradual market saturation with basic banking services, increasing demand for more sophisticated financial products and maturing capital markets – may lead banks to seek business opportunities in new (and possibly higher-risk) market segments. These challenges stress the need for better risk management practices, stepped-up bank supervision, more intensive home-host supervision coordination and close cooperation between bank supervisors and the supervisory bodies responsible for non-bank financial intermediaries.

References

Adams, R. and H. Mehran. 2003. Is Corporate Governance Different for Bank Holding Companies? In: Federal Reserve Bank of New York Economic Policy Review 9(1). 123–142.

Aghion, P., P. Bolton and S. Fries. 1996. Financial Restructuring in Transition Economies. Tilburg University. Center for Economic Research. Working Paper 96111.

Alexander, K. and R. Dhumale. 2001. Enhancing Corporate Governance for Financial Institutions: The Role of International Standards. ESRC Centre for Business Research. Working Paper 196.

Alexander, K., R. Dhumale and J. Eatwell. 2006. Global Governance of Financial Systems: The International Regulation of Systemic Risk. Oxford: Oxford University Press.

Allen, F. 2005. Corporate Governance in Emerging Economies. In: Oxford Review of Economic Policy 21. 164–177.

Allen, F. and D. Gale. 1999. Corporate Governance and Competition. Wharton School Center for Financial Institutions. Working Paper 99-28.

Andrews, M. 2005. State-Owned Banks, Stability, Privatization and Growth: Practical Policy Decisions in a World Without Empirical Proof. IMF Working Paper WP/05/10.

Arrow, K. 1985. The Economics of Agency. In: Pratt, J. and R. Zeckhauser (eds.). Principals and Agents: The Structure of Business. Boston: Harvard Business School Press. 37–50.

Arun, T. and J. Turner. 2004. Corporate Governance of Banks in Developing Economies: Concepts and Issues. In: Corporate Governance: An International Review 12(3). 371–377.

Baer, H. and C. Gray. 1995. Debt as a Control Device in Transitional Economies: The Experiences of Hungary and Poland. World Bank Policy Research Working Paper 1480.

Balling, M., E. Hennessy and R. O'Brien. 1998. Corporate Governance, Financial Markets and Global Convergence. Dordrecht: Kluwer.

Beck, T., R. Levine and N. Loayza. 2000. Finance and the Sources of Growth. In: Journal of Financial Economics 58(1–2). 261–300.

Begg, D. and R. Portes. 1993. Enterprise Debt and Economic Transformation: Financial Restructuring in Central and Eastern Europe. In: Mayer, C. and X. Vives (eds.). Capital Markets and Financial Intermediation. Cambridge: Cambridge University Press. 230–255.

Berglöf, E. and S. Claessens. 2006. Enforcement and Good Corporate Governance in Developing Countries and Transition Economies. World Bank Research Observer 21(1). 123–150.

Berglöf, E. and A. Pajuste. 2005. What Do Firms Disclose and Why? Enforcing Corporate Governance and Transparency in Central and Eastern Europe. In: Oxford Review of Economic Policy 21(2). 178–197.

Berglöf, E. and G. Roland. 1995. Bank Restructuring and Soft Budget Constraints in Financial Transition. In: Journal of the Japanese and International Economies 9. 354–375.

Berglöf, E. and G. Roland. 1998. Soft Budget Constraints and Banking in Transition Economies. In: Journal of Comparative Economics 26. 18–40.

Berglöf, E. and E. L. von Thadden. 1999. The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries. William Davidson Institute. Working Paper 263.

Bonin, J., I. Hasan and P. Wachtel. 2005a. Bank Performance, Efficiency and Ownership in Transition Countries. In: Journal of Banking and Finance 29. 31–53.

Bonin, J., I. Hasan and P. Wachtel. 2005b. Privatization Matters: Bank Efficiency in Transition Countries. In: Journal of Banking and Finance 29. 2155–2178.

Bonin, J. and P. Wachtel. 2004. Dealing with Financial Fragility in Transition Economies. BOFIT Discussion Paper 22.

Boot, A. and A. Thakor. 1993. Self-interested Bank Regulation. In: American Economic Review 83(2). 206–212.

Boot, A. and A. Thakor. 2009. The Accelerating Integration of Banks and Markets and its Implications for Regulation. In: A. Berger, P. Molyneux and J. S. Wilson (eds.). Oxford Handbook of Banking. Chapter 3.

Brissimis, S., M. Delis and N. Papanikolaou. 2008. Exploring the Nexus Between Banking Sector Reform and Performance: Evidence from Newly Acceeded EU Countries. In: Journal of Banking and Finance 32. 2674–2683.

Bruckbauer, S., S. Gardó and L. Perrin. 2004. Banking in CEE. BA-CA Xplicit. April.

Bruckbauer, S., S. Gardó and L. Perrin. 2005. Banking in South-Eastern Europe. BA-CA Xplicit. September.

Caprio, G. and D. Klingebiel. 1996. Bank Insolvency: Bad Luck, Bad Policy, or Bad Banking? In: Annual World Bank Conference on Development Economics. 1996. 79–114.

Caprio, G. and R. Levine. 2002. Corporate Governance of Banks – Concepts and International Observations. Global Corporate Governance Forum – Research Network Meeting. April.

Chai, J. and B. Johnston. 2000. An Incentive Approach to Identifying Financial System Vulnerabilities. IMF Working Paper WP/00/211.

Ciancanelli, P. and J. Reyes-Gonzales. 2000. Corporate Governance in Banking: A Conceptual Framework. SSRN Working Paper. June.

Claessens, S. 2004. Corporate Governance: Review of the Literature and Outstanding Issues. Presentation at the University of Amsterdam, Euro-Mediterranean Partnership. Brussels. June 10–11, 2004.

Claessens, S. 2006. Corporate Governance and Development. In: World Bank Research Observer 21(1). 91–122.

Claessens, S. and L. Laeven. 2003. Financial Development, Property Rights and Growth. In: Journal of Finance 58(6). 2401–2436.

Crotty, J. and G. Jobome. 2004. Corporate Governance in Transition Economies: A Synthesis of the Evidence. Aston Business School Research Papers RP0402.

Das, U. and S. Ghosh. 2004. Corporate Governance in Banking System: An Empirical Investigation. In: Economic and Political Weekly. March. 1263–1266.

Das, U., M. Quintyn and K. Chenard. 2004. Does Regulatory Governance Matter for Financial System Stability? An Empirical Analysis. IMF Working Paper WP/04/89.

De Haas, R. 2001. Financial Development and Economic Growth in Transition Economies: A Survey of the Theoretical and Empirical Literature. De Nederlandsche Bank. Research Series Supervision 35.

De Haas, R. 2002. Finance, Law and Growth During Transition: A Survey. De Nederlandsche Bank. Staff Reports 74.

De Haas, R. 2004. Law, Finance and Growth During Transition: A Survey. In: De Economist 152(3). 375–402.

De Nicolò, G., L. Laeven and K. Ueda. 2006. Corporate Governance Quality: Trends and Real Effects. IMF Working Paper WP/06/293.

Diamond, D. 1984. Financial Intermediation and Delegated Monitoring. In: Review of Economic Studies 51. 393–414.

Dittus, P. 1994. Bank Reform and Behavior in Central Europe. In: Journal of Comparative Economics 19. 335–361.

Dittus, P. 1996. Why East European Banks Don't Want Equity. In: European Economic Review 40(3–5). 655–662.

EBRD. 2009. Law in Transition 2009 – Corporate Governance in Banking. May. 28–57.

Eisenhardt, K. 1989. Agency Theory: An Assessment and Review. In: Academy of Management Review 14. 57–74.

Enoch, C., A. Gulde and D. Hardy. 2002. Banking Crises and Bank Resolution: Experiences in Some Transition Economies. IMF Working Paper WP/02/56.

Eriksson, T. 2005. Managerial Pay and Executive Turnover in the Czech and Slovak Republics. In: Economics of Transition 13(4). 659–677.

Fama, E. 1980. Agency Problems and the Theory of the Firm. In: Journal of Political Economy 88(2). 288–307.

Fama, E. and M. Jensen. 1983. Separation of Ownership and Control. In: Journal of Law and Economics 26. 301–325.

Ferri, G. 2003. Corporate Governance in Banking and Economic Performance – Future Options for People's Republic of China. ADB Institute Discussion Paper 3. August.

Fink, G. and P. Haiss. 1998. Seven Years of Financial Market Reform in Central Europe. In: Corporate Governance in Central and Eastern Europe: Transition Management is a Tough Job. SUERF Study 3.

Fink, G. and P. Haiss. 1999. Bank Failure and Lemming Behaviour. In: European Business Journal 11(4). 208–211.

Fink, G., P. Haiss, L. Orlowski and D. Salvatore. 1999. Privileged Interfirm/Bank Relationships in Central Europe: Trigger or Trap for Corporate Governance? CASE Network Studies and Analyses 170.

Fox, M. and M. Heller. 2006. Corporate Governance Lessons from Transition Economy Reforms. Princeton: Princeton University Press.

Fries, S., D. Neven and P. Seabright. 2002. Bank Performance in Transition Economies. EBRD Working Paper 76.

Fries, S. and A. Taci. 2002. Banking Reform and Development in Transition Economies. EBRD Working Paper 71.

Fries, S. and A. Taci. 2005. Cost Efficiency of Banks in Transition: Evidence from 289 Banks in 15 Post-communist Countries. In: Journal of Banking and Finance 29(1). 55–81.

Gelauff, G. and C. Broeder. 1997. Governance of Stakeholder Relationships – The German and Dutch Experience. SUERF Study 1.

Gompers, P., J. Ishii and A. Metrick. 2003. Corporate Governance and Equity Prices. In: Quarterly Journal of Economics 118(1). 107–155.

Gandy, B., P. Shaw, P. Tebbutt and M. Young. 2007. Corporate Governance in Emerging Market Banks. In: Corporate Governance in Financial Institutions. SUERF Studies 2007/3. 93–143.

Grosfeld, I. 1997. Financial Systems in Transition: The Role of Banks in Corporate Governance. In: Gupta, K. L. (ed.). Experiences with Financial Liberalization. Boston: Kluwer Academic Publishers.

Hainz, C. 2003. Bank Competition and Credit Markets in Transition Economies. In: Journal of Comparative Economics 31. 223–245.

Halme, L. 2000. Bank Corporate Governance and Financial Stability. In: Halme, L. (ed). Financial Stability and Central Banks: Selected Issues for Financial Safety Nets and Market Discipline. London: Bank of England Centre for Central Banking Studies. 32–70.

Hardy, D. 2006. Regulatory Capture in Banking. IMF Working Paper WP/06/34.

Harm, C. 2002. Bank Management between Shareholders and Regulators. SUERF Study 21.

Hanousek, J. and G. Roland. 2002. Banking Passivity and Regulatory Failure in Emerging Markets: Theory and Evidence from the Czech Republic. CEPR Discussion Paper 3122.

Hasan, I. and K. Marton. 2003. Development and Efficiency of the Banking Sector in a Transitional Economy: Hungarian Experience. In: Journal of Banking and Finance 27. 2249–2271.

Haselmann, R., K. Marsch and B. Weder di Mauro. 2009. Real Effects of Bank Governance: Bank Ownership and Corporate Innovation. CEPR Discussion Papers 7488.

Heinrich, A., A. Lis and H. Pleines. 2007. Factors Influencing Corporate Governance in Post-Socialist Companies: An Analytical Framework. William Davidson Institute. Working Paper 896.

Heremans, D. 2007. Corporate Governance Issues for Banks: A Financial Stability Perspective. Catholic University of Leuven. Center for Economic Studies Working Paper Series. February.

Hermes, N. and R. Lensink. 2000. Financial System Development in Transition Economies. In: Journal of Banking and Finance 24. 507–524.

Holmstrom, B. and J. Tirole. 1997. Financial Intermediation, Loanable Funds and the Real Sector. In: The Quarterly Journal of Economics 112(3). 663–691.

Honohan, P. 1997. Banking System Failures in Developing and Transition Countries: Diagnosis and Prediction. BIS Working Papers 39.

Ivaschenko, I. and P. Brooks. 2008. Corporate Governance Reforms in the EU: Do They Matter and How? IMF Working Paper WP/08/91.

Jensen, M. and W. Meckling. 1976. Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure. In: Journal of Financial Economics 3. 305–360.

Jones, D. and T. Kato. 1998. Chief Executive Compensation During Early Transition: Further Evidence from Bulgaria. The William Davidson Institute. Working Paper 146.

Kaufmann, D., A. Kraay and M. Mastruzzi. 2009. Governance Matters VIII: Aggregate and Individual Governance Indicators 1996-2008. World Bank Policy Research Working Paper 4978. June.

Király, J., K. Mérő and J. Száz. 2007. Cases of Corporate (Mis)Governance in the Hungarian Banking Sector. In: Gup, B. (ed.). Corporate Governance in Banking: Global Perspective. Cheltenham: Edward Elgar Publishing. 252–278.

Knack, P and S. Keefer. 1995. Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures. In: Economics and Politics 7. 207–227.

Koivu, T. 2004. Banking Sector Development and Economic Growth in Transition Countries. In: Balling et al. (eds.). Financial Markets in Central and Eastern Europe: Stability and Efficiency Perspectives. London: Routledge. 47–60.

La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. Vishny. 1998. Law and Finance. In: Journal of Political Economy 106(6). 1113–1155.

Leechor, C. 1999. Banking on Governance? Conflicts of Interest Facing Bank Owners and Supervisors. World Bank. Public Policy for the Private Sector. Note 198. October.

Levine, R. 1997. Financial Development and Economic Growth: Views and Agenda. In: Journal of Economic Literature 35(2). 688–726.

Levine, R. 1998. The Legal Environment, Banks and Long-Run Economic Growth. In: Journal of Money, Credit and Banking 30(3). 596–613.

Levine, R. 2004. The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence. World Bank Policy Research Paper 3404.

Levine, R. 2005. Finance and Growth: Theory and Evidence. In: Handbook of Economic Growth 1. Amsterdam: Elsevier. 865–934.

Lewis, M. 2002. Governance Structures. In: Sevic, Z. (ed.). Banking Reforms in South-East Europe. Cheltenham: Edward Elgar Publishing. 79–98.

Lindgren, C., G. Garcia and M. Saal. 1996. Bank Soundness and Macroeconomic Policy. IMF.

Llewellyn, D. T. 2007. Corporate Governance Issues in Non-Shareholder Value Institutions: A Case Study of Mutual Building Societies in the UK. In: Corporate Governance in Financial Institutions. SUERF Studies 2007/3. 53–89.

Macey, J. and M. O'Hara. 2003. The Corporate Governance of Banks. Federal Reserve Bank of New York. Economic Policy Review. April.

Meagher, P. 2002. Changing Hands: Governance and Transformation in Hungary's Financial Sector. In: Review of Central and East European Law 2002–3(1). 1–76.

Méon, P. and L. Weill. 2005. Does Better Governance Foster Efficiency? An Aggregate Frontier Analysis. In: Economics of Governance 6(1). 75–90.

Mishkin, F. 1997. Understanding Financial Crises: A Developing Country Perspective. In: Annual World Bank Conference on Development Economics 1996. 29–77.

Mitchell, J. 1993. Creditor Passivity and Bankruptcy: Implications for Economic Reform. In: Mayer, C. and X. Vives (eds.). Capital Markets and Financial Intermediation. Cambridge: Cambridge University Press. 197–224.

Nenovsky, N. and K. Dimitrova. 2008. Deposit Over-Insurance in EU Accession Countries – A Moral Hazard Boomerang to the Euro Area? "Paolo Baffi" Centre Research Paper Series 2008-20.

Nollen, S., Z. Kudrna and R. Pazdernik. 2005. The Troubled Transition of Czech Banks to Competitive Markets. In: Post-Communist Economies 17(3). 363–380.

Oman, C. 2001. Corporate Governance and National Development. OECD Technical Papers 180.

Oman, C., S. Fries and W. Buiter. 2003. Corporate Governance in Developing, Transition and Emerging Market Economies. OECD Development Centre. Policy Brief 23.

Pistor, K., M. Raiser and S. Gelfer. 2000. Law and Finance in Transition Economies. In: Economics of Transition 8. 325–368.

Pistor, K. 2006. Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies. In: Fox, M. and M. Heller (eds.). Corporate Governance Lessons from Transition Economy Reforms. Princeton: Princeton University Press. 35–83.

Podpiera, J. and L. Weill. 2008. Bad Luck or Bad Management? Emerging Banking Market Experience. In: Journal of Financial Stability 4(2). 135–148.

Pratt, J. and R. Zeckhauser. 1985. Principals and Agents: an Overview. In: Pratt, J. and R. Zeckhauser (eds.). Principals and Agents: The Structure of Business. Cambridge: Harvard Business School Press. 1–36.

Prowse, S. 1997. The Corporate Governance System in Banking: What Do We Know? In: BNL Quarterly Review. Special Issue. March. 11–40.

Quintyn, M. 2007. Governance of Financial Supervisors and its Effects – A Stocktaking Exercise. SUERF Studies 2007/4.

Reininger, T., F. Schardax and M. Summer. 2002. Financial System Transition in Central Europe: The First Decade. SUERF Studies 16.

Revoltella, D. 1998. Financing Firms in East European Countries: An Asymmetric information and Agency Costs Approach. In: Corporate Governance in Central and Eastern Europe. SUERF Study 3.

Rossi, S., M. Schwaiger and G. Winkler. 2005. Managerial Behavior and Cost/Profit Efficiency in the Banking Sectors of Central and Eastern European Countries. Vienna: OeNB. Working Paper 96.

Saal, M. 1996. Governance and Incentives. IMF. Paper for the Workshop on Systemic Bank Restructuring in Baltic Countries. Stockholm. May 20–22, 1996.

Sauerzopf, B. 2008. Corporate Governance and Credit Institutions. In: Financial Stability Report 16. Vienna: OeNB. 135–148.

Saunders, A. and A. Sommariva. 1993. Banking Sector and Restructuring in Eastern Europe. In: Journal of Banking and Finance 17. 931–957.

Schüler, M. 2003. Incentive Problems in Banking Supervision – The European Case. ZEW Discussion Paper 03-62.

Shleifer, A. and R. Vishny. 1997. A Survey of Corporate Governance. In: Journal of Finance 52(2). 737–783.

Tang, H., E. Zoli and I. Klytchnikova. 2000. Banking Crises in Transition Countries – Fiscal Costs and Related Issues. World Bank Policy Research Working Paper 2484.

Tirole, J. 1999. Corporate Governance. CEPR Discussion Paper 2086.

Tirole, J. 2001. The Theory of Corporate Finance. Princeton: Princeton University Press.

Weill, L. 2002. Does Restructuring Improve Banking Efficiency in a Transition Economy? In: Applied Economics Letters 9(5). 279–281.

Weill, L. 2003. Banking Efficiency in Transition Economies: The Role of Foreign Ownership. In: Economics of Transition 11(3). 569–592.

Weill, L. and C. Godlewski. 2009. Collateral and Adverse Selection in Transition Countries. In: Eastern European Economics 47(1). 29–40.