REVISITING BANK GOVERNANCE FROM AN AGENCY PERSPECTIVE: IN SEARCH OF THE BANKS’ TYPE IV AGENCY PROBLEM AND SOLUTION

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ABSTRACT

In this paper, I revisit corporate governance of banks from an agency perspective. Acknowledging the already elaborated three types of agency problems, I advocate some more attention to the Type IV agency problem, i.e. the misaligned interest between banks and the economy, which in particular matters for East Asian developmental states whose economic development heavily relies on banks, “the nerve of the developmental state.” I analyze how this Type IV agency problem takes place and attribute that to the informational asymmetry in banking sector, in particular the adverse selection between banks and borrowers. To address this market failure through private ordering, banks need a governance mechanism to ensure an information system in place for mitigating the informational asymmetry, but the bank governance reform after the Financial Crisis, be it the risk management reform or the shareholder empowerment movement, fails to scratch the itch. This justifies some level of governmental intervention, especially a case for the government ownership of banks. In this sense, the prevalence of government-owned banks in East Asian countries provides for an opportunity, but it could be a disaster as well if polluted by the grabbing hand of the government. Accordingly, I propose some governance guidelines for “governing the government,” such as private sectors participation, accountability of government directors and disclosure of governmental intervention. By revisiting the bank governance from this new perspective of Type IV agency problem, I anticipate that banks may serve a “good servant” to instead of a “bad master” of the economy.

KEYWORD: bank governance, agency problem, risk management, shareholder empowerment, Financial Crisis, government ownership, government director, informational asymmetry, adverse selection, developmental state

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I. INTRODUCTION

The primary, or perhaps the paramount, goal of corporate governance and corporate laws is to reduce the agency problems of corporations, “motivating the agent to act in the principal’s interest rather than simply in the agent’s own interest.”

With more than eight decades of academic efforts since Adolf Berle and Gardiner Means identified the “separation of ownership and control” and the associated agency problems, corporate governance literatures have generally identified three types of agency problem. Type I agency problem refers to the misaligned interest of the managers (the agent) with that of the shareholders (principal), Type II refers to the misaligned interest of the controlling shareholders (agent) with that of the minority shareholders (principal), and Type III refers to the misaligned interest of the firm (agent) with that of other stakeholders such as creditors, labors, suppliers, customers, community, etc. (principal).

Immense efforts have been devoted to identifying, studying and resolving the agency problems.

This approach, centering on agency problems, applies to the studies of corporate governance of banks (hereinafter “bank governance”) as well. Tons of literatures have employed the agency theory in illustrating the unique agency problems of banks and the need for a distinct corporate governance regime for banks.

The Global Financial Crisis of 2008 (hereinafter the “Financial Crisis”) vividly exposed the deficiency of current bank governance practice and resulted in significant reforms. On global level, the Organisation for Economic

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1 REINIER KRAAKMAN, THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 35-37 (2d. 2009) (stating that “the normative goal of advancing aggregate social welfare is generally equivalent to searching for optimal solutions to the corporation’s agency problems, in the sense of finding solutions that maximize the aggregate welfare of the parties involved”). Note that the “principal-agent” here is more in a functional term than a legal term, encompassing all situations where the welfare of one person (the “principal”) depends on the actions of another person (the “agent”). KRAAKMAN, id. at 35.


Cooperation and Development (the “OECD”) and the Basel Committee on Banking Supervision (the “Basel Committee”), the two international pilots leading the global harmonization of corporate governance and bank supervision, each proposed several reform directions, aiming at enhancing the risk management, strengthening the board’s capacity, addressing the opaqueness, and improving the compensation structure. On country level, the U.S. Congress promulgated the well-known Dodd Frank Wall Street Reform and Consumer Protection Act (the “Dodd Frank Act”) in 2010 for reforming the financial sector, in which the Act also addresses several corporate governance issues and adopts the proposals advocated by shareholder empowerment reformists. The European Union and its member states, for instance, the United Kingdom, has also taken considerable efforts in reviewing and reforming their bank governance regime. The central concern of the bank governance reform after the Financial Crisis, in a nutshell, focuses on the risk management, motivated by the desire to prevent systemic risk in the financial system. This is unsurprising at all, considering that the Financial Crisis uncovered the banks’ long ignorance of risk control while pursuing the profits. In addition to risk management, reforms of bank governance also converge with the long-advocated shareholder empowerment movement, implicating issues such as executive compensation and proxy access. To summarize the progress of bank governance reforms in the past five years, we witness a clear direction centering on the risk control of banks and toward the enhanced protection of the interest of shareholders and creditors.

What is buried in these contemporary studies of bank governance, however, is the bank’s fundamental role in the economy. Banks play the intermediary role by receiving the household savings in forms of deposits, mutual funds, etc., accumulating them into investment


9 The major review of the bank governance in the United Kingdom is the Walker Review in 2009, see generally DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES – FINAL RECOMMENDATIONS (Nov. 26, 2009).
funds, and investing them in forms of loans or equity. This series of activities ultimately transforms household savings into investment in businesses, which creates flow of money and thus promotes economic development. 10 Through this process banks serve the “money creation” function. They create extra money to the one actually issued by the government, which again promotes the economic development. 11 This intermediary role explains the specialty of bank and imposes on banks some public mission in the society. In this aspect, risk management in the banking sector matter because collapse of banking system may stall the mobilization and allocation of the capital of a society and stagnate the production and development of the real economy. In other words, the development of real economy is the goal while the prevention of systemic risks should be the means. Current studies of bank governance, however, appear to over-emphasize the “means” while ignoring a broader and more fundamental issue. As the economists Tamara Lothian and Roberto Mangabeira Unger observe, in these years banks have significantly departed from their role as the good server of the real economy and increasingly become the “bad master.” 13 The recent bank governance reforms, however, appears less concerned of how to bring the banks back to their public role and how to align the interest of banks with that of the real economy.

Approaching the bank governance from the misaligned interest of banks with that of the real economy is more crucial for East Asian countries. Two reasons may illustrate it. Firstly, unlike Western developed countries whose banking system was seriously hit by the Financial Crisis, banking sectors in East Asia appear less affected, implying a lesser degree of failure in risk management here. Therefore, while admitting the importance of risk management, it appears of less urgency for East Asian countries. Secondly and most importantly, in the landscape of global economy, East Asian countries, including Japan, South Korea, Singapore, Taiwan and the recent China, present special model of economic development featured by the so-called “developmental states,” which is distinct with the market economy as implemented in the U.S. and U.K. Under this unorthodox development model, which was conceived as contributing to the economic “miracles” of East Asian countries after the World War II, the state heavily intervenes in the economy in the name of “industrial policy” and picks and chooses the strategic industries and/or specific individual champions to support. 14 In this process, finance, which is under the state’s control in the form of ownership of banks or directed credits, serves as “the nerve of the developmental state,” assisting the state to influence the

11 See id. at 51-54.
12 Macey & O’Hara, supra note 4, at 102.
economy’s investment pattern, guide sectoral mobility and channel the investible fund to the picked and chosen winners. In this aspect, banks have a closer tie to the development of an economy. Hence, when reflecting on the bank governance in East Asia, the real economy aspect at least warrants some weigh.

The Asian Financial Crisis in the end of the 20th century casted serious doubts on the success of developmental state model; some even claimed that it ended this very model. Nevertheless, this account should not affect the above conclusion. It is credibly believed that the developmental states remain, and the emergence of China further substantiates this point. In line with this observation, the state’s control of banks serving the industrial policy is still present in many East Asian countries. In Taiwan, for instance, government ownership of banks is still significant, and several recent instances also demonstrate the state’s exercise of its ownership for implementing its industrial policy. For instance, to support the cultural businesses in Taiwan, the Taiwanese Financial Supervisory Commission (“TFSC”) issued the “Project on Encouraging the Lending of Domestic Banks to Creative Industries,” effective from January 1, 2014, aiming to lend NTD 360 billion (around USD $12 billion) to Taiwanese cultural businesses in the next three years. To enhance the competitiveness of Taiwanese banking industries, TFSC also declared in late March, 2014 that the consolidation of Taiwanese government-owned banks would take place by the end of 2014. Similar state intervention and direction also took place in other East Asian countries. One representative example is China’s stimulus plan in 2009, under which the Chinese Communist Party ordered banks to lend for countering the cyclical pressure caused by the Financial Crisis, amounting to around USD 1.4 trillion lending in 2009. Hence, the close tie between banks and the economy, established under the context of developmental states and featured by the state’s heavy hand, remains in place in East Asia even nowadays. Bank governance in this context deserves a different consideration; at least a wholesale implantation of the current bank governance reform

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18 For the discussion of whether China follows a developmental state path, see generally Andrzej Boleta, *China as a Developmental State*, 5 MONTENEGRIN J. ECON. 106 (2007); Pranab Bardhan, *The Paradigm of Capitalism under a Developmental State: Does it Fit China and India?*, 55:2 SINGAPORE ECON. REV. 243 (2010).
22 CARL E. WALTER & FRASER J.T. HOWIE, *RED CAPITALISM: THE FRAGILE FINANCIAL FOUNDATION OF CHINA’S EXTRAORDINARY RISE* 26 (2011). Much of the lending went to projects without immediate cash flow, such as real estate and high-speed railways; WALTER & HOWIE, *id.* at 37.
from the West without digests should be unwarranted.

In this paper I attempt to explore how to align the interest of the banks with that of the real economy. I will demonstrate how the current bank governance studies based on the original three types of agency problems falls short of addressing the real concern after the Financial Crisis. To fill this gap, I identify the fourth type of agency problem, which refers to the misaligned interest of the banks (agent) with that of the economy (principal). I will further explore this Type IV agency problem in the East Asian context, indicate the government failure problems unique to this context, and propose some preliminary principles for addressing these problems. My analysis will be structured as follows. In Part II of this paper, I review and summarize the current literatures on bank governance on the basis of agency theory, in which I identify how this thread of studies ignores a more fundamental issue, i.e. the misaligned interest between banks and the real economy. In Part III of this paper, I proceed on to examine how this misaligned interest takes place by applying the market failure theory, especially the informational asymmetry theory. Based on this analysis, I demonstrate how the risk management reform and shareholder empowerment movement after the Financial Crisis fall short of addressing this misaligned interest, which justifies the state intervention in banking sector. I then compare different types of governmental intervention, including the public benefit test, subsidization and regulatory intervention, and most importantly, government ownership of banks, advocating a case for the last form of intervention. In Part IV of this paper, I take note of the associated downsides of government ownership of banks and present several preliminary principles for mitigating them, which involve the issue of board composition, mission and duty of government directors and disclosure. I finally conclude my paper in Part V. Through these analyses, I anticipate to present a different thinking of bank governance in East Asia as opposed to that in the West, aiming at addressing a more fundamental issue in banking sector and bringing the banks back to its expected role in the economy.

II. BANKS GOVERNANCE AND AGENCY PROBLEMS: A REVIEW AND CRITIQUE OF CURRENT STUDIES

Bank governance literatures generally reach a consensus that corporate governance of banks is different with that of ordinary firms. In a nutshell, banks are special to the extent that they are more leveraged and thus incur higher risks, especially the liquidity risks caused by their “borrow-short, lend-long” activities. As the leverage of banks heightens, the

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24 Devriese et al., supra note 4, at 98; Heremans, supra note 4, at 4; Klaus J. Hopt, supra note 5, at 4. For discussion of other differences between banks and ordinary firms, see e.g., Mulbert, supra note 5, at 10-14 (stating
creditors emerge as another significant source supplying the banks’ capital. This essential feature of banks necessitates a reexamination of the role of debt governance in bank governance.

What renders a corporate governance structure built on debt governance different with that on equity governance is the different risk appetite and profits preference between creditors and shareholders. Shareholders are relatively risk-pursuing and profits-seeking, because as the firm’s residual claimants they benefit from the firm’s upside performance but their loss is controlled due to the limited liability, resulting in their convex claims on the income of the firm. In contrast, creditors are relatively risk-averse, because as the firm’s fixed claimants their benefits derived from the firm is fixed with a ceiling but their loss is unprotected, resulting in their concave claims against the firm. Accordingly, if the weight of debt governance increases, the traditional focus of corporate governance on “profit” maximization should diminish, while the emphasis on “risk” instead steps in.

In this part, I will review the current bank governance literatures as well as the reform movement after the Financial Crisis, displaying how the risk-centered thinking dominates the current bank governance discussions.

A. The Application of the Current Agency Theory to the Bank Governance

Among various types of agency problems, corporate governance studies traditionally focuses on equity governance, that is, Type I and II agency problems, depending on the ownership type of a firm. Underlying it is a very fundamental assumption built on the shareholder primacy norm, a widely recognized default rule of corporate laws which assumes shareholders’ interest as the ultimate goal to be pursued. However, shareholder primacy

that banks are special because they undertake the liquidity producing function, they are highly leveraged, their balance sheets are more opaque, they do a substantial part of business with each other, they hold a substantial portfolio of risk-profile derivatives and securities, they are subject to credit runs, and they are heavily regulated and supervised. Caprio, Jr. & Levine, supra note 4, at 27-41 (identifying three main factors that renders bank governance special, that is, banks are more opaque, heavily-regulated and subject to government ownership). The pioneer study was put forward by Eugene F. Fama, see generally Eugene F. Fama, What’s Different about Banks?, 15 J. MONETARY ECON. 29 (1985) (illustrating that for small organizations, bank loans have lower contracting costs than that of outside debts, and for all organizations bank loans may signal an organization’s credit worthiness and thus reduce the informational costs of other financial contracts).

See e.g., Heremans, supra note 4, at 6.
Heremans, supra note 4, at 3.
26 See e.g., Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits, THE NEW YORK TIMES (Sep. 13, 1970); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 435-37 (2003); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 35-39 (1992); American Bar Association, Committee on Corporate Laws, Other Constituency Statutes: Potential for Confusion, 45 BUS. LAW. 2253, 2268-70 (1990); Ryan J. York, Visages of Janus: The Heavy Burden of Other Constituency Anti-takeover Statutes on Shareholders and the Efficient Market for Corporate Control, 38 WILLAMETTE L. REV. 187, 197-98 (2002); Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 GEO. L. J. 439, 441 (2001); Kraakman, supra note 1, at 28. To be sure, the shareholder primacy norm is not as popularly perceived as in Anglo-Americans. For instance, Germany appears to favor an employee-oriented norm while France, Japan and China appear to favor a state-oriented norm. However, it is observed that the global corporate law is converging toward shareholder primacy norm. Henry Hansmann & Reinier Kraakman, Reflections on The End of History for Corporate Law, in CONVERGENCE OF CORPORATE GOVERNANCE: PROMISE AND PROSPECTS 32
norm does not hold true in any occasions. It specifically conflicts with the interest of other stakeholders, including creditors, labor, consumers, suppliers, community, etc. To overcome this limit, the agency theory identifies the Type III agency problem acknowledging an issue the misaligned interest between other stakeholders (the principal) and shareholders (the agent). For bank governance, as creditors are the most crucial stakeholder of the banks, the major Type III agency problem of banks becomes this debt governance issue. Below I briefly summarize the current findings of the major agency problems of banks.

a. **Type I Agency Problem: Shareholder vis-à-vis Manager**

In a firm with dispersed shareholding structure, each shareholder’s holding is too minimal for any of them to dominate the firm’s management and operational decisions. The minimal shareholding also causes each shareholder with limited incentive to invest his/her labor, time and expenses in monitoring and supervising the firm. This “strong managers, weak owners” phenomenon results in entrenched and unconstrained managers who are subject to inadequate supervision and free to exercise their control of the firm in their own interest without due regard to the shareholders’ interest. To control this Type I agency problem, conventional ways under the corporate law include shareholders’ voting right on material corporate matters (e.g., merger and acquisition, liquidation, etc.), shareholders’ right to elect board members, board supervision of the management, independent directors, fiduciary duty claims, hostile takeover, etc. Among them, one undergoing hot debates recently is the equity-based executive compensation.

Type I agency problem should plague those diffusely-owned banks as well. However, within the context of bank governance, the weakened power of shareholders is sometimes praised. It is pointed out that managers may be less risk-preferring than shareholders since managers in their nature resemble creditors. They are fixed claimants of the firm as well, to the extent of their fixed compensation. Unlike shareholders who have nothing to lose if the bank goes bankrupt, they would lose their investment in specific human capitals; moreover, unlike shareholders, they typically have limited capacity in diversifying their said investment. In light of these, it is argued that managers have a longer horizon of interest than short-term investors, and managerial control thus may better reduce excessive risk-taking of banks.

(Abdul Rasheed & Toru Yoshikawa eds., 2012).

28 For literatures arguing against the shareholder primacy norm, see generally Einer Elhauge, *Sacrificing Corporate Profit in the Public Interest*, 80:3 N.Y.U. L. REV. 733 (2005).

29 KRAAKMAN, supra note 1, at 35.

30 See generally MARK ROE, STRONG MANAGERS, WEAK OWNERS (1994).

31 Devriese et al., supra note 4, at 99; Macey & O’Hara, supra note 4, at 98.

32 Devriese et al., supra note 4, at 99; Heremans, supra note 4, at 13.

33 Hopt, however, cautioned that the directors’ and managers’ risk aversion is true only for such high risks that would endanger their position and only if they understand and evaluate these risks as such, and the factor of over-optimism as mentioned by behavioral economics could also compromise the directors’ and managers’ risk aversion attitude. Hopt, supra note 5, at 15-16.
Based on this observation, it is argued that, considering the need of bank governance to control excessive risks undertaken by banks, vesting the managers with more discretion may prevent banks from being captured by the myth of profit maximization, better balance the interest of creditors and control the risks.\(^{34}\)

**b. Type II Agency Problem: Minority vis-à-vis Controlling Shareholder**

In a firm with concentrated shareholding structure, the agency problem is quite different. With a powerful and dominant shareholder in place, managers are subject to enhanced monitor and supervision, which minimizes the Type I agency problem.\(^{35}\) Instead, it is the controlling shareholder that controls the operation of the corporation. As the controlling shareholder holds the most shares of the corporation and thus presumably possesses the most interests in the corporation, it is less likely to act against the interest of the corporation as doing that will harm itself the most. To that extent, a controlling shareholder might be better incentivized than managers to act in the interest of the corporation.

Nevertheless, the controlling shareholder is still likely to pursue its own interest in sacrifice of the corporation’s interest if the benefits garnered therefrom are greater than the losses. One typical example is tunneling the interest of the corporation into the controlling shareholder’s own pocket. Although tunneling may decrease the firm’s value and thereby decrease the value of the controlling shareholder’s investment, the overall gain is higher as the controlling shareholder only has partial interest in the firm but receive full interest from the tunneling.\(^{36}\) This misaligned interest between the controlling shareholder and minority shareholders leads to the Type II agency problem. To control the Type II Agency Cost, conventional methods under the corporate law include imposing fiduciary duty upon controlling shareholder, mandating equal treatment among all shareholders, etc.

For banks, the concentrated shareholding is a double-edged blade. For ordinary cases, dispersed ownership might be more superior considering that it facilitates the proxy contest or hostile takeover for monitoring the corporate controllers, while such mechanism is absent for concentrated ownership. In the bank governance context, however, it is not necessarily the case. Concentrated ownership might better fit the banks’ risk control mandate. Bank governance requires long-term commitment and long-term players as good monitors,\(^{37}\) while dispersed shareholding structure has an unstable ownership and thus may frustrate the banking stability objectives.\(^{38}\) In addition, in a dispersed shareholding structure it may be difficult to

\(^{34}\) See generally Devriese et al., *supra* note 4.


\(^{36}\) This in particular emerges when the controlling shareholder possesses control right in excess of its cash flow right, which arises due to differential voting rights, cross-shareholding, pyramid structure, etc. In such cases, the controlling shareholder has increased incentives to tunnel the interest of the corporation to its own pocket.


\(^{38}\) Devriese et al., *supra* note 4, at 100.
oblige the shareholders to bail-in the insolvent bank. 39 In contrast, the controlling shareholders in some sense resemble managers, who are less likely to diversify their risks than ordinary portfolio investors. 40 A more delicate analysis further classifies the controlling shareholders into those who have control rights equal to their cash flow rights (the “non-levered controlling shareholder” or “straightforward controlling shareholder”) and those who have control rights in excess of their cash flow rights (the “levered controlling shareholder”) and argues for the relative desirability of the former as the latter diversifies the controlling shareholder’s risk and thus may lead to more risk-taking behaviors. 41 In any event, large shareholders are still likely to engage in high-risk activities because this strategy allows the shareholders to reap the upside while shifting the downside loss to creditors. 42 To reduce the controlling shareholder’s over-pursuit of profits and over- ignorance of risks, it is proposed that the regulator should intervene in vesting more power with the management in order to maintain the management’s autonomy. 43

c. Type III Agency Problem: Creditor vis-à-vis Shareholder

As mentioned above, the major concern of bank governance literatures is the excessive risks undertaken by banks, which highlights the role of creditors. 44 Nevertheless, unlike creditors of ordinary firms, who are mostly banks, customers or other sophisticated fund providers with considerable bargaining power, banks’ creditors are mostly public depositors or investors who are diffused. 45 They are less sophisticated in and less capable of negotiating the terms of credits and monitoring the banks. 46 They are less incentivized to engage in meaningful monitor, thanks to the deposit insurance and the general tendency to bailout the bank which control the public depositors’ losses and thus lead to moral hazard problem. 47

39 Devriese et al., supra note 4, at 95; Heremans, supra note 4, at 12-13.
40 Heremans, supra note 4, at 14.
41 Heremans, supra note 4, at 12-16. However, empirical studies do not necessarily support this finding. Laeven and Levine, for instance, found that large owners (i.e. shareholders holding more than 10% shares) with substantial cash flow rights have greater incentives and power to increase bank risk taking than small shareholders and managers. See generally Laeven & Levine, supra note 42.
43 Heremans, supra note 4, at 15. One vehicle having been raised is the “agreement on the autonomy of bank management,” a soft law on the basis of negotiated agreements with bank shareholders to ensure the independence of bank management in credit policy. For related introduction, see Devriese et al., supra note 4, at 109-114. Mulbert, however, finds the benefits of having directors independent of large shareholders ambiguous, depending on whether the positive effects of the large shareholder’s more intense monitoring activities are greater than the costs associated with his extraction of private benefits. Mulbert, supra note 5, at 20.
44 Devriese et al., supra note 4, at 99; Heremans, supra note 4, at 4-5, 16-17.
45 Macey & O’Hara, supra note 4, at 97; Devriese et al., supra note 4, at 98; Heremans, supra note 4, at 6 Heremans, supra note 4, at 3. A caveat, however, relates to the interbank lending activities, which cause banks themselves becoming each other’s creditors. In this case, banks go have sophisticated creditors, but this at the same time also leads to the systemic risks of the whole financial system. See Heremans, supra note 4, at 5.
46 Devriese et al., supra note 4, at 106. For a discussion of the different implications of diffused creditors and concentrated creditors for corporate governance, see Caprio, Jr & Levine, supra note 4, at 22-23; Hopt, supra note 4, 17-18.
47 Macey & O’Hara, id. at 97-98; Caprio, Jr. & Levine, supra note 4, at 35-39; Adams & Mehran, supra note 4,
Even if some large creditors might be in place, they are typically secured creditors who are unaffected by banks’ excessive risk-taking and thus less incentivized in monitoring banks.\textsuperscript{48} The notorious opaqueness of banks in both their organization and their activities further increases the difficulty of meaningful supervision.\textsuperscript{49} Hence, although it is widely agreed that bank governance demands more attention to debt governance, available vehicle for representing creditors’ interest is inherently weak. This justifies the regulator’s intervention to “mimic” the role of creditors.\textsuperscript{50}

To address this Type III agency problem, from a corporate governance perspective it is proposed that banks’ creditors deserve some enhanced protection.\textsuperscript{51} It is argued that, considering that an individual bank’s failure can cause systemic risks to the whole financial system, which is a negative externality, some levels of compromise of the shareholder primacy norm are promised.\textsuperscript{52} Specifically, it is proposed that banks’ creditors should be entitled to the fiduciary claim conventionally assigned to shareholders to sue bank directors and managers for their failure to consider the impact of their decision on the safety and soundness of the bank.\textsuperscript{53} In the U.S., the Federal Reserve also developed the “source- of-strength” doctrine that requires the bank holding companies (i.e. the bank’s major shareholders) to maintain enough financial resources to aid their bank subsidiaries in case of financial difficulties.\textsuperscript{54} A more comprehensive recommendation concludes that to deal with the Type III agency problem here, it requires a new prudential definition of independence of directors, which defines independence in a financial sense as directors who “have no (or minimal) shareholdings in the company and receives no (or limited) performance linked remuneration” and such financially independent directors should constitute the majority of the bank’s board.\textsuperscript{55}

B. Bank Governance in a Post-Financial Crisis Era

The outbreak of Financial Crisis during 2008-2009 heavily hit the bank governance studies. While some argue that failures of bank governance had little or even no relevance

\textsuperscript{48} Hopt, supra note 4, at 55.
\textsuperscript{49} Heremans, supra note 4, at 4.
\textsuperscript{50} Devriese et al., supra note 4, at 95, 99; Heremans, supra note 4, at 7-8 (arguing that the main objective of regulation remain to monitor Type III Agency Cost). In fact, the regulator indeed wears the hat of the creditor due to the deposit insurance, under which it undertakes the contingent obligation to pay for the depositors’ losses on behalf of the banks once the banks goes bankrupt.
\textsuperscript{51} See generally Macey & O’Hara, supra note 4; Caprio, Jr & Levine, supra note 4, at 44-45.
\textsuperscript{52} Macey & O’Hara, supra note 4, at 95; Devriese et al., supra note 4, at 106.
\textsuperscript{53} Macey & O’Hara, supra note 4, at 102-103 (arguing that the directors should inform themselves of whether a particular decision will impair the ability of the banks to pay its debts, materially increase the riskiness of the banks, and materially reduce the bank’s capital position, and the directors should undertake continuing obligations to develop and maintain a detailed system for monitoring and oversight.) See also Mullineux, supra note 4, at 377.
\textsuperscript{54} See Macey & O’Hara, supra note 4, at 96.
\textsuperscript{55} Heremans, supra note 4, at 19-20. For the same view, see also Mulbert, supra note 5, at 20.
with the outbreak of the Financial Crisis, the majority opinion, such as OECD and the Basel Committee, maintains that failures of banks governance accelerated and aggravated the Financial Crisis. Reflecting on the bank governance failure during the Financial Crisis, many reforms of bank governance have been proposed, and the major focus basically lies on the need to strengthen the creditor governance, especially the role of risk management in the banks.

a. Emphasis on Type III Agency Problem and Risk Management

Since the Financial Crisis was triggered by several large banks’ insolvency resulted from their failure to manage the credit or liquidity risks, the post-crisis reform of bank governance naturally centered on how to improve the banks’ risk control, which is primarily related to the Type III Agency Cost. While conventionally it is the banking regulator that undertakes this mission by stipulating the permitted level of banks’ risk exposure and enforcing the regulation, it is increasingly accepted that financial regulation is not simply a substitute to the corporate governance; instead, the latter complements the former in controlling the banks’ exposure to risks. Market disciplines have formed one of the three pillars in the Basel Committee’s core principles for effective banking supervision since the Basel II, and apparently, private players should have more incentives than the public regulator in controlling the banks’ risk exposure. To control banks’ excessive risk-taking and to prevent another round of financial crisis, a robust bank governance system with effective risk control mechanism is widely considered needed.

The board of directors becomes one hot zone calling for reforms. It is widely believed that risk control falls within the duty of the board, and that the board’s failure to assess and control the banks’ exposure of risks was one factor contributing to the financial crisis.

57 See generally 2009 OECD KEY FINDINGS, supra note 6; 2010 OECD CONCLUSIONS, supra note 6.
58 See generally BASEL 2010 PRINCIPLES, supra note 6.
59 For academic literatures on this point, see e.g., Kirkpatrick, supra note 5, at 1; Hopt, supra note 5, at 14. For an introduction of the evolving perception of corporate governance failure as one attribute to the Financial Crisis, see Mulbert, supra note 5, at 7-9; Cheffins, supra note 23, at 20. However, the limited role of bank governance failures for the financial crisis is also noted. Hopt, supra note 5, at 49.
60 See e.g., David A. Becher & Melissa B. Frye, Does Regulation Substitute or Complement Governance?, 35 J. BANKING & FIN. 736 (2011); Adams & Mehran, supra note 4; Heremans, supra note 4, at 8; Heremans & Bosquet, supra note 5, at 1568; Cheffins, supra note 23, at 37. Nevertheless, the existence of financial regulation certainly affects the internal governance of banks; for instance, the deposit insurance scheme as mentioned above. Other instances include the capital adequacy rule and the activities restriction, which are claimed to lead to excessive risk taking by banks in order to obtain more profits within these regulatory restrictions. See generally Laeven & Levine, supra note 42, at 260, 269-273; Sepe, supra note 5, at 386-89.
61 Macey & O’Hara, supra note 4, at 99. See also Polo, supra note .
62 See Murphy, supra note 5, at 129-30.
63 See e.g., Kirkpatrick, supra note 5, at 17-24; Heremans & Bosquet, supra note 5, at 1572-73; Jaap Winter, The Financial Crisis: Does Good Corporate Governance Matter and How to Achieve It?, 6-7 (Duisenberg School Fin.
Commentators noted that the board simply took too much comfort in the banks’ compliance with the regulatory requirement and assumed too much that regulators would identify any potential problems, thereby took too little effort in identifying its bank’s specific risk profile and formulating a tailor-made risk policy.\textsuperscript{64} The board also had limited access to relevant information for evaluating the banks’ risk exposure, which was caused by the complex organizational structure of large banks, the associated increasing opaqueness and absence of channel to transmit information for risk management, leading to less attention to the firm-wide risk exposures, less respect to the warning signs of liquidity risks and excessive risk exposure.\textsuperscript{65} Many directors even failed to possess necessary knowledge in finance for fulfilling their duty to manage the risks.\textsuperscript{66} The Basel Committee has noted these deficiencies and proposed future directions for improving the banks’ board practice.\textsuperscript{67} Other specific proposals include relaxing the independence requirement for ensuring the expertise and capacity of board members,\textsuperscript{68} extending the fiduciary duty of directors and management to creditors,\textsuperscript{69} and, most aggressively, empowering the regulator to appoint some members to the banks’ board.\textsuperscript{70}

Among all proposals, the most prominent one relates to the improvement of the banks’ risk management. It is noted that, before the Financial Crisis, attention was mostly addressed to internal controls related to financial reporting while less to a broader context of risk management, resulting in lower prestige and status of a risk management staff vis-à-vis traders.\textsuperscript{71} To address this deficiency, two main institutions stand out, namely, the Chief Risk Officers (“CRO”) and the risk management committee.\textsuperscript{72} On the management level, it is

\begin{itemize}
  \item Pol’y, Paper No. 4, 2011. \textit{Contra} Adams, supra note 59.
  \item Kikpatrick, supra note 5, at 11; Adams, supra note 59, at 34; Cheffins, supra note 23, at 33. For an account of this failure from a perspective of behavioral economics, see Winter, \textit{id.} at 4-5.
  \item Kikpatrick, supra note 5, at 6-12, 20; Hopt, supra note 5, at 12-14; 23-25.
  \item Kikpatrick, supra note 5, at 22-23; Hopt, supra note 5, at 12. For state-owned banks which retain politicians to sit on the board, this problem gets further aggravated. Kikpatrick, \textit{id.} at 23; Hopt, \textit{id.} at 12.
  \item \textit{See generally} BASEL 2010 PRINCIPLES, supra note 6. For the introduction and comments of the Basel’s approach, see Mulbert, \emph{supra} note 5, at 21-24.
  \item Kikpatrick, \emph{supra} note 5, at 21-23 (noting also that the ordinary fit and proper person tests do not necessarily address the issue of competence); Hopt, \emph{supra} note 5, at 30, 60; Adams, \emph{supra} note 59, at 34; Marcinkowska, \emph{supra} note 5, at 51; Renee B. Adams & Hamid Mehran, \textit{Bank Board Structure and Performance: Evidence for Large Bank Holding Companies}, 21(2) J. FIN. INTERMEDIATION 243 (2012) (finding empirical evidence that board independence is unrelated to banks’ performance). It is also argued that the more independent the directors are, the more dependent they are on the executives for the data and information, narrowing the board’s source of information and placing the CEO in a position to manipulate the board. Winter, \emph{supra} note 63, at 7; Murphy, \emph{supra} note 5, at 145. Heremans and Bosquet, on the other hand, argued for a different definition of the independence centering on the financial independence of directors. Heremans & Bosquet, \emph{supra} note 5, at 1573.
  \item Mulbert, \emph{supra} note 5, at 20, 36-37. For an introduction of the board reforms in European Union level, \textit{see generally} Winter, \emph{supra} note 63, at 8-10 (including a mandatory separation of board chairman from the CEO, a nomination committee comprised solely of non-executive directors, professional requirement of the board, etc.)
  \item Mulbert, \emph{supra} note 5, at 20, 36-37; Sepe, \emph{supra} note 5, at 398-400. For arguments against the constituency clause and the regulator’s representation on banks’ board, see Hopt, \emph{supra} note 5, at 21-22, 56.
  \item Kikpatrick, \emph{supra} note 5, at 6, 12. \textit{See also} Hopt, \emph{supra} note 5, at 11.
  \item For an introduction of the reform of risk management in the European Union level, \textit{see generally} Winter, \emph{supra} note 63, at 8-10 (including a mandatory establishment of a risk committee in the banks having an independent function, requiring the management body of the banks to bear overall responsibility for the banks’ risk strategy and risk appetite, etc.). Another recently debated approach is the mandatory issuance of subordinated debts for
\end{itemize}
proposed that the CRO is the key person. To ensure the function of CRO, especially its independence from the risk-generator, it is proposed that the CRO should have the power to report directly to the risk management committee, better having a seat on the board or risk management committee. Moreover, the CRO’s remuneration should be subject to the board or the board remuneration committee. The removal of CRO should also require the prior agreement of the board. On the board level, it is proposed that a risk management committee should be established separately from the audit committee for the specific task of risk control. The rationale is that risk management has a primarily prospective and forward looking dimension, while audit committee’s role is primarily retrospective and backward looking. In addition, the members of the risk management committee should be mainly individuals with technical financial expertise in risk controls or solid business experience.

b. Executive Compensation and Shareholder Empowerment Movement

Another “hot spot” bank governance problem is the executive compensation. It is widely conceived that banks’ equity-based executive compensation linked to banks’ short-term profits inappropriately incentivizes bankers’ to pursue short-term profits maximization in ignorance of long-term risk accumulation, which led to the Financial Crisis. To elaborate it by an example, bankers who are interested in boosting their compensation in the short run might prefer giving a high interest loan to a risky borrower, which increases the revenue of the banks and the income of the bankers in the short run, but at the same time undertakes more risks in the long run. In that sense, equity-based executive compensation is a “reward for failure,” which is detrimental to the banks’ risk control. Empirical evidence also supports the finding that incentive pay has a positive impact on financial performance but a negative impact on loan quality in the long run, suggesting that short-termism behaviors can be caused by equity-based pay.


Kikpatrick, supra note 5, at 19; Mulbert, supra note 5, at 29; Hopt, supra note 5, at 26-27, 57.

Murphy, supra note 5, at 133.

Kikpatrick, id. at 19; Hopt, id. at 57; Marcinkowska, supra note 5, at 56. For a different view, see Mulbert, supra note 5, at 29 (arguing that risk committee is advisable but not indispensable).

Murphy, supra note 5, at 131.

Kikpatrick, supra note 5, at 19.

See e.g., 2009 OECD KEY FINDINGS, supra note 6, at 14-30 and 40; REPORT ON THE FINANCIAL CRISIS IN THE U.S., supra note 56, at xix; Kikpatrick, supra note 5, at 12-16; Mulbert, supra note 5, at 16-17; Hopt, supra note 5, at 13 and 52. Contra Adams, supra note 59 (finding the empirical evidence that bank directors earned significantly less compensation than their counterparts in nonfinancial firms).


To address the executive compensation problem, the Basel Committee has highlighted that the board should “set formal performance standards for senior management consistent with the long-term objectives, strategy and financial soundness of the bank, and monitor senior management’s performance against these standards.” 82 To implement this principle, procedurally, it is proposed that a compensation committee should exist, comprised of independent directors. 83 Substantively, it is proposed that compensation incentives should be based on risk-adjusted and cost of capital-adjusted profits and phased in order to coincide with the risk time horizon of such profit and reflect the overall value of related business groups and the organization as a whole. 84 On top of that, it is proposed that the regulator should have the authority to make proper changes to their ill-designed compensation system. 85

The reform of executive compensation is accompanied by the shareholder empowerment movement. The introduction of the “say on pay” regime best illustrates it. 86 The U.S. Dodd Frank Act, for instance, introduced the “say on pay” regime by adding Article 14A to the Securities Exchange Act, which requires a separate resolution subject to a non-binding shareholders’ vote to approve the compensation of executives and golden parachute compensation. 87

c. Do We Miss a Broader Picture?

The recent bank governance reforms display the reflection on the poor bank governance

82 BASEL 2010 PRINCIPLES, supra note 6, ¶ 31.
83 The U.S. Dodd Frank Act, for instance, added Article 10C to the Securities Exchange Act, ordering the SEC to direct securities exchanges to require listed companies to have full independent members on the compensation committee. See Dodd-Frank Act, §952. The European Commission also adopted the Capital Requirements Directive IV, entering into effect on July 17, 2013, provides for the requirement of an independent remuneration committee in its article 95.
84 Kikpatrick, supra note 5, at 15; Marcinkowska, supra note 5, at 58. Specific measures include linking the remuneration to levels of residual risk, calculation of bonuses based on long-term performance on bases of risk-adjusted and time-horizon measures, deferred payout for variable compensation, clawback provisions, payout of a substantial portion of the variable compensation in shares or share-linked instruments, prohibition of guaranteeing bonuses for more than one year, etc. Mulbert, supra note 5, at 35. The U.S. Dodd Frank Act, for instance, added Article 10C to the Securities Exchange Act for requiring compensation limits and clawback provisions. See Dodd-Frank Act,§952.
85 Mulbert, supra note 5, at 36.
86 It is advocated that the shareholders’ power over the banks’ compensation decision should enhance, be it in the form of mandatory or voluntary shareholders’ vote on the compensation of top executives and/or board. Mulbert, supra note 5, at 33-35.
87 See Dodd-Frank Act,§951. Another major shareholder empowerment movement is the proxy access reform, which amends Section 14(a) of the Securities Exchange Act of 1934 and expressly authorizes the Securities and Exchange Commission (SEC) to adopt rules for shareholders to nominate directors to the boards of reporting companies. See Dodd-Frank Act, §971. SEC promulgated the implementing regulation Rule 14a-11 in 2010, permitting a shareholder or group of shareholders that hold at least 3% of the voting power for over three years to nominate a maximum of 25% of the board. The D.C. Circuit, however, invalidated Rule 14a-11 in 2011, rendering the proxy access reform into a deadlock. Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011). For related discussion, see generally James D. Cox & Benjamin J.C. Baucom, The Emperor Has No Clothes: Confronting the D.C. Circuit’s Usurpation of SEC Rulemaking Authority, 90 TEX. L. REV. 1811 (2012); Joseph A. Grundfest, The SEC’s Proposed Proxy Access Rules: Politics, Economics, and the Law, 65:2 BUS. LAW. 361 (2010); Lucian A. Bebchuk & Scott Hirst, Private Ordering and the Proxy Access Debate, 65:2 BUS. LAW. 329 (2010).
practice before the Financial Crisis and an effort in improving banks’ risk management. These efforts are certainly positive to the extent that they address the risks in the financial system and secure the stability of the financial system and thereby stabilize the economy.

But a broader and more fundamental issue is less noticed. One primary cause of the Financial Crisis was the unexpected burst of the housing bubbles in the U.S. in 2006, which in turn triggered the Financial Crisis in 2008-2009. And the cause of the housing problem may be attributed to the long time unequal allocation of wealth in the U.S. society, which resulted in the housing problems for more and more citizens. To resolve this social problem, the government designed several housing subsidy policies to intervene in the housing market so as to make the purchase of houses affordable for general citizens. When the housing market became overheated due to the excessive demand fueled by these subsidy programs, the bubble suddenly burst, resulting in serious drop of housing price and significant losses of banks which engaged in housing lending businesses. Fueled further by the correlation, connectedness, and contagion effect, loss of individual banks in the housing market was upgraded to systemic risks and spread to the whole financial system, resulting in the Financial Crisis. While bank governance should be improved to control the systemic risks for the future, at least some reflection on how bank governance can be designed to address the root cause, i.e. the unequal allocation of investible fund, should be equally warranted.

This observation brings us to reflect on a deeper issue, i.e. how bank governance relates to economic development. As Lothian and Unger have observed:

[T]heoretically, the role of banks and stock markets is to finance production as well as consumption. In fact, the financial markets and intermediaries at the heart of the financial crisis – and responsible for much of the increase in financial activity in the past few decades – had little to do with the funding of long term investment and increasingly more to do with financing of asset trading and position taking by highly leveraged financial institutions.

Accordingly:

[U]nder the present arrangements of all contemporary market economies, the link between the accumulated saving of society and its agenda of production is weak. To a large extent, the finance of production relies on the retained and reinvested earnings of private firms, which is to say that production finances itself. Finance is then free to serve itself rather than to serve production, and to design successive layers of financial engineering with an ever more tenuous relation to any transactions.

88 Some studies of the Financial Crisis do argue that the only thing went wrong before the Financial Crisis was the unexpected burst of the housing bubble. See generally Wallison & Burns, supra note 56.
89 Lothian & Unger, supra note 13, at 48.
in the real economy.\textsuperscript{90}

According to their observation, this resulted in a failure of “financial deepening.”\textsuperscript{91} rendering the finance unable to perform its supposed goal of channeling the saving of the society into productive investment.\textsuperscript{92} Moreover, the financial sector not only fails to support the production, but is effective in disrupting the production (the good instance illustrating it is the financial innovation causing the Financial Crisis) and intensifying the inequality in the real economy.\textsuperscript{93} The reform agendas that have been presented as far, be it focusing on reinstating precaution, strengthening supervisory and resolution authority, counterbalancing risks of financial instability or addressing consumer protection, all fall short of dealing with these more fundamental problems.\textsuperscript{94}

Similar observation is also made by Mehrsa Baradaran.\textsuperscript{95} She observes the bank governance from a social contract perspective, in which she argues that the social contract between banks and the government is: the government promises that “it will protect banks from runs, liquidity shortages, and investor irrationality,” while banks in return promise that “they will operate safely, play their essential role in financing the expansion of the economy, and serve the needs of their customers and local communities.”\textsuperscript{96} According to Baradaran’s observation, banks undertake a distinctively public mission under the social contract which at least consists of three aspects: safety and soundness, consumer protection and access to credit.\textsuperscript{97}

The bank governance reform after the Financial Crisis appears to focus on the first two parts of the banks’ promise but leaves the latter part unaddressed.\textsuperscript{98}

\textsuperscript{90} \textit{Id.} at 15.
\textsuperscript{91} \textit{Id.} at 27.
\textsuperscript{92} \textit{Id.} at 28.
\textsuperscript{93} \textit{Id.} at 15-16. For instance, many financial innovations are found contributing little to economic efficiency but welfare-decreasing. See Stiglitz, supra note 111, at 21-22. After the Financial Crisis, the collateralized debt obligations (CDOs), which diversifies the risks of collateral originators and results in the notorious “originate-to-distribute” practice, is under severe attack; the high frequency trading is also considered one culprit of the short-termism in the capital market.
\textsuperscript{94} \textit{Id.} at 17-19. In their view, cutting down the size of financial firms or requiring heightened leverage ratio would not help for channeling the savings to the investment in production and innovation. \textit{Id.} at 30. To deal with them, Lothian and Unger advocate a “more market and more government” approach, under which public spending, aiming at supporting the country’s network of local banks, small and medium enterprises and education, might be the most desirable way to link the finance to production and innovation. Other instances of desirable direction of public spending may include that on infrastructure or low-carbon economy. Note, however, that they are less excited about the use of government-owned banks for controlling the direction of finance, arguing that financial deepening possesses more advantages and decentralization and democratization of finance is more desirable, considering that central government tends to favor a relatively small number of big enterprises, leading to credit rationing. \textit{Id.} at 37-41, 51.
\textsuperscript{96} \textit{Id.} at 1284-85.
\textsuperscript{97} \textit{Id.} at 1286.
\textsuperscript{98} \textit{Id.} at 1334. Baradaran explained that this omission might be due to that the Financial Crisis was caused by the overabundance of consumer access to mortgage credit, and she called for governmental regulation mandating banks’ focus on increasing lending to the poor.
Similarly in the same alliance is Marc Schneiberg’s piece. He specifically proposed a financial market architecture containing “parallel and more locally based systems of community banking and cooperative, mutual, and state-owned enterprises in financial markets” that “partially displace investor-owned for-profit corporations by cultivating financial enterprises that are structured to serve different constituencies and aims than shareholder value or the pursuit of financial profits in global financial markets.” He argues that this system may subject for-profit corporations to direct competition from firms that prioritize the interests of consumers and local communities, thereby tempering their predatory behaviors and risk-taking excesses, producing useful redundancies and decoupling in financial systems and thereby buffering local economies from crises, and expanding access to capital for underserved groups and thereby creating new opportunities for local and small business development. He believes that this system may transform the relations and incentives among stakeholders of the financial sector and tie the finance more closely to the substantive economic interests of the sectors and communities they serve.

This grander issue concerning the link of banks with the real economy is more relevant for East Asian banks. The global crisis did not originate in Asia, and the direct damage to the financial sector in Asia has been much less than in Europe and the U.S. Instead, what the East Asian banking system faced after the financial crisis is a more stagnant economy caused by the global financial meltdown and the associated loss of consumers’ and investors’ confidence. The crucial issue is less the failure of banks’ risk management, considering that East Asian banks’ risk management was generally not that bad in the sense that they had less capital or liquidity risk problem. Rather, the more crucial issue for the state and banking sector in East Asia is where to fund in order to ensure a sustainable economic development.

This issue is further complicated by the state’s control of banks, a quite common phenomenon in East Asia. East Asia represents the most successful area in economic development after World War II. Instead of following the orthodox instruction based on neoliberalism and free market, economic development in East Asian countries features the state’s heavy hand in the economy for engineering the economic development, planning the industrial policy, supporting the chosen industries, etc. This so-called “developmental state”

100 Id. at 142.
101 Id. at 144.
102 Id. at 143-44. Schneiberg provided two U.S. instances to illustrate his point, one consumer-owned mutual enterprises example (the property insurance mutuals) and the other state-owned bank example (the Bank of North Dakota). See generally id.
104 For a comparison of the East Asian economic development model with the orthodox model and the lessons learned therefrom, see generally Dani Rodrik, The Past, Present, and Future of Economic Growth, (Global Citizen
model was the secret of the success of many East Asian economies during the 1980s, including Japan, South Korea, Taiwan and Singapore; China also took this model subsequently. Under this model, the banking sector serves the “nerve” of the developmental state.

On the one hand, East Asian economies mostly have a bank-based financial system, where banks are the major capital provider while alternative sources of fund are relatively scarce. On the other hand, the state typically holds strong control of the banking sector, in the form of either the government ownership or directed credits, and is capable of guiding the direction of banks’ funds. Although the East Asian Financial Crisis in the end of the twentieth century and the increasing globalization of financial sectors forced some change of this developmental state practice, states in East Asia still have considerable influence on banks’ funds. In this aspect, banks in East Asia maintain a closer tie to the development of an economy. This special banking structure additionally calls for a reflection on bank governance from a real economy aspect.

The state’s control of banks demonstrates both an opportunity and a threat. With this control, it is easier for the state to intervene in banks’ decisions and channel the funds to more desirable locations. In other words, the state has more leverage in directing the resources to championed industries or businesses, small and medium enterprises (“SMEs”), productive activities, research and development activities, technological innovation, infrastructure, etc. Nevertheless, there is no guarantee that the state’s hand is necessarily a helping hand. It is also likely that it is a grabbing hand, in the sense that the state instead directs the funds to serve the interest of politicians and their cronies instead of the real economy, resulting in resources concentrated in the vested interest and obstructing the development of the economy. Hence, while the tools (i.e. the state’s control) are in hand, how to design a bank governance regime that is capable of channeling the fund to desirable places becomes another issue.

In light of the above, despite the importance of risk management, a separate and at least equal attention should be duly paid to the misaligned interest of the bank with that of the real economy. I denominate this type of misaligned interest the “Type IV agency problem” of banks, in which banks are the agent while the economy is the principal.

105 See generally WOO-COMINGS (ED.), supra note 14; WADE, supra note 14.
106 Woo-Comings, supra note 15, at 10-11.
108 According to the data as of 2010, the average ratio of total assets of government-owned banks to total assets of banks during 1999-2010 remains high in several East Asian countries, such as China (99.2%), Indonesia (71.2%), Thailand (70.8%), Philippines (64.1%), South Korea (52.9%), Japan (11.8%). On the other hand, Hong Kong (0.7%), Malaysia (0.5%) and Singapore (0%) appear the outliers. See Ata Can Bertay et al., Bank Ownership and Credit over the Business Cycle: Is Lending by State Banks Less Procyclical?, 20 (World Bank Pol’y Res., Working Paper No. WPS 6110, 2012).
109 This denomination coincides with the analogy made by Lothian and Unger which positions the banks as the
III. CLARIFYING THE CAUSES AND SOLUTIONS OF THE BANKS’ TYPE IV AGENCY PROBLEM

In this part, I will survey the cause of banks’ Type IV agency problem, analyze why the recent bank governance reforms fall short of addressing it and indicate several prescriptions and their respective limits.

A. How Does the Banks’ Type IV Agency Problem Arise?

That market failure may cause discrepancy between private returns of banks (and their shareholders) and social returns has long been noted by economists. Informational asymmetry is one major reason causing this discrepancy, and the specific type of the informational asymmetry here is the adverse selection problem. To elaborate, banks’ major activities are lending, and in the lending market, borrowers typically know more about their creditworthiness than lenders do. Therefore, banks, as the lender, are typically in a disadvantageous position in verifying the credit information of borrowers and assessing their creditworthiness.

Banks, however, have limited approaches to overcome this informational asymmetry. A traditional method dealing with it is to ask for a higher interest rate from borrowers, so that only those borrowers that are able to create more value (i.e. efficient borrowers) to cover this additional cost of capital will engage in borrowing from the banks. It is expected that by virtue of this pricing mechanism, banks can distinguish between efficient and inefficient borrowers and dissuade the riskier ones, thereby channeling the fund to safer borrowers despite the informational asymmetry.

The reality, however, could be to the contrary. In the real world, often times borrowers who are willing to undertake a higher interest rate are the riskier ones rather than the efficient ones: their risk of default is too high for them to be funded through normal channels, thus they are so desperate that they are willing to pay a higher cost of fund. In light of this likelihood of adverse selection, a higher interest rate pricing strategy in fact signals a higher risk premium and invites riskier borrowers (and therefore higher probability of default). Moreover, the high interest rate also implicates a moral hazard problem, in the sense that borrowers who obtain a higher interest loan may have decreased incentives to repay; in that case higher interest rate may to the contrary induce borrowers to take up riskier projects, thereby increasing the

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111 Joseph E. Stiglitz was the pioneer studying the impact of information asymmetry on banking sector, see generally id.
112 For related introduction of the adverse selection problem of banks, see e.g., Eduardo Levy Yeyati et al., A Reappraisal of State-owned Banks, 7(2) ECONOMIA 209, 219-20 (2007); Jacob Yaron, State-owned Development Finance Institutions (SDFI); Background, Political Economy and Performance Assessment, 15, http://www.iadb.org/res/publications/pubfiles/pubs-492.pdf (2004); Mullineux, supra note 4, at 378.
likelihood of default. In the end, charging a higher interest rate simply worsens the situation.

These adverse selection and moral hazard problems in turn reduce banks’ willingness to lend to customers whose creditworthiness is unverifiable. Typical of them are start-ups, SMEs, or remote areas businesses. There are several strategies that banks may adopt to control their risk exposure, but none of them really works. Firstly, banks may impose information requirements on borrowers, asking credit information from borrowers for verifying their creditworthiness. These businesses, however, have relatively limited information about their credits. For instance, the business history of start-ups could be too short for the banks to conduct any meaningful verification. The business prospects of these borrowers could be subject to dramatic uncertainty as well, rendering it difficult to assess their repayment capacity. Secondly, banks may impose collateral requirements on borrowers if the credit information is unclear enough to reach the lending decision. These businesses, however, usually have only limited asset with limited value for collateralization. For many start-ups or SMEs, their major asset is mainly fungible or intangible, while banks can hardly take it due to the difficulty in appraising its value.

A more exquisite strategy for the banks to deal with this informational asymmetry is a pooling strategy. In light of the difficulty to bargain for an interest rate contingent upon the borrowers’ creditworthiness due to the scarcity of observable and verifiable information, banks would alternatively pool the borrowers by risk categories and price the debt based on the average risk of each category. This pooling strategy may still result in inefficient allocation of capital in two ways. For the category receiving the banks’ funds, there is an internal cross-subsidization issue, in the sense that those safer borrowers within the category receive the same rate with those riskier borrowers in the same category, leading to a suboptimal outcome under which more funds are channeled to the riskier borrowers. It could further invite the lemon effect, that is, the presence of a large number of bad borrower increases the lending risk of banks, thereby raising the cost of funds of the pool in general and thus crowding out the good borrowers in the same pool. For the category that is considered too risky and thus unable to receive the banks’ funds, there is again a credit rationing problem. In any event, for those efficient borrowers who are pooled in the riskier category, they face either a higher cost of debt or difficulties to raise debts.

Due to the limits of these strategies, ultimately banks would prefer contracted and selective credits. That is, they would rather lend to large enterprises, charging a lower

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113 Yaron, id. at 15.
114 Sepe, supra note 5, at 369-70.
115 Sepe, supra note 5, at 364. See also Stiglitz, supra note 110, at 29-30.
117 Other methods for overcoming the informational asymmetry include some investment restriction covenants to
interest rate but at the same time undertaking less risk. This results in “credit rationing,” under which large portion of the society’s investible fund is channeled to large businesses, while those small businesses remain constrained in banks’ funding and face access to credits problems. Alternative finances, such as venture capital or private equity funding, are also less available for these small businesses because they remain less developed in many countries and typically only those high-tech growth firms would have access to them while SMEs can only rely on banks as their primary source of external finance. SMEs, in this sense, become the “missing middle” whose needed finance is too large for micro-finance institutions and too small and risky for private commercial banks. This way of allocating the society’s investible fund is obviously inefficient.

In sum, a rational bank pursuing its own interest is likely to fail in channeling the funds to efficient borrowers due to the informational asymmetry, which results in the Type IV agency problem.

B. How Does the Current Bank Governance Reform Miss the Target?

Identifying the informational asymmetry as the root cause of banks’ Type IV agency constrain the borrower’s discretion, some financial covenants to mandate a minimum financial goal, some governance covenants allowing the bank to appoint representative to serve the board member of the borrowers. The costs of these covenant arrangements, however, could be high, and it is difficult to monitor and enforce the covenant. Therefore, the reduction of credits is still likely. Sepe, supra note 5, at 365-71.

Ironically, this result is against the conventional observation of the banks’ strength, which argues that banks loans are special as opposed to other financial vehicles because they have lower cost of information which is of cost advantage for small firms who are cost-constrained to generate publicly available information for issuing outside debts. To elaborate it, Fama argues that banks loans are inside debts where the creditor may get access to information from the borrower’s decision process not otherwise publicly available; specifically, banks’ such access can be derived from the ongoing history of borrowers as depositors which provides information that allows a bank to identify the risks of loans to depositors. In light of this informational cost advantage, Fama argues that banks loans have cost advantage for small businesses who are cost-constrained in providing publicly available information. Fama, supra note 24, at 37-38.

Mullineux, supra note 4, at 376. See also Herinz P. Rudolph, State Financial Institutions: Mandates, Governance, and Beyond, 5 (World Bank Pol’y Res., Working Paper No. WPS 5141, 2009) (noting that even in developed economies, funding for venture capital and SMEs is still challenging). Even in the U.S., a relatively developed financial system, it is observed that “rational profit-seeking banks wisely focus on larger loans leaving the smaller loans to the payday lenders and others who are willing to take on this risk for the high profits earned through usurious interest rates and other questionable practices,” leading to a system that is “bifurcated with one regulated and government-sponsored banking system for the rich and another unregulated, usurious, and costly fringe banking system for the poor.” Baradaran, supra note 96, at 1335-36.

What is worse is that banks may prefer lending to business activities which have rosier prospects of profits, such as real estate investment whose return is more guaranteed due to that housing price has a general tendency to increase. For business activities that are subject to higher uncertainty, such as investment in entrepreneurship or innovative research and development, they may thus face credit rationing. This may result in an imbalance in capital allocation and thus fewer productive and innovative activities in an economy, which is another misalignment of interest between the banks and the real economy.

A separate problem from the informational asymmetry is the externality. It is argued that even if the informational asymmetry is absent, private lenders may have limited incentives to finance projects that produce externalities in a manner that is “socially profitable but financially unattractive.” Yeyati et al., supra note 112, at 220.
problem is crucial. This identification enables us to suit the remedy to the case. In this part I will explain how the current bank governance reform, centering on risk management and shareholder empowerment, fails to address this problem.

\[ \text{a. The Limits of Risk Management Reform} \]

The major emphasis of bank governance reform after the Financial Crisis is risk management. Despite all the progress having been made so far, I argue that it is less conducive to aligning the interest of banks with that of the real economy. In fact, there is a risk that the enhanced risk management oppositely aggravates the Type IV agency problem.

Risk is not an ideal index accounting for the interest of the real economy. Efficiency is. To align the interest of banks with that of the economy and channel the investible fund to the most efficient user, it is expected that banks charge the interest rate from the borrower according to his/her efficiency in using the fund: the more efficient the borrower is, the less interest rate being charged. Efficiency, however, is a composite concept, referring to the risk-adjusted value to be created by the borrower, which can be decomposed into at least two elements: value and risks. Therefore, to evaluate the efficiency of a borrower, banks should comprehensively look into both the riskiness of the borrowers and the value to be created. Risk management, however, solely looks at the risks aspect, while neglecting to weigh the social value to be created by the lending. Between a risk-free project with no default rate but bringing no extra social value over and a risky project with 10% default rate but bringing $1 billion social value, a risk well-managed bank will favor the former. This will result in inefficient allocation of investible funds.

In addition, risk management reform does not help in reducing informational asymmetry. As mentioned above, the major cause of the Type IV agency problem is informational disadvantages of banks as opposed to borrowers. To overcome it, one method worth considering by banks is investment in establishing an information system for better knowing borrowers. Risk management reform, however, less concerns such investment. The central spirit of risk management is to prevent potential risks. To perform this mandate, when faced with a risky project, banks may either invest their resources in knowing more about this project and therefore reduce the risks or refrain from involved in this project. For instance, for a borrower engaging in businesses unfamiliar to the bank, the bank may either conduct necessary survey of that business to become more certain about the potential risks of the project, or simply reject the request. Considering that investment in survey takes time, labor, costs but cannot guarantee a risk free conclusion, it is less convincing that a CRO or a risk management committee will propose banks to go for the first approach for controlling potential risks. In that way, enhanced risk management simply reduces the lending to risky project that could be socially desirable, rather than reducing informational asymmetry.
To be sure, due consideration of risks certainly matters for stabilizing the financial system. In regards of the efforts of risk management reform after the Financial Crisis, I do not intend to negate. What I want to highlight here is the informational asymmetry problem inherent in the banking sector. Without addressing this market failure, emphasis on risk management alone might lead to an unintended consequence of credit rationing in favor of large enterprises who are less risky due to their larger capital and assets for collateral but not necessarily more efficient. This unequal access to credits can also broaden the gap between the rich and the poor and lead to social inequality. From both the efficiency viewpoint and the equality viewpoint, this consequence is not an optimal one.

b. The Limits of Shareholder Primacy and Shareholder Empowerment

After the Financial Crisis, shareholder empowerment becomes the mainstream direction of corporate governance reform; but such direction is questionable. According to Christopher M. Bruner, the reason supporting this movement is because “our corporate governance system largely revolves around two power constituencies, the board and the shareholders. Thus, to the degree that the crisis was caused by board oversight failures, the answer must be more shareholder[s’] monitoring of boards themselves.” This simple dichotomy, however, does not really scratch where it itches from many aspects.

i. Shareholder Empowerment Resolves Neither the Type I nor the Type III Agency Problem

Many pieces have well illustrated that shareholder empowerment movement fails to align with the bank governance reform driven by the concern of risks. As mentioned above, shareholders are not the right person that are equipped and motivated to control the risks exposure of banks. They have limited knowledge and initiative, their investment horizon tends to be short-termist and myopic, and their risk appetite tends to be risk-pursuing. For banks, this risk-pursuing attitude is particularly troublesome. Banks’ management might be

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123 Such phenomenon has been reported in, for instance, China. It is observed that Chinese banks tend to favor state-owned enterprises over private enterprises, although the latter is the one better contributing to the Chinese economic development. It is documented that by 2005 Chinese SMEs accounted for 99.6% of enterprises in China and contributed 59% of the GDP, but in 2003 only 12% of their capital was from bank loans and no more than 10% of their investments were financed through bank loans, while state-owned enterprises enjoyed more than 30% of their investments funded by banks. See Zheng Song et al., Growing Like China, 101 AM. ECON. REV. 196, 202-04 (2011); Yang Yao & Linda Yueh, Law, Finance, and Economic Growth in China: An Introduction, 37:4 WORLD DEV. 753, 757 (2009); David Dollar & Shang-Jin Wei, Das (Wasted Capital): Firm Ownership and Investment Efficiency in China, 10 (IMF, Working Paper No. 07/9, 2007). One rationale supporting this lending practice is that state-owned enterprises are large in size and have the state’s implicit guarantee due to the “too-big-to-fail” concern. See Yan Liang, Development Finance: China’s Banking System in Light of the Global Financial Crisis, 45:1 THE CHINESE ECON. 8, 17-18 (2012).

124 See e.g., Sepe, supra note 5; Bruner, id.; William W. Bratton & Michael L. Watcher, The Case against Shareholder Empowerment, 158 U. PENN. L. REV. 653 (2010); Lynne L. Dallas, Short-Termism, the Financial Crisis, and Corporate Governance, 37 J. CORP. L. 265 (2012).
forced to increase the risk-taking in order to satisfy the now empowered shareholders because what shareholders want is more risk (and the associated risk premium) rather than less.126

Moreover, shareholder empowerment is not necessarily a better way to address the Type I agency problem and to protect shareholders’ interest as well. Debates surrounding shareholder empowerment movements are still ongoing, and their major battlefield lies in the short-term/long-term interest of the shareholders (and the firm).127 It is generally accepted that shareholders’ interest denotes the long-term interest of shareholders.128 The point is: on maximizing shareholders’ interest, whether shareholders themselves are the most appropriate guardian?129 It is argued that shareholders themselves concern more the short-term interest rather than long-term interest because as compared with managers, shareholders’ investment in a firm has a shorter horizon of interest, rendering shareholders less interested in the long-term value creation than short-term profits pursuit.130 Here I do not intend to intervene in the associated debates. What I do want to highlight here is that, even within the context of Type I agency problem, the desirability of shareholders empowerment movement is still controversial at this stage.131

ii. Shareholder Empowerment Does Not Address Type IV Agency Problem

126 Hopt, supra note 4, at 54; Cheffins, supra note 4, at 46-48.
127 For arguments against shareholder empowerment, see e.g., Leo E. Strine, Jr., Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law, 114 COLUM. L. REV. 449 (2014); Leo E. Strine, Jr., One Fundamental Corporate Governance Question We Face: Can Corporations be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term, 66 BUS. LAW. 1 (2010). For counter-arguments, see e.g., Lucian A. Bebchuk, The Myth that Insulating Boards Serves Long-term Value, 113 COLUM. L. REV. 1637 (2013); Mark J. Roe, Corporate Short-Termism – In the Boardroom and in the Courtroom (Eur. Corp. Governance Inst. – Law, Working Paper No. 210/2013, 2013).
128 While the market value of the firm may serve the proxy. Hansmann & Kraakman, supra note 27, at 441.
129 There is a long debate within the shareholder primacy proponents between shareholder empowerment or director primacy. Bainbridge, for instance, believes that while shareholder primacy norm should dominate the ends of firms, the means to achieve this objective and to guard the shareholders’ interest should be governed by director primacy rather than shareholder empowerment. See generally Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 57 NW. U. L. REV. 547 (2003).
130 It is observed that in the capital market, the major part of the investors is comprised of institutional investors with short investment horizon, such as mutual funds. These “money managers” tend to hold their investment shortly. Even those institutional investors with a very long investment horizon, such as pension funds, in fact have become short-term investors. One reported cause is that the modern portfolio theory mandates diversification of investment, leading to the investment model of “large in number of invested companies, but small in any individual,” which results in less incentive for institutional investors to supervise individual firms’ performance. In addition, to maintain the portfolio the institutional investors are thus forced to frequently trade in and out their portfolio shares, leading to shorter horizon of investment. Another cause is that institutional investors increasingly outsource their investment to external asset managers, which are constantly subject to competitive pressure to show good investment results. Winter, supra note 63, at 7-8. For theoretical accounts of shareholders’ short-termism, see generally Jeremy C. Stein, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior, 104:4 Q. J. ECON. 655 (1989); Jesse M. Fried, Current-Shareholder Bias and the Limits of Shareholder Empowerment, http://ssrn.com/abstract=1986944 (2012).
131 One side note here is that shareholder empowerment basically aims at addressing the Type I agency problem, but generally speaking that is less the concern of most countries other than the U.S. and the U.K. In most countries, most banks have a controlling shareholder in place; thus the governance problem in their banking sector is not the separation of ownership and control, but that the ownership and control are so highly concentrated, i.e. the Type II agency problem. Empowering shareholders with more power is not the right solution.
Most importantly, turning back to the central concern of this paper, i.e. the Type IV agency problem, shareholder empowerment is not a desirable solution. Even if accepting that shareholder empowerment may secure the shareholders’ interest, there remains a gap between shareholders’ interest and the social welfare.\textsuperscript{132} The assumed logical superiority of the shareholder primacy norm lies in that shareholders, as a residual interest holder of the firm, are a better proxy for representing the interest of the firm; thus maximizing the shareholders’ interest is maximizing individual firms’ interest and, in aggregate, the whole society’s welfare.\textsuperscript{133} In the context of banks, this denotes that in pursuing the interest of banks’ shareholders (i.e. the banks’ profits), banks managers will be motivated to lend the funds to those borrowers willing to pay a higher interest rate, while such borrowers are assumed to be more efficient ones who are able to create higher returns. In this manner, the investible funds of the society can be used more efficiently, thereby maximizing the social welfare. To that extent, shareholder primacy norm and shareholder empowerment might align the interest of the banks with that of the economy. Nevertheless, as mentioned above, this rosy picture is more an illusion due to the presence of informational asymmetry between banks and borrowers. In that case, banks’ pursuit of risk-adjusted profits taking into account the risks caused by the informational asymmetry can no longer warrant an efficient allocation of fund.

In an ideal world, banks can consider investing in financial techniques and experiences for mitigating the informational asymmetry, but shareholder empowerment movement might discourage banks to take this step. Indeed, banks can invest in knowing better their borrowers, including surveying their profile and credit history, familiarizing themselves with the borrowers’ business prospects or even intervening in the borrowers’ businesses decisions to control the borrowers’ risks, etc. For instance, to expand lending in a remote area, a bank can open a branch, attract deposits from local residents and establish experience of and familiarity with the business prospects in that area. While this investment bears costs (and usually considerable costs), it is efficient to the extent that the future return derived from that remote area exceeds the present investment costs. However, it is less likely for shareholders, who are myopic and short-termism, to have the superior judgment to go for this business strategy. Shareholder empowerment movement will do nothing more than simply perpetuating this reality.

Finally, shareholder empowerment and shareholder primacy norm are both incomplete

\textsuperscript{132} Even shareholder primacy proponents agree that shareholder primacy is merely a means (and the most effective means) to maximize social welfare, not in itself the end. Hansmann & Kraakman, \textit{supra} note 27, at 441; Kraakman, \textit{supra} note 1, at 28. For a comprehensive analysis, see generally William W. Bratton & Michael L. Wachtler, \textit{Shareholders and Social Welfare}, 36 SEATTLE U. L. REV. 489 (2013).

\textsuperscript{133} Other strengths of shareholder primacy norm include that it provides a clearer criteria for evaluating the managers’ performance and better suits the intensive competition for capital in modern economy, and that shareholders are relatively weaker than other stakeholders in bargaining for a protective contract terms and thereby deserve stronger protection. See Hansmann & Kraakman, \textit{supra} note 27, at 449.
when the focus is shifted from maximization of welfare to distribution and allocation of welfare. In several occasions, shareholders, as one interested group of the firm, may have divergent or even conflicting interest with other stakeholders. In that case, shareholder primacy norm appears to draw a clear allocation rule which mandates the bank management to maximize shareholders’ interest (which is somehow synonymous to minimizing the interest of other stakeholders). In the context of banks’ Type IV agency problem, this represents that banks’ shareholders have priority entitlement to the asset of the banks, while interest of banks’ customers (i.e. borrowers), among other stakeholders, is subordinated. Nevertheless, it is less clear why such allocation is always beneficial to the society as a whole. This leads to a distribution issue, which is of concern even for welfare economists to the extent that distribution affects the individuals’ tastes for fairness and thus their well-being. Hence, even though assuming that shareholder primacy and shareholder empowerment increase the productive efficiency of banks, there remains a gap toward reaching the distributional efficiency and maximizing the overall welfare of the real economy.

To conclude, even if shareholder empowerment movement is capable of securing shareholders’ interest, it has its limits in addressing the Type IV agency problem, but as Baradaran has well noted, “bank profitability is a means to an end and not an end itself; [t]he proper end is ensuring that the nation’s banks do what the public needs them to do and not the other way around.”

C. A Case for Governmental Intervention: The Forms and Limits

Government intervention can be justified to the extent that the market failure is in place and is unresolvable by private orderings. To reduce banks’ Type IV agency problem caused by informational asymmetry in banking sectors, I argue that government intervention is needed, and I examine several possible forms of governmental intervention.

a. Regulatory Requirement of “Public Benefit Test”

Banking sector is a regulated sector, allowing rooms for the government to intervene in the name of public interest. One regulatory tool that is common but seldom considered seriously is the “public benefit test” as contained in many banking provisions. Many banks’ activities require administrative approval from the regulator, such as establishing a banking branch, engaging in new financial services, investing in other financial or non-financial firms, engaging in merger and acquisition activities, etc. Related banking provisions usually

136 Baradaran, supra note 96, at 1284.
137 For a discussion of the public benefit test as applied in the U.S., see id. at 1338–42.
stipulate that in deciding to approve it or not the regulator should “…”\textsuperscript{138} How this “public benefit test” is being applied in practice, however, appears less clear. In the U.S., for instance, it is observed that the regulator rarely inquires specifically into the interest accrued to the public.\textsuperscript{139} It is argued that a more effective application of this public benefit best should be useful for pursuing the interest of the economy.

An obvious limit inherent in this “public benefit test” is its passivity. It is of concern only when a regulatory approval is required, and it only serves to reject banks’ certain activities detrimental or unhelpful to the economy. If what the economy needs from banks are acts, the public benefit test cannot mandate them. For instance, the public benefit test cannot force a bank to open branches in remote area or extend loans to SMEs. Hence, the public benefit test is of merits only to the extent that it eliminates undesirable banking activities, but it falls short of encouraging desirable ones.

\textbf{b. Regulatory Intervention: Subsidies and Regulation}

Subsidization is a less interventional approach for encouraging desirable banking activities.\textsuperscript{140} In Taiwan, for instance, the government establishes the SMEs Development Fund for supporting or guaranteeing banks’ lending to SMEs. Subsidization’s merits are two-fold. On the one hand, as opposed to individual banks, the government may have relatively superior access to the information related to the aggregate economy and thus be better positioned to define the areas that are efficient but underserved of credits. By classifying the areas eligible for the subsidies, the government identifies the target for individual banks, thus saving the banks’ search costs. Subsidies then incentivize profits -driven banks to channel their funds to these desirable places. On the other hand, subsidization does not require the government to intervene in individual lending decisions of the banks, which are left to the banks’ business judgment. This prevents over-pursuit of public interest in sacrifice of banks’ own interest and reduces the potential of political intervention. It also preserves the room for market discipline to function and saves the government’s costs in assessing the desirability of each and every individual loan.

Subsidization’s merits at the same time are its limits. It is an incentive scheme that is non-mandatory; thus it may fail to incentivize banks to extend lending to desirable places if the privilege is not lucrative enough. It is also costly since it expends on the government’s budget. Moreover, absent the power to intervene in each individual leading decision, the government can only designate the desirable targets in a general manner but lacks the teeth to ensure the

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\item In Taiwan, for instance, in determining whether to approve the incorporation of a financial holding company, the Financial Holding Company Act Article 9(1)(iii) requires the regulator to consider “the impact … on the public interest.”
\item Baradaran, supra note 96, at 1338-42 (finding that the U.S. regulator mostly interpret it as either advancing efficiency or increased competition; there is absent specific inquiry into the interest accrued to the public).
\item Similar to this approach is the use of subsidization to encourage banks to extend loans to SMEs. For instance,
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channeling of banks’ funds to the efficient users. For instance, for subsidies privileging banks extending loans to SMEs, it is likely that banks simply lend to those SMEs that are capable of providing adequate collateral or have personal links with the managers, instead of investing in establishing an information system for making more efficient lending to SMEs.

In that way, subsidization does not reduce the informational asymmetry in the banking sector. To elaborate, to address the Type IV agency problem we need banks to invest in establishing an information system for reducing the informational asymmetry in the banking sector so as to bring “financial deepening.”\textsuperscript{141} Subsidization is useful to the extent that the privileged banks take advantage of the benefit conferred therefrom to offset their costs incurred from establishing an information system. However, since establishing such system is such an abstract concept that is non-contractible \textit{ex ante}, it is difficult for the government to design a subsidy program conditioned on that. Accordingly, it is likely that banks use these subsidies in other places (such as window-dressing their financial statement) rather than breaking through the informational asymmetry. They might take the government subsidy but simply palter.\textsuperscript{142}

Another form of regulatory intervention is a mandatory requirement of lending to directed places. For instance, in China since 2011, the China Bank Regulatory Commission (“CSBC”) directed all Chinese banks to increase their lending to small businesses and specifically mandate two criteria: that the increase ratio of lending to small businesses cannot be lower than that of average lending, and that the increase amount of lending to small businesses cannot be lower than that in the same period last year.\textsuperscript{143} Compared with subsidization, its benefit lies in the fewer costs incurred by the government. However, banks are less incentivized under this intervention; thus, correspondingly the government has to incur enforcement costs to ensure banks’ compliance. In addition, this approach remains less addressing the central concern as mentioned above: the informational asymmetry in the banking sector remains undealt with, and banks might simply palter with the mandatory requirement.

c. \textit{Operational Intervention: Directed Credits and Government Ownership}

The above discussion presents a need of governmental intervention in the banks’ operational decisions, especially the establishment of a robust information system capable of reducing the informational asymmetry in the market. Subsidization and regulation fall short

\textsuperscript{141} Caprio, Jr. and Levine have noted the importance of improvements to credit information in facilitating the expansion of banking to groups that were previously excluded. Caprio, Jr & Levine, supra note 4, at 43. Cihak, and Demirguc-Kunt also remotely noticed the importance of having a credit information platform for reducing the information asymmetry. Cihak, & Demirguc-Kunt, supra note 5, at 17-19.

\textsuperscript{142} For instance, during the Financial Crisis the U.S. Treasury intended to use the TARP fund to support the banks in order to restore the liquidity drought. The banks receiving the TARP fund, however, did not use these funds for such purposes, but simply used them to improve their own balance sheet. See Baradaran, supra note 96, at 1283-84, 1321-23.

\textsuperscript{143} CSBC Issues No. 59 (2011), No. 94 (2011), No. 37 (2013) and No. 7 (2014).
of it as mentioned above, which therefore results in a case for a more aggressive form of government intervention: government ownership or control of banks, “the ultimate way in which bureaucrats intervene with the operation of a bank.”

The case for government ownership or control of banks is not on that they enable the government to direct individual lending decisions. While government-directed loans help to serve the underserved places, the advantage of the government ownership is something more fundamental; otherwise the merits of government ownership would resemble subsidies, while a more efficient way of subsidization is to directly subsidize the targeted group rather than going through all these indirect processes. To elaborate, the advantage of government ownership is that it facilitates the establishment of an “information system”: This information system is like Rome, which “is not built in a day” but takes considerable commitment and investment. Banks need to learn by experiment, such as engaging in related businesses, developing necessary human and business connections with related market participants, experiencing the trials and errors, etc. Neither a profit-seeking bank nor a risk-avoiding bank would easily undertake this commitment; to establish a workable information system banks might need the government’s constant pressure. This establishes a case for the government ownership: the government may exercise its control of the banks to establish the information system, thereby reducing the market failure of informational asymmetry and bringing the financial deepening in place.

It could be argued that government ownership is unnecessary despite the need to establish the information system because regulation can undertake the same mission. Nevertheless, this position sustains only if the government knows exactly what it desires and if such desire can be written in a contract or specified by regulation. If a mandate bears the “non-contractible quality,” it might justify the government ownership. As mentioned above,

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144 Caprio, Jr & Levine, supra note 4, at 39. In fact, this coincides with one role traditionally undertaken by many government-owned banks, i.e. serving the long-term development by filling the market gaps in long-term credit, infrastructure, agriculture finance, and finance to underserved segments of the economy (notably the SMEs). Cihak, & Demirguc-Kunt, supra note 5, at 13; Gutierrez et al., supra note 120, at 2.

145 Stiglitz provided some rationales for the directed credits, arguing that, to the extent that financial institutions failed to take social returns into account in making loans, directed credit may be desirable. Stiglitz, supra note 111, at 42–45.

146 See Gutierrez et al., supra note 120, at 5. The negative effects of a below-the-market lending rate (i.e. the subsidized lending interest rate) are further illustrated by Yaron, see Yaron, supra note 112, at 11–13.

147 Gutierrez et al. on the other hand argued the government’s informational advantage does not necessarily justify the state ownership of banks as there could be other as effective intervention to facilitate access to credit, such as improving credit history availability and the ability to pledge collateral. Gutierrez et al., supra note 120, at 5. However, the intervention they proposed appears to be less effective in securing a robust enough information system.

148 Yeyati et al., supra note 112, at 221; See also David E.M. Sappington & Joseph E. Stiglitz, Privatization, Information and Incentives (Nat’l Bureau Econ. Res., Working Paper No. 2196, 1987); Oliver Hart et al., The Proper Scope of Government: Theory and an Application to Prisons, 112:4 Q. J. ECON. 1127 (1997). An associated criticism of this claim arisen from the agency view is that if the government cannot write a specific enough contract for regulation, how could it incentivize the bureaucrats to exercise the ownership for the public goods? Yeyati et al., supra note 112, at 222. However, this counter-argument appears to overlook the different difficulty between
however, the exact content of the information system is less contractible *ex ante*. This thus warrants some case for the government ownership of banks.149

IV. CAUTIONS FOR GOVERNMENT OWNERSHIP OF BANKS

The above part argues a case for government ownership of banks. Nevertheless, it is not available everywhere. The U.S., for instance, is traditionally antagonistic against government ownership of the banks, which can be observed from the critiques during the Financial Crisis of the Treasury’s temporary ownership of several financial institutions due to the bailout scheme.150 In these countries, even though there is a case for government ownership of banks, politically such intervention is less feasible. Unlike these “regulatory states,” East Asian countries in contrast have relatively friendly attitudes toward government ownership of banks.151 Although the Asian Financial Crisis in the end of the 20th century brought some reflection on this practice, government ownership of banks remains relatively prevalent nowadays. This ideological difference creates some leverage for the East Asian governments to deal with the banks’ Type IV agency problem. To be sure, I am not arguing that government ownership of banks is the optimal solution. As Lothian and Unger argue, as opposed to government ownership of finance, having a well-developed financial market with enough financial deepening is more desirable.152 My position is simply that in the absence of this Garden of Eden, government ownership of banks at least can serve the second-best.153

My argument, however, appears to be contradictory to mainstream studies. There,---

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149 In theory, this conclusion coincides with the social view and development view of government ownership of banks. The social view emphasizes the role of the government in making up for market imperfections that leave socially profitable investments underfinanced. The development view further stresses the need for government in economies where the scarcity of capital, the general distrust of the public, and endemic fraudulent practices among debtors may fail to generate the sizable financial sector required to facilitate economic development. Yeyati et al., *supra* note 112, at 210. See also Stiglitz, *supra* note 111; Arun & Turner, *supra* note 4, at 374. In practice, this conclusion also coincides with the traditional role played by the state-owned development banks in many countries, which aims at mitigating the market failure caused by the presence of costly and asymmetric information hampering the access to finance for first time borrowers, externalities that result in un---


153 My conclusion coincides with the observation of Yeyati et al. that government ownership of banks may create a “big push” to internalize the positive externalities, which is especially justified in the absence of developed capital markets that provide alternative sources of funding. Yeyati et al., *supra* note 112, at 220.
regulatory intervention has already been unwelcomed by some theorists, and government ownership of banks is especially notorious. Two main theories explain the undesirability of government ownership of banks. The political view points out that the politicians tend to maintain the government-owned banks for serving their own personal or political objectives rather than for the social efficiency. The agency view, on the other hand, points out that agency costs within government bureaucrats may offset the social gains of government ownership. Real world practice and empirical studies also show that government ownership of banks is likely to invite political intervention in banks’ operation and thereby lead to poorer performance of banks and the economy. The core concern is: despite the

154 See e.g., Caprio, Jr & Levine, supra note 4, at 37-39 (indicating that the government’s motives are quite different, subject to political forces and insulated from market forces, leading to the negative impact of greater supervisory power on bank development); Ross Levine, The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence 12. For a neutral discussion of the state-owned banks, see generally A. Michael Andrews, State-owned Banks, Stability, Privatization, and Growth: Practical Policy Decisions in a World without Empirical Proof (IMF Working Paper No. WP/05/10, 2005); Yeyati et al., supra note 112.  

155 For the criticism of government ownership of banks, see generally Hopt, supra note 4, at 21; Caprio, Jr & Levine, supra note 4, at 39-43; Levine, supra note 154, at 16. 

156 See Yeyati et al., supra note 149, at 210.  

157 See generally Yaron, supra note 112, at 10-14; Giuliano Iannotta et al., The Impact of Government Ownership on Bank Risk, 22 J. FIN. INTERMEDIATION 152 (2013) (finding that government-owned banks have lower default risk but higher operating risk, indicating the presence of government protection, and that government-owned banks’ operating risk tend to increase in election years, suggesting the political view); Rainer Haselmann et al., Real Effects of Bank Governance: Bank Ownership and Corporate Innovation (CEPR, Discussion Paper No. DP7488, 2009) (finding that government involvement in the allocation of credit comes at the cost of lower corporate innovation and thus economic growth); Alejandro Micco et al., Bank Ownership and Performance: Does Politics Matter?, 31 J. BANKING & FIN. 219 (2007) (finding that government-owned banks in developing countries tend to have lower profitability and higher costs, but less the case in industrial countries; such poorer performance also widens in election years); Yeyati et al., supra note 112 (finding no significant relation between government ownership of banks and bank credit to the private sector, but also no indication that government ownership has the positive effect that its advocates have proposed); I. Serdar Dinc, Politicians and Banks: Political Influences on Government-owned Banks in Emerging Markets, 77 J. FIN. ECON. 453 (2005) (finding that government-owned banks’ lending increases during the election years); Paola Sapienza, The Effects of Government Ownership on Bank Lending, 72:2 J. FIN. ECON. 357 (2004); James R. Barth et al., Bank Regulation and Supervision: What Works Best?, 13 J. FIN. INTERMEDIATION 205 (2004); Rafael La Porta et al., Government Ownership of Banks, 57:1 J. FIN. 265 (2002); Gerard Caprio & Maria Soledad Martinez Peria, Avoiding Disaster: Policies to Reduce the Risk of Banking Crises (The Egyptian Center for Econ. Stud., Working Paper No. 47, 2000). For a further analysis of how the corporate governance weakness of government-owned banks appears in practice, see David H. Scott, Strengthening the Governance and Performance of State-Owned Financial Institutions, 3-4 (The World Bank, Fin. & Private Sector Dev., Fin. Systems Dep’t, Pol’y Res. Working Paper No. WPS4321, 2007). For empirical studies less in disfavor against government ownership of banks, see e.g., Chung-Hua Shen et al., The Government’s Role in Government-owned Banks, J. FIN. SERVICES RES. (May, 2013) (finding that unless government banks are required to purchase a distressed bank, their performance are at part with that of private banks); Svetlana Andrianova et al., Government Ownership of Banks, Institutions and Economic Growth, 79 ECONOMICA 449 (2012) (finding that government ownership banks is in fact associated with higher long-run growth rates after controlling the institutional quality); Tobias Korner & Isabel Schnabel, Public Ownership of Banks and Economic Growth: The Impact of Country Heterogeneity, 19(3) ECON. TRANSITION 407 (2011); Marcia Million Cornett et al., The Impact of State Ownership on Performance Differences in Privately-owned versus State-owned Banks: An International Comparison, 19 J. FIN. INTERMEDIATION 74 (2009) (finding the initial poorer performance of government-owned banks and a later close of the gap and attributing this phenomenon to the globalization of financial services competition); Yener Altunbas et al., Bank Ownership and Efficiency, 33(4) J. MONEY, CREDIT & BANKING 926 (2001) (finding little evidence that private banks are more efficient than government-owned banks); Yeyati et al., supra note 112, at 221 (finding that the presence of government-owned banks leads to significant improvement of overhead costs in banking sector in low-income countries, showing that
enumerated merits of governmental intervention, the government is not guaranteed to be benevolent. It could intervene in banks’ operational affairs as either a helping hand or a grabbing hand, while agency theorists predict the latter the default scenario. Moreover, government ownership of banks could further transfer unfair competitive advantage to the government-owned banks since the government is more likely to come to the rescue if bankrupt, leading to the crowding-out of private banks and distortion in the banking sector.

In this part I will argue that government ownership of banks can be less awful than what mainstream literatures assert. It has its theoretical strengths as mentioned above, especially its merits in reducing the informational asymmetry and addressing the Type IV Agency Cost, with the qualification that the government exercises its ownership with a benevolent helping-hand. This practice also remains widespread even after the privatization wave during the 1980s-1990s, suggesting that government ownership of banks is expected to stay perpetuated for some while. Considering the theoretical merits and political reality, those countries expected to maintain the government ownership of banks in the near future should learn to live with it and take advantage of this reality to transform it into opportunities. Admittedly, government ownership in the end might become a grabbing hand. Specifically for banking industries, considering the huge interest involved in this sector, politicians and bureaucrats are more likely to deviate from benevolence. To preserve the theoretical merits of government ownership of banks while controlling the potential negatives caused by a grabbing-hand

in very poor countries the presence of government-owned banks can have positive spillovers on their private counterparts).

The property rights theorists believe that government-owned firms incur more serious moral hazard problems and agency problems than private firms. They concern that a government is essentially owned by all diffused taxpayers, and since no taxpayer has the right to sell his/her ownership of the government, the government is subject to less supervision. Related literatures often cite Armen Alchian as the leading proponent of the property right theory. See generally Armenian A. Alchian, Some Economics of Property Rights, 30 II POLITICO 816 (1965). For other literatures following this line, see e.g., Enrico Perotti, State Ownership: A Residual Role? (World Bank Pol’y Res., Working Paper No. 3407, 2004); Arun & Turner, supra note 4, at 374. Gutierrez et al., supra note 120, at 4-5; Scott, supra note 157, at 20.

The recent financial crisis also underscored the potential countercyclical role of government-owned banks in offsetting the contraction of credit from private banks and weathering the crisis, although it is less than clear whether these funds were allocated to the constrained borrowers or politically favored ones. See generally Bertay et al., supra note 108 (finding that lending by state banks is less procyclical and, in high-income countries, even countercyclical and arguing that government-owned banks can play a useful role in stabilizing credit over the business cycle as well as during periodis of financial instability); Rudolph, supra note 119; Gutierrez et al., supra note 120, at 8-9; Cihak, & Demirguc-Kunt, supra note 5, at 13-15 (noting that government-owned banks may provide the state with an additional tool for crisis management, such as providing a safe haven for retail and interbank deposits, serving a fire break in contagion and stabilizing aggregate credit.) See also Alejandro Micco & Ugo Panizza, Bank Ownership and Lending Behavior, 93 ECON. LETTER 248 (2006); Yeyati et al., supra note 112, at 224, 231-32.

Reasons include: First, politicians may find it easier to disguise their political motivation, considering that banking sectors are more complicated and outsiders may suffer more serious informational asymmetry to ascertain the quality of a specific bank loans. Second, it takes longer time to ascertain the costs of any politically motivated loan, considering that loan usually has longer period of maturity. Third, politicians may have more opportunity to divert the funds, considering that banking sectors operate across the whole economy rather than in a defined industry. Finally, politicians may have more control over the banking sector considering that this sector normally has higher entry barriers. Dinc, supra note 157, at 454.
government, a robust governance mechanism needs to be in place. With the anticipation that political influences can at least coexist with the development mandate, in this part I will propose several governance principles for government-owned banks.

A. Between Market Failure and Government Failure: Can We Choose None of Them?

To address the market failure caused by the informational asymmetry in the banking sector, I submit a case for government ownership of banks; but as the degree of governmental intervention intensifies, the potential of government failure also enhances, and so does the negative impact of government failure. Market failure and government failure, however, are not in an either-or relationship. It is possible to “create mechanisms that negate the ‘grabbing hand’ of politicians and regulators while creating incentives for official agencies to improve social welfare” and this should be our goal here.

To control government failure, better political institutions ensuring the accountability of government officials and politicians certainly help. On governmental intervention in the banking sector, related methods having been raised include openness and competitiveness of the political system, effectiveness of the media, and independent banking regulator, etc. Empirical evidence also found that in countries with high-quality political institutions (as measured by democracy indices, assessments of political rights, governance indicators, and corruption indices), government ownership of banks does not seem to influence economic growth, showing that good political institutions may mitigate the agency problem between taxpayers and politicians and make politicians’ abuse of government-owned banks less likely. In line with this finding, a set of corporate governance mechanism “governing the government” is undoubtedly warranted.

To be sure, absence of government failure is not the precondition for adopting the government ownership of banks or any form of governmental intervention. As having been noted, existence of government failure or corruption does not imply that governmental intervention is harmful. It still depends on the magnitude of government failure and the seriousness of market failure. Therefore, the incapability of the following governance mechanism in eliminating all possibility of government failure cannot dictate the failure of

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162 Andrews, supra note 155, at 29 (believing that governance structures can significantly mitigate the pitfalls of government ownership). Of course, it is also likely that the cost for investing in corporate governance reforms is too large to be justified or affordable. Scott, supra note 157, at 5.
163 Yeyati et al., supra note 112, at 246.
164 Levine, supra note 154, at 13-14.
165 Yeyati et al., supra note 112, at 246.
167 Levine, supra note 154, at 13-14.
168 Korner & Schnabel, supra note 157, at 422-25.
169 Id. at 435.
government ownership of banks.170

B. Some Preliminary Governance Principles as the Antidotes

Several proposals have been put forward for improving corporate governance of government-owned banks, 171 and their central theme is similar: to commercialize the government-owned banks as possible, that is, requiring the government-owned banks to be operated on a commercial basis as possible.172 Specific recommendations include: requiring a clear mandate, aiming at specific target sector, 173 imposing the financial sustainability requirement, 174 stipulating the rules of cooperation with the private sector, positioning government-owned banks as a complementary role, promoting the participation of private banks, 175 designing standards for measuring the public policy performance of government-owned banks, 176 and periodically reviewing the needs of government ownership.177

These series of proposals indeed set forth a general framework for governing the government-owned banks. On this basis, I highlight three additional areas worth attention: the board composition, fiduciary duty and disclosure.

a. Board Composition: a “Partial Governmental Representation”

The real economy’s interest in banks needs to be resolved, but it cannot be resolved in undue sacrifice of banks’ continuity, including their profitability and safety and soundness. To clarify my position, while I argue for due consideration of the economy’s interest, I am not

170 It is also found that enhanced competition in the financial market can reduce the negative effect of government ownership of banks, considering that in that case the performance of governmental bureaucrats becomes more verifiable, which increases the accountability. See generally Cornett et al., supra note 157. Enhanced competition, however, could be a double-edged blade. From a real economy oriented perspective, enhancing the competition in the banking market is not necessarily desirable because under the competitive pressure, the banks’ operation might be captured by the shareholders’ interest and profits, which might undermine the ability of the government to use the banking system to achieve social and economic objectives. Arun & Turner, supra note 4, at 375.
171 See e.g., Cihak, & Demirguc-Kunt, supra note 5, at 16-17; Gutierrez et al., supra note 120; Rudolph, supra note 119; Andrews, supra note 155; Scott, supra note 157; Yaron, supra note 112.
172 See e.g., Gutierrez et al., supra note 120, at 3; Rudolph, supra note 119; Andrews, supra note 155, at 27-28. At the same time, it is proposed that the government-owned banks should avoid serving a vehicle to transfer government subsidies.
173 It is thus argued that on this basis government-owned commercial banks are less desirable than government-owned development banks as the former lacks a clear mandate. Rudolph, supra note 119, at 6.
174 The mandate is expected to be a financially sustainable one, aiming at a sector sizable enough to create a sustainable business for the government-owned banks. It is further proposed that the mandate should stipulate a minimum rate of return on capital to ensure that the government-owned banks will generate enough resources to accomplish the mandate. See Rudolph, supra note 119, at 4-5. For further analysis of how financing the policy mandates should be structured, see Rudolph, supra note 119, at 16-19; Scott, supra note 157, at 20-21.
175 Gutierrez et al., supra note 120, at 19-24; Rudolph, supra note 119, at 4; Yaron, supra note 112, at 17-18, 36. For instance, the government-owned banks should refrain from providing first-tier lending as possible but should co-finance, extend credit guarantees, or auction the subsidies (or guarantees) in cooperation with the private banks as possible.
176 It is proposed that such performance evaluation should contain two primary criteria, i.e. the outreach to target clientele and the self-sustainability. See Yaron, supra note 112, at 5, 21-27. For further analysis, see Rudolph, supra note 119, at 20-21.
177 Rudolph, supra note 119, at 4-21; Scott, supra note 157, at 5, 13-14, 19-21.
arguing for its supremacy. If the shareholder primacy norm is imperfect for bank governance because interest of shareholders should not be unsurmountable, so is the case for that of other stakeholders, including creditors, labors, customers as well as the economy. In the end, it is all about weigh and balance between different interests, communication, negotiation and coordination.

The decision-making body of banks, i.e. the board, should be the place for such weigh and balance, communication, negotiation and coordination. The board decides the general policy of banks, the appointment of management to conduct daily operation affairs on behalf of the bank, and possesses the supervisory power over the management, making it the central nerve of banks. In this sense, the shape of banks’ board composition dictates how much weight each interest should be given in the decision-making process of banks.

Designing a board composition structure of government-owned banks capable of containing various interests should be the way forward. Some commentators find private sector participation appealing because it invites the “smart money investors” as a check and balance mechanism. This “partial governmental representation” is a right direction because private sector participation and the thereby appointed business directors allow the interest of privates, among others, the shareholders, to be represented; business directors may therefore defend and bargain for the profitability and financial soundness of banks in the board meeting, which is important in order to ensure the financial sustainability and survival of government-owned banks. The presence of business directors can also help in holding government directors accountable. On the other hand, there could be a justified concern that private sector participation invites profit maximization motives to the internal decision process, which risks compromising the policy objectives. This concern, however, depends on relative bargaining power between business directors and government directors, and the relative seats of each group on the board matters. For instance, in cases where market failure is serious while government failure is minor, or for banks incorporated to conduct development missions (such as government-owned development banks), government directors should take majority seats on the board and the charge of general affairs of the banks while private sector should take minority seats and serve a supervisory role. In contrast, in cases where market failure is modest while government failure is a bigger concern, government directors should

178 Gutierrez et al., supra note 120, at 24. This proposal is out of the concern that when the government tempts to fund the projects on the government agenda, it paid less enough attention to the private and social return rate of these investments, leading to capital risks of the government-owned banks participating in such project. Gutierrez et al., supra note 120, at 6-7. For instance, it is indicated that the Chinese government’s stimulus plan initiated in 2009 for addressing the domestic contraction caused by the Financial Crisis failed to consider the return of the project, leading to significantly potential fiscal threat of the Chinese banks and the risks of the financial system. See WALTER & HOWIE, supra note 22, at 37.

179 It is argued that a clear mandate of the government-owned banks with the expected return and a shareholder agreement clarifying the objectives of the private partners might help. Gutierrez et al., supra note 120, at 24-25. However, such ex ante design appears less available if considering the non-contractible quality of these mandates.
concede, leaving business directors to take majority seats and playing a supervisory role. To conclude, no specific way of board composition holds true in any occasion; the bottom line is, in order to facilitate conversation between the government and privates, board composition with partial governmental representation is needed for creating a collegial relationship which contains representatives of both camps.\footnote{38}

Another related issue is the qualification of government directors. Some principles have been proposed: \footnote{181} the government should stipulate a clear designation of a shareholder representative (a specific ministry or agency) to exercise the shareholders’ right on behalf of the government and a specific ownership policy,\footnote{182} avoid nominating government officials as board members\footnote{183} while supporting professional and capable board member candidates.\footnote{184} I totally agree that the expertise of government directors is the key here, especially the expertise in identifying the informational asymmetry, the vision of development and the innovation in establishing the information system. However, I am more skeptical of discouraging government officials from serving the board members. As long as the appointed officials possess adequate knowledge or experience for addressing the Type IV agency problem, there is no need to prevent their representation simply because they have a closer tie with the government.\footnote{185}

\textbf{b. Mission and Duty of Government Directors}

The major task of government directors is certainly to address the informational asymmetry in the banking sector. To undertake this task, government directors should not adopt a passive hands-off policy.\footnote{186} They shall actively involve in corporate affairs, including

\begin{itemize}
  \item Admittedly, partial governmental representation functionally replicates the idea of “partial government ownership.” It is argued, for instance, that partial privatization of banks is not effective in addressing the weakness of state-owned banks. Andrews, supra note 155, at 11. However, it is also observed that in some cases of privatization, private investors might prefer a continued government minority stake as a possible means of influencing favorable outcomes in an unpredictable legal system, or increasing the likelihood that important state-owned banks honor the commercial terms of their contracts with the privatized banks. Andrews, supra note 155, at 18.
  \item Gutierrez et al., supra note 120, at 25-31; Rudolph, supra note 119, at 21-26; Scott, supra note 157, at 6-18.
  \item It is proposed that arrangement involving two ministers is more preferable; one minister responsible for the public sector finance (such as Ministry of Finance) and the other sectoral minister. Scott, supra note 157, at 7-8, 19. It is also proposed that a clear separation of ownership from regulation and supervision is preferred in order to prevent conflict of interests. Scott, supra note 157, at 9.
  \item Or, if necessary, the number should be limited. Scott, supra note 157, at 11.
  \item Empirical evidence suggests that the poorer performance of German government-owned banks during the Financial Crisis was caused by the financial incompetence of supervisory board. See generally Harald Hau & Marcel Thum, \textit{Subprime Crisis and Board (In-)competence: Private Versus Public Banks in Germany}, 24 \textit{Economic Policy} 701 (2009).
  \item To the opposite, having a person who is representative of the government’s position is important because we need the government’s representation on the board to speak for the economy.
  \item Therefore I am skeptical of the idea that the desirable governance of government-owned banks should break the linkage between the management and the government (by such as having a clear management contract) and require the government owner to mimic the practices of a private sector owner as possible. Rudolph, supra note 119, at 26 (introducing the practice of Chile’s BancoEstado). This proposal is understandable to the extent that it aims to reduce the government intervention and the accompanied grabbing hand. However, in that way, the
\end{itemize}
the lending decision, of government-owned banks, ensuring that banks do not serve only the interest of the rich and large enterprises, but also those entities with the potential to grow but are underserved due to the informational asymmetry. In particular, they should dedicate in building the information system for banks to overcome the barrier of informational asymmetry, so as to bring financial deepening in the banking sector.

In a broader sense, government directors, similar to other business directors, should act in the best interest of banks. The real issue is what accounts for the “best interest of banks.” Mainstream literatures on this tend to focus on ensuring the financial sustainability of government-owned banks and identify it as the primary task of government directors. To me, the best interest of banks is a function decided upon various interests, including the profitability and financial soundness of banks as well as the reduction of informational asymmetry, etc. To the extent that government directors reach his business decision in good faith, on an informed basis, absent conflict of interest, and rationally believe that the decision is in the best interest of the bank, their decision should fall within the protection umbrella of the business judgment rule.

One crucial water gate preventing government directors from pursuing their own personal interest or politicians’ interest is the conflict of interest norm, which involves the duty of loyalty. To prevent intervention of these undue interests, it is suggested that fiduciary laws should discourage the government and government directors from imposing undue pressure on government-owned banks to finance specific projects sponsored by the government or specific companies, such as prohibiting government-owned banks to lend to government agencies or state-owned enterprises. This prohibitive rule could be too rigid, especially considering that some infrastructure projects might face similar informational asymmetry problem as well. However, if a specific lending of government-owned banks involve personal interests of government directors or the political interest of politicians or bureaucrats related to government ownership (include the government director, the shareholder representative, other related government officials and congressmen), the transaction should be considered an interested transaction and the duty of loyalty shall apply.

government becomes simply a capital provider while serving no public purpose. This cannot improve the informational asymmetry so as to bring financial deepening.

187 Gutierrez et al., supra note 120, at 29. The rationale behind is that policies for using government-owned banks to support credit growth will succeed only to the extent that they are prudently applied. Rudolph, supra note 119, at 4. For further introduction of a desirable board and audit committee practice, see Scott, supra note 157, at 14-18.

188 To satisfy the informed test and rationality test in order to be entitled to this protection, I argue that government directors shall have rational grounds (such as survey of the borrowers’ credits) to support their belief that the borrowers are efficient. The cost for establishing such grounds, however, can be higher than the profits to be earned from this particular borrower if this cost can rationally support the establishment of an “information system” (including establishing the experience of government-owned banks).
c. Disclosure: Full Disclosure of the Government’s Any Directions

Transparency and disclosure have long been recognized as a useful tool for improving corporate governance of government-owned banks, which helps minimizing political influence and preventing lack of board and management policy. Specifically, it has been suggested that government-owned bank should report any undue pressure from politicians regarding its credit decisions to its board.

On top of these existing proposals, I would like to raise a more aggressive recommendation. I propose that all actions and opinions of government directors and all directions from the government on any corporate affairs of banks should be disclosed to the public. This disclosure rule can serve two purposes: firstly, it exposes any political influence from politicians on government-owned banks under the sunshine, which increases the government’s accountability. Secondly, it ensures that the government and government directors are faithfully undertaking their developmental mission and communicates such policy of the government to the public.

V. CONCLUSION: TOWARD A SOCIAL WELFARE-ORIENTED BANK GOVERNANCE REGIME

For most East Asian countries, government ownership of banks is an irresistible reality. It could be an opportunity or a disaster, depending on whether related political institutions can control the grabbing hand of the government and transform it to a helping-hand one. Coordinating the interest of shareholders and creditors as noted by conventional literatures on the one hand and now the additional interest of the real economy on the other hand is never an easy task. To strike a fine balance between the profitability of banks, soundness of financial system and welfare of the economy, robust governance mechanism is the key. While laws and regulations cannot dictate this balance ex ante due to its non-contractible quality, they can instead establish an environment to facilitate the bargaining for this balance.

East Asian governments are long considered benevolent in relative terms. How far the government ownership of banks in East Asia can go and address the Type IV agency problem, and how laws and practices give a hand during this process, are both worth observing. In this paper, I lay out a general structure for understanding the misaligned interest between banks and the economy. After reviewing the current status of bank governance development centered on shareholder empowerment and risk management, I criticize that it misses a broader picture of the problem, i.e. the Type IV agency problem, and fails to recognize the importance of

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189 See e.g., Rudolph, supra note 119, at 5-6.
190 For instance, it is argued that the nomination process of board directors, including the minimum fit-and-proper criteria, should be disclosed.
191 Rudolph, supra note 119, at 26 (introducing the practice of Canada’s Business Development Bank)
192 Rudolph proposed that the communication between the government and the government-owned banks should be recorded in writing. Rudolph, supra note 119, at 5. He, however, did not mention the disclosure.
improving the access to credits problem in the economy. I then explore the cause of banks’ Type IV agency problem and identify it as the market failure in the banking sector majorly in the form of informational asymmetry (in particular the adverse selection problem). To mitigate this new type of agency problem requires the establishment of an information system, while the recent reform of either the risk management or the shareholder empowerment appears inadequate. In light of this private ordering failure, I advocate a case for governmental intervention, in particular government ownership of banks. East Asian countries, an area largely maintaining this practice, should find my conclusion encouraging. Nevertheless, I caution the grabbing hand of government which may compromise or even defeat the purpose of government ownership of banks; therefore I propose several practical frameworks for “governing the government,” including the private-public collegial board structure, duty of loyalty and disclosure, aiming to hold bureaucrats and politicians accountable and thus reducing the likelihood of grabbing hand. Through this paper, I anticipate that bank governance reform in a new direction featured by its social welfare orientation will receive better attention in the future.