Complementing and Conflicting Views of Corporate Governance and Regulations in Banks and Financial Institutions: A Review

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Abstract

This paper reviews the previous studies for identifying the findings related to governance structure and regulations of Banks and Financial Institutions (BFIs) from the perspective of legitimacy theory. The findings are inconclusive on complementing or conflicting as previous literature on the role of different governance mechanisms of BFIs has no clear consensus and has also ignored the regulatory arbitrage, an important dimension of governance. The study contributes to the literature in two ways. Firstly, most of the past studies, empirical or review, mainly focus on the agency theory or the stakeholder theory to study the BFIs governance. This study focuses on the legitimacy theory as the agency theory or the stakeholder theory cannot directly be applied in the BFIs due to its specific nature. Secondly, the regulatory arbitrage is one of the main reasons as why the governance between BFIs and non-financial firms is different.

Keywords: Agency Theory, BFI, Governance, Legitimacy Theory, Regulation

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1. Introduction

Corporate governance (hereafter, governance) is emerging as a subject of profound significance (Clarke and Branson, 2012) in Banks and Financial Institutions (hereafter, BFIs). Effective governance practices are essential to achieving and maintaining public trust and confidence in the banking and financial systems (Bezawada, 2020), the essential systems to the effective functioning of the sector and economy as a whole. BFIs do business with the savings of depositors and invested capital of investors and the protection of their capital is to be ensured by the regulators with effective governance policies and practices. Further, the risk associated with invested capital can also be decreased with good governance practices (Gupta, 2009). Thus, intense regulations are required in banking system as compared to other industries and the regulations may be one of the measures of good governance mechanism (Bezawada, 2020). Poor governance may contribute to BFIs failures which can pose significant public costs and consequences due to their potential impact on any applicable deposit insurance systems and the possibility of broader macroeconomic implications, such as contagion risk and impact on payment systems.

Conceptually, regulations should complement the governance of the BFIs and legitimize its existence in the society. However, even though governance can complement and strengthen both the monitoring and intervention roles of regulatory agencies but it may also conflict with shareholder objectives and impose restrictions that limit the effectiveness of traditional governance mechanisms. At the same time, some regulations in fact may create an opportunity for some BFIs for taking excessive risk; utilize the regulatory arbitrage opportunity thereby legitimizing the firm to the stakeholders. As a result, the regulations can complement the internal governance of the BFIs or they create a barrier for the same. Therefore, the main objective of the present study is to review previous studies to identify the findings related to governance structure and the regulations of the BFIs. If the findings are consistent, then regulations complement the governance and on the other hand, if the findings are not consistent, then regulations are conflicting with the governance. The study is different from the previous studies due to two main contributions. Firstly, most of the past studies, empirical or review, mainly focus on agency theory or stakeholders' theory to study the BFIs governance. Thus, previous literature is dominated by the agency theory. This study argues that the conventional agency theory does not directly apply in BFIs and opposed the non-financial firms due to its specific nature. The current study reviews the past literature from the perspective of legitimacy theory i.e., whether regulations are complementing the governance or it is actually conflicting with the governance. Secondly, as opposed to most of the past studies that explains the differences of governance of BFIs and non-financial firms, this study argues that regulatory arbitrage is one of the main reasons as why the governance between BFIs and non-financial firms are different.

For the purpose of the study, the papers that are reviewed are selected randomly. However, the contents of the papers relevant for this study and scope, ranking or indexing [most of the papers are published journals ranked in Australian Business Dean Council (ABDC) and indexed in Social

Science Citation Index (SSCI)] of the journals are considered to ensure the quality of papers to be reviewed. Table 1 presents the list of some important papers for the scholars and readers' ease. Consistent with the study of Daily, Dalton, and Cannella (2003) who argued that governance is the determination of the broad structure and function, this paper reviews some important empirical studies on governance, focusing on selected governance mechanisms, specifically related to the board of the BFIs (Daily et al., 2003). More specifically the paper focuses on board independent, board committee, board quality (expertise) and board size and further examines whether the findings of previous studies are consistent with the hypothesis that regulations complement the governance of the BFIs. Further, BFIs are required to follow the regulations imposed by Central banks in regards to independent board members, board committees, and board size and board quality. Therefore, for the purpose of the current review, it is assumed that the BFIs have already incorporated these regulations into their board. Hence, the findings of the previous studies are taken as a proxy for regulations.

The next sections discuss the theoretical perspective and review of literature on governance in BFIs and regulations and governance in BFIs. The last section presents conclusion, implications, and future research.

Table 1. List of Some Important Papers

Name of Journal	Author/s	Paper Title
Restoring Financial Stability (2009)	Acharya, V.V., J. Carpenter, X. Gabaix, K. John, M. Richardson, M. Subrahmanyam, R. Sundaram and E. Zemel	Corporate governance in the modern financial sector
International Review of Finance (2012)	Adams, R. B.	Governance and the Financial Crisis
Journal of financial Intermediation (2012)	Adams, R. B. and H. Mehran	Bank board structure and performance: Evidence for large bank holding companies
Journal of financial Intermediation (2007)	Adams, R. B. and D. Ferreira	A theory of friendly boards
Journal of Financial Economics (2009)	Adams, R. B. and D. Ferreira	Women in the boardroom and their impact on governance and performance
International Review of Finance, (2012)	Adams, R.B. and D. Ferreira	Regulatory pressure and bank directors: Incentives to attend board meetings
Corporate Governance: An International Review (2016)	Al-Hadi, A., M. M. Hasan and A. Habib	Risk committee, firm life cycle, and market risk disclosures
Journal of Banking and Finance (2000)	Anderson, R. C. and D. R. Fraser	Corporate control, bank risk taking, and the health of the banking industry

International Review of Financial Analysis (2013)	Barakat, A. and K. Hussainey	Bank governance, regulation, supervision, and risk reporting: Evidence from operational risk disclosures in European banks
Journal of Finance (2010)	Bebchuk, L. A., Y. Grinstein and U. Peyer	Lucky CEOs and lucky directors
SSRN.https://dx.doi.org/10.2139/ssrn.253714. (2000)	Ciancanelli, P. and J.A. Reyes-Gonzalez	Corporate governance in banking: A conceptual framework
The Academy of Management Review (2003)	Daily, C. M., D.R. Dalton and A. A. Jr. Cannella	Corporate governance: Decades of dialogue and data
Journal of Political Economy (1983)	Diamond, D. W. and P. H. Dybvig	Bank runs, deposit insurance, and liquidity
Journal of Economic Surveys (2016)	De Haan, J., and R. Vlahu	Corporate governance of banks: A Survey
Journal of Monetary Economics (2002)	Demirgüç -Kunt, A. and E. Detragiache	Does deposit insurance increase banking system stability? An empirical investigation
Journal of Banking and Finance (2008)	de Andres, P. and E. Vallelado	Corporate governance in banking: The role of the board of directors
BIS Papers (2014)	Domanski, D. and V. Sushko	Rethinking the lender of last resort: workshop Summary
Journal of Finance (2016)	Drechsler, I., T. Drechsel, D. Marques-Ibanez and P. Schnabl	Who borrows from the lender of last resort
Journal of Corporate Finance (2012)	Erkens, D.H., M. Hung and P. Matos	Corporate governance in the 2007–2008 financial crisis: Evidence from financial institutions worldwide
Corporate Governance: An International Review (2007)	Durisin, B. and F. Puzone	Maturation of corporate governance research, 1993–2007: An assessment
Journal of Law and Economics (1983)	Fama, E.F. and M.C. Jensen	Separation of ownership and control
Universidad de San Andres Working Paper (2004)	Gonzalez-Eiras, M.	Banks' liquidity demand in the presence of a lender of last resort
Stanford University Working Paper, Rock Center for Corporate Governance (2014)	Gornall,W. and I. A. Strebulaev	Financing as a supply chain: The capital structure of banks and borrowers
Corporate Governance: An International Review (2010)	Hagendorff, J., M. Collins and K. Keasey	Board monitoring, regulation, and performance in the banking industry: Evidence from the market for corporate control
Review of Financial Studies (2008)	Harris, M. and A. Raviv	A theory of board control and size
Economic Policy (2009)	Hau, H. and M. Thum	Subprime crisis and board incompetence: private vs. public banks in Germany

Journal of Corporate Finance (2010)	John, K., H. Mehran and Y. Qian	Outside monitoring and CEO compensation in the banking industry
Corporate Governance: An International Review (2016)	John, K., S. De Masi and A. Paci	Corporate governance in Banks
Annual Review of Financial Economics (2013)	Laeven, L	Corporate governance: What's special about banks
Macquarie Applied Finance Centre Research Paper (2012)	Lingel, A. and E.A. Sheedy	The Influence of Risk Governance on Risk Outcomes – International Evidence
Charles A. Dice Center Working Paper No. 2010-14, Fisher College of Business Working Paper No. 2010-03-014	Minton, B.A., J. P.A. Taillard and R. Williamson	Do Independence and financial expertise of the board matter of risk taking and performance?
Journal of Banking and Finance (2010)	Pathan, S. and M. Skully	Endogenously structured boards of directors in banks
Journal of Banking and Finance (2013)	Pathan, S. and R. Faff	Does board structure in banks really affect their performance?
Journal of Banking and Finance (2009)	Pathan, S	Strong boards, CEO power and bank risk-taking
Corporate Governance: An International Review (2016)	Srivastav, A. and J. Hagendorff	Corporate governance and bank risk- taking
Journal of Business Finance and Accounting (2011)	Upadhyay, A. and R. Sriram	Board size, corporate information environment and cost of capital
Journal of Banking and Finance (2013)	Wang, T. and C. Hsu	Board composition and operational risk events of financial Institutions
Corporate Governance: An International Review (2011)	Yeh, Y. H., H. Chung and C. L. Liu	Committee independence and financial institution performance during the 2007-08 credit crunch: Evidence from a multi-country study
Journal of Finance and Banking Studies (2018)	Zakaria, Z., N. Purhanudin and A. N. Wahidudin	The Role of Board Governance on Bank Performance

2. Theoretical Perspective

Theoretically, governance research has been and continues to be dominated by the Agency theory due to the moral hazard and adverse selection (Durisin and Puzone, 2009). The Agency theory views a firm as a relationship of contracts between the principal (providers of the capital) and the agent (manager of the capital). In contrast, the stakeholder theory views go beyond just a single shareholder to include a wider group of stakeholders, other than just shareholders. Freeman (1984) argued that the purpose of the firm is defined by the overall value creation for stakeholders and that it should be managed in the interest of all its stakeholders. The stakeholder theory has brought significant attention and support since its early formulation as it attempts to develop the alternatives

for corporate governance which include and balance a multitude of interests. It is highly regarded for bringing ethics and addressing morals and values while managing a firm. Previous studies show that theories of governance usually (not exclusively) adopt either an agency/shareholder approach (Jensen, 2001) or the stakeholder theory of the corporation (Donaldson and Preston, 1995). In contrast to these two theories, the present study argues that legitimacy theory is more applicable in the current context. Legitimacy theory argues that organizations can only continue to exist if the society in which they operate perceives that the organization is operating within the bounds of a value system acceptable to society (Dowling and Pfeffer, 1975). It suggests that management can influence the general public's perceptions of the firm. Therefore, legitimacy theory implies that being legitimate, to a large extent, is controllable by the corporation itself (Donaldson and Preston, 1995). This attempt at managing legitimacy may take many forms, from the corporation changing its activities to consistent with social perceptions through attempts, to influence processes that may cause a change in social perceptions or values. Legitimacy theory is a theoretical construct used for making viable prediction (Burlea and Popa, 2013). It does not explain what managers should or ought to do. It simply explains the actions of the managerial behaviour. However, many scholars have also criticized the legitimacy theory (Mobus 2005; Owen 2008) due to its abstract nature. Theory works in two levels i.e. an organizational level which is known as Strategic Legitimacy Theory (SLT) and macro level which is known as Institutional Legitimacy Theory (ILT). Blending of these two levels determine the legitimacy of the organization in the society. If an organization has legitimacy means that it is perceived and accepted by the stakeholders and society as having the right to exist and perform moral activities (Burlea and Popa, 2013). We argue that maintaining good governance is one of the key functions and attempts made by the BFIs to be legitimized in the society.

Further, the application of the legitimacy theory in the regulation and governance may further be justified due to the regulatory arbitrage. The impact of regulatory arbitrage in regulation and governance of BFIs is largely ignored by the existing literatures. Downs and Shi (2015) argue that regulatory arbitrage is one of the loopholes in regulations arising from regulatory inconsistency and can be considered as a regulatory leakage (Aiyar, Calomiris, and Wieladek (2014b). In the past, BFIs have utilized the opportunity of regulatory arbitrage when it exists (Willesson, 2017). Therefore, this paper argues that regulatory arbitrage is closely related to the governance issue of BFIs as it is an attempt to legitimize its actions by taking advantage of regulatory loopholes and inconsistencies. The likelihood of using regulatory loopholes is consistent with violating the established governance practices and codes. The paper also argues that as regulatory arbitrage is against the G20/OECD (2015) governance principle number VII (7) that requires bank boards to comply with the law and relevant standards. Thus, the Boards of the BFIs have greater responsibilities to monitor and minimize the possibility of the regulatory arbitrage.

Consistent with the argument above, procedural legitimacy which is defined in terms of democratic accountability, with elections being the principal defining characteristic, and also in terms

of institutional arrangements like separation of powers, transparency, and rule of law principles intended to combat abuses of power is closely linked with the BFIs governance policies. One of the objectives of the regulations imposed by central banks is that a fully functioning Board of directors (a test of procedural legitimacy) cannot take actions that will pollute the environment, treat their workers badly, or take money from investors. However, due to the regulatory loopholes and complex agency relation, BFIs can use the regulations to legitimize its operations and accountability even though it may not be consistent with the governance principles.

3. Review of Literature

3.1. Governance in BFIs

The governance structure of BFIs is different from non-financial firms (Adams and Mehran, 2012; de Haan and Vlahu, 2016) even though it is equally important in both types of firms. As with any company, BFIs also have Board of Directors (hereafter, Board) who are responsible for the monitoring, advising and controlling of the management activities to ensure that managers' interest are aligned with the interest of the shareholders. But the scope is not limited to only separation of ownership and control in BFIs. Therefore, standard governance features may limit the effectiveness of standard governance mechanisms in BFIs (Laeven, 2013). Following are the main five differences of governance in BFIs than non-financial firms.

First, difference is the complex agency relationship. BFIs have a special nature of the agency relationship which is not widely covered in the existing literatures. As opposed to the agency theory, in which main opponents are owners and the mangers; there are at least three opponents of asymmetric information in BFIs i.e. among depositors, the bank and the regulator; among owner, managers and the regulator; and among borrowers, managers and the regulator (Ciancanelli and Gonzalez, 2000). Thus, the conventional agency theory which is the dominant theory in the governance study (Durisin and Puzone, 2009) cannot be directly applied in the BFIs.

Second, one is the most prominent conflict of interest that exists in BFIs between equity-holders and debt-holders which includes depositors (John, et al., 2016). Deposit is the primary resource and it is considered as the major source of debt for the BFIs. As a result, BFIs are by nature highly levered firms as compared to non-financial firms. Past studies show that the average leverage of BFIs, measured as the ratio of debt to assets, is around 87 to 95 percent, as against 20–30 percent of average leverage if non-financial firms (Gornall and Strebulaev, 2014). In BFIs, debt-holders (depositors) have the primary claim on the asset of the BFIs. Some literatures have highlighted that the managers of a firm with high leverage (like BFIs) have a strong incentive to invest in the high-risk project to align the interest of owner and the managers. Therefore, agency costs are more pronounced in BFIs than in non-financial firms (Laeven, 2013) due to the conflict of interests of debt-holders from those of the equity-holders. According to John, De Masi, and Paci (2016), "standard managerial incentives that align shareholders' interests with managers' interests might increase a conflict between equity-

holder and debt-holder in leveraged firms" (p3). As a result, equity-holders have the potential to increase the agency cost of debt in BFIs that may result in the loss of value of the firm.

Similarly, deposits are in general short term in nature. But the assets that are financed by using short term deposits tend to be longer dated. Hence, they are exposed to liquidity risk and bank runs due to the maturity mismatch (Diamond and Dybvig, 1983). In addition, funding through deposits creates an incentive to the BFIs for taking excessive risk as the depositors bear substantial portion of the cost of the failure (de Haan and Vlahu, 2016). Therefore, depositors have a high incentive to monitor the activities of the BFIs. But in general, depositors do not or cannot monitor the performance of the management of the BFIs mainly due to two reasons. Firstly, the information asymmetry and coordination costs are high for the depositors (Demirgüç-Kunt and Detragiache, 2002). Secondly, since most of the depositors are generally protected by some deposit–insurance, they have less incentive of monitoring the performance of banks' manager due to the moral hazard. After the seminal work of Diamond and Dybvig (1983), deposit insurance is considered as an optimal policy against the potential risk of depositor runs. However, some empirical studies also acknowledge that it is also a source of moral hazard that leads more bank failures and the systemic crisis. For example, Demirgüç-Kunt and Detragiache (2002) found a positive correlation of the deposit insurance with the probability of a banking crisis.

Further, the third difference between BFIs and non-financial firms is the opacity of BFIs assets. The assets of banks in general are opaquer than the non-financial firms because of large informational asymmetries of the loan quality. In addition, as opposed to the manufacturing firms, the risk compositions of the assets of BFIs change quickly and these risk compositions create a difficulty for the Board to monitor the loan quality. As a result, the risk compositions of the assets are not readily available for outside investors and market (John, et al., 2016). According to Levine (2004), "the opacity and the asymmetry of information in the context of banking makes it more difficult for diffuse equity holders to control managers and for debt holders to control banks from risk shifting from shareholders to debt holders (p4)". On the contrary, the study of John, Mehran, and Qian (2010) claims that the opacity of the BFIs assets may not pose significant governance problem due to the strong disclosure requirements and constant scrutiny from the market. However, the financial crisis in 2008 and subsequent banks' failures after the crisis show that strong disclosure requirements may not necessarily solve the problem of the opacity of the banks' assets.

Fourth and last, BFIs are the Lender of Last Resort which is even though not widely covered in the literature. The concept of Lender of Last Resort (hereafter, LLR) is one of the reasons of the failure of governance and moral hazard in BFIs. In 1873, Bagehot first time proposed the concept of the LLR role of central bank that is responsible for the systemic stability. Bagehot supported to lend freely to solvent but illiquid BFIs against the good collateral to minimize the possibility of bank run. It is also one of the most controversial policies of the central banks around the world. On one hand, it creates an opportunity for the central banks to stabilize the macroeconomic variables and the

payment system in case of crisis by lending necessary fund to BFIs. But on the other hand, it also creates moral hazard and exposes the central bank to financial risks (Domanski, and Sushko, 2014). For example, during the Argentinian banking crisis in 2001, banks started to reduce the liquidity holdings before the crisis in the anticipation of LLR involvement with no fundamental reason (Gonzalez-Eiras, 2004). The study of Drechsler, Drechsl, Marques-Ibanez, and Schnabl (2016) examines the LLR lending during the European sovereign debt crisis. Their finding, weakly capitalized banks took out more LLR loans than the strongly capitalized banks during the European Sovereign Debt crisis in 2010, is not consistent with the classical theory of LLR that advocates central bank lending to BFIs to minimize the systematic crisis by allowing them to continue financing their existing assets.

Further, some studies also link LLR to moral hazard and serious erosion of competition, giving some BFIs preferential treatment on the market most specifically too big to fail institutions. In the case of run on large financial institutions like too big to fail, it may also bring down the whole financial system due to the domino effect and systemic impact. The classical example is the bailout of City Group in 2008. The City Group was bailed out by US government in 2008 citing the reason of safeguarding the financial system from the failure. In addition, other large BFIs (for example AIG, Bank of America, Bear Stearns, Fannie Mae, Freddie Mac and in Europe some Royal Bank of Scotland, ING, Fortis) are also bailed out by the government in 2008. It is also an example of the preferential treatment from the government to too big to fail BFIs. Hence, the perception of the management of too big to fail BFIs that the government does not let them to fail has been considered as one of the main reasons of banking crisis in the past. It also gives rise to moral hazard as it makes banks more susceptible to risk-taking. Hence, LLR is considered to be the reason of growing frequency of systemic crisis and major issue of governance.

Based on the above reviews, the complex agency relationship among managers, board, regulators, debt-holders along with the opacity of the assets and arrangement of LLR, the governance structure of BFIs is quite different than non-financial firms. Therefore, as opposed to the standard governance mechanism that aligns the managers' interests with those of the equity-holders may not completely apply in BFIs. While the study by Acharya et al. (2009) proposes to design governance of BFIs by aligning the managers' interests with the interests of debt-holders (including depositors), this paper argues that the governance of BFIs should be designed so as to align the managers' interests with the interests of debt-holders (including depositors) and regulators as well.

3.2. Regulations and Governance in BFIs

Daily, Dalton, and Cannella (2003) argued that corporate governance is the determination of the Broad uses to which organizational resources will be displayed and the resolution of conflicts between stakeholders. Consistent with the argument, the Boards of the BFIs are at the center stage of the governance study. There are two main types of Boards. In Anglo-Saxon capitalism, there is a

unitary/monistic Board structure, where both the executive and non-executive segments are combined. In Rhine capitalism, there is typically a two-tier Board structure installed, with a separate management/executive board and a supervisory/non-executive board. The Anglo-Saxon model is based on the common law system in which a controlling shareholder have dominant influence on the appointments of both executive and non-executive directors. Most of the past researches in the governance are focused on the Anglo-Saxon System of the Board structure where shareholders' wealth maximization is the main objective of the firm.

Corporate Boards represent a central internal mechanism of governance of BFIs. This heightened research interest in Boards is well reflected in Durisin and Puzone's (2009) bibliometric analysis of governance literature. They have identified strands of work on Board structure and composition, as well as Board members' characteristics, as one of the dominant streams of research in this literature with a substantial number of contributions. However, existing theoretical studies have not provided clear answer to the impact of regulation on the effectiveness of governance (de Haan and Vlahu, 2016). According to de Haan and Vlahu (2016), regulations may act as a substitute for monitoring by Boards if the managerial discretion is limited by the regulations. Similarly, firm-level governance may be promoted by the strict regulatory environments. This firm-level governance is effective in controlling for agency cost so that a complementary relationship exists between governance and regulations (Hagendorff et al., 2010). But, in general, previous literature agreed that the design of internal governance mechanisms is affected by the presence of regulations which ultimately have an impact on BFIs performance (de Haan and Vlahu, 2016).

Over the years, the bank regulators around the world have established strict regulations on the composition of the BFIs Board structure, Board size, Board quality, Board independences, Board committees, and ownership concentration etc. Even though these regulations are imposed to ensure the proper monitoring of the Board to the executives thereby implement effective governance, it may hinder the smooth function of the executives of the BFIs. For example, different Board committees can impose different rules/policies which may create a conflict with the executives and limit their discretion. There are several previous empirical studies that focus on the impact of Board (size, structure, independence, etc.) to the financial performance of the BFIs. However, the results are mixed. Below are the brief reviews of the Board characteristics of BFIs.

One of the critical issues in the governance of BFIs is the Board independence as it is critical for the internal governance of the firms. In the past, the studies investigated the relation between board independences and firm performance. They argued that a diligent scrutiny is done by the independent directors because of incentives and seeking their reputation as effective monitors of managerial discretion (Fama and Jensen 1983). Anderson and Fraser (2000) suggest that a Board's effectiveness in its monitoring function is determined by its independence. Since independent directors are in a better position to make management disciplined, they are expected to be more effective in prohibiting opportunistic behaviors, thereby reducing potential agency conflicts (Bebchuk et al., 2010).

Further, the reduction in the Board's information production and monitoring function with hurts in advisory role can happen with more independence as theorized by Adams and Ferreira (2007). Consistent with this, Adams and Mehran (2012) found that Board independence is not related to bank performance. de Andres and Vallelado (2008) show that outside directors and bank performance have an inverted U-shaped relationship. The authors claim that the inclusion of outsiders improves performance, but when a high proportion of the total Board is reached, performance starts to decrease. Consistent with this, Pathan and Skully (2010) further investigated the effect of independent directors. They found that BFIs benefit from a higher number of independent directors when the cost of monitoring managers is low. Further, the CEO responds to increased Board independence by providing less information if stronger monitoring incentives are provided to the independent directors than dependent directors. Harris and Raviv (2008) made a similar point. They show that, except for situations in which agency costs are high, shareholders are more contented with a Board controlled by insiders. These results challenge the policy formulation concerning the inclusion of a high number of independent directors.

The issue of Board independence, Board expertise (quality) and the size of the Board are interlinked. It is argued that the number of independent Board members may not necessarily be effective for BFIs if they lack sufficient expertise to monitor complex transaction banking firms and oversee the actions of the Chief Executive Officer (CEO) (Adams, 2012; Zakaria et al., 2018). According to John, de Masi, and Paci (2016), the main questions of the board expertise is "How many "financial experts" should a bank board have? Are financial experts able to assess the risks posed by the more complex products? Should nonfinancial experts be included on the board of a bank?"(p9). The expertise of the Board members is also extensively researched in the past. Due to the complex agency relationship and more opaque nature of the operations, the monitoring functions of the Board of the BFIs is also complex, more demanding and requires specific expertise. Therefore, an important policy concern, particularly from the perspective of the role played in risk management, is considered for the sector-specific expertise of bank directors.

Consistent with the resource dependency theory, Board with financial experts arguably have lower costs in acquiring information about the complexity and associated risks of certain financial transactions and hence are better able to efficiently monitor senior management (Harris and Raviv 2008). However, previous literature shows that outside directors of financial institutions lack any significant recent experience in the banking industry (Minton et al., 2011). Without sufficient knowledge of banking, supervisory Board members cannot effectively monitor the executive Board. For example, quarter of all publicly-traded U.S. commercial bank holding companies with over one billion dollars in assets do not have a single financial expert among their independent director during 2008/09 (Minton et al., 2011).

In Nepal, BFIs are required to conduct a training/orientation, for the Board members in the area of compliance, transparency, conflict of interest and international best practices at least once in a year

(Unified Directives 2076). In India, a committee formed to Review Governance of Boards of Banks in India (Report of the Committee to Review Governance of Boards of Banks in India, 2014) recommended that without upgrading the skills in Boards of public sector banks and without reconfiguring the entire appointments process for Boards, it is unlikely that these Boards will neither be empowered nor be effective. The empirical findings of the past literatures on the performance and the expertise of the Board are mixed but largely support the hypothesis that Board members with the expertise increase the performance of the BFIs. For example, Hau and Thum (2009) reported the positive relationship between lack of financial experience of Board members in German banks and realized losses in 2007/2008. But no significant relationship between financial experience of Board members and firms' stock returns was found during the crisis (Erkens et al., 2012). Similarly, Srivastav and Hagendorff (2016) found that Board attributes (i.e. educational qualification and prior relevant experience of Board members) can have an important impact on BFIs risk-taking incentives.

The results for Board size are also mixed. For example, Pathan and Faff (2013) found that both Board size and independence of directors decrease bank performance for a panel of large US bank holding. Wang and Hsu (2013) found Board size is negatively and nonlinearly associated with the possibility of operational risk events. They found that when the board size exceeds 14, adding an incremental Board member increases the likelihood of operational risk events. In contrast, Upadhyay and Sriram (2011) argued that managerial performance can simply be monitored by a larger Board because of control of greater resources. This is consistent with the resource dependency theory. The reason, the research on banks finds a positive relationship between Board size and bank performance, might be because banks are complex firms and the benefits of larger Boards overcome their costs. De Andres and Vallelado (2008) found a limit (19 directors) beyond which the costs associated with a larger Board (such as coordination problems, slow decision making, and control costs) dominate the benefits. In contrast, no relationship was found between Board size and bank performance during the crisis (Erkens et al., 2012).

The relevant finding that emerges in the literature is that the optimal Board size is a trade-off between advantages (better monitoring and more competence to address problems) and disadvantages (control and coordination problems). Some studies also show that small Board leads to excessive high risk taking than large Board (Pathan, 2009). Some researchers also studied the effectiveness of the Board diversity (minority community, race, demography, gender, age, etc.). A Board composition that represents diverse members would collectively possess more information and therefore would have the potential to make better decisions (de Haan and Vlahu 2016). Once more, the empirical results are mixed. For example, Adams and Ferreira (2009) provide evidence that boardroom gender diversity improves several important aspects of Board behavior. They suggested that gender-diverse Boards are tougher monitors as the firms with relatively more women on Boards may make to hold CEOs accountable for poor stock price performance.

Another area of the Board effectiveness research is the function of Board committees. Initially, the Board committees rarely featured in scholarly work. But now the regulators have increasingly recommended the establishment of different Board committees in BFIs which is in line with the provisions of corporate governance codes. In fact, some authors argue that the effectiveness of the Board is influenced by Board committees (John, et al., 2016). According to Governance requirement, Unified Directives 2076 issued by Central Bank of Nepal, BFIs in Nepal are required to have minimum four Board sub committees i.e. Audit Committee, Risk Management Committee, Human Resource Committee, and Anti Money Laundry Committee. As per the regulations, only non-executive Board member can be the chairman of the Board committee.

The empirical evidences from the other countries are also mixed but largely support the function of the Board committees. For example, Barakat and Hussainey (2013) examined the quality of audit committee and operational risk disclosure in European banks. They have used a sample of 85 banks from 20 EU countries (Austria, Belgium, Bulgaria, Cyprus, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Lithuania, Malta, the Netherlands, Poland, Portugal, Spain, Sweden, and the United Kingdom) for the years 2008–2010. They found that the banks with more active audit committees provide operational risk disclosure of higher quality. Consistent with the findings; Lingel and Sheedy (2012) studied the quality of oversight of the Board risk committee. They reported evidence that the proportion of experienced bankers in the risk committee has increased significantly from 2004 to 2010. They showed that stronger risk governance reduces risk and increases return on assets (ROA) in a sample that includes 60 banks representing 17 nations with different regulatory and business contexts. They suggested that decisions about risk governance matter regardless of specific local conditions.

In Asia, Al-Haidi, Hasan, and Habib (2016) investigated whether the existence of separate risk committee characteristics is associated with market risk disclosure for a sample of financial firms in Gulf Cooperation Council (GCC) countries (i.e. Oman, Bahrain, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates) for the years 2007– 2011. They found that firms with a separate risk committee, better risk committee qualification, and larger risk committee size are associated with greater market risk disclosure. Some researchers have also studied the effectiveness of the involvement of the independent director in the Board committees. For example, Yeh, Chung, and Chih-Liang (2011) studied the effect of independent directors on different committees in the 2007–2008 financial crisis. Using the 20 largest financial institutions from the G8 countries (Australia, Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States), they found that the independence of both the auditing and risk committees has a positive effect on performance during the crisis.

4. Conclusions, Implications and Future Research

In view of the differences between BFIs and non-financial firms (regulations, opacity, high leverage) the optimal corporate governance of BFIs is different, even from a traditional corporate governance perspective. The current review shows that, in general, the literature on the role of different governance mechanisms of BFIs has no clear consensus. Hence, most of the current literature finds inconclusive results on the effect of financial expertise on bank performance and risk taking (John, et al., 2016). The reasons could be the time period covered and the methodology used. Similarly, another reason is the significant ignorance of interdependence of different dimensions of governance. Because the efficacy of one dimension may be conditioned by another dimension, therefore the role of each mechanism is not to be assessed in isolation. Therefore, based on our findings, it is argued that the regulations are conflicting with the governance of BFIs. Future research should focus on the interactions and interlink of different governance mechanism of the BFIs rather than investigating one or two dimensions independently. For example, even though the importance of board independence has been emphasized by both regulators and policymakers and the empirical effect of independent directors on outcomes in BFIs are consistent to some extent. However, it ignored the quality of the independent director. Therefore, future research should investigate the “quality” of independent directors (John, et al., 2016). Similarly, existing literature has generally ignored some dimensions of governance. For example, the issues of governance in regulatory arbitrage are largely ignored by the exiting studies. At the same time, theoretically, future research should focus on BFI’s governance mechanism based on legitimacy theory than conventional theories like Agency Theory. It may explain the conflicting results of the previous studies of governance of BFIs.

Essentially, variation in national regulations and governance systems may explain differences between studies including BFIs from several countries since substantial evidence found to confirm the interaction among governance of BFIs, financial regulation and national governance (de Haan and Vlahu, 2016). Different national regulatory bodies may have different objectives and requirements when performing various monitoring functions on behalf of depositors and such heterogeneity may affect the efficiency of various governance mechanisms (de Haan and Vlahu, 2016). Further research needs to be carried out in developing and under developing countries to understand and test the established theories with the country specific issues and investigate whether the regulations imposed are actually complimenting the governance or conflicting with the sound governance system of the BFIs.

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