ISSN: 2755-0214

Journal of Economics & Management Research

SCIENTIFIC Research and Community

Review Article

Open Access

Banking Governance: An Internal Mechanism Approach

Akram Belhadj Mohamed

Faculty of Economics and Management of Mahdia, Tunisia

ABSTRACT

The banking governance is determined by a set of mechanisms which get at once the external level which that interns to the organization. These mechanisms conjugate to guide the behavior and the decisions of the leader so that he works in interest of stockholders as well as that of the organization. We suggest in this article focusing on the internal mechanisms of the governance through a presentation of the main works which treat with this subject and in case those who approach the systems of control and incitement of the leader set up by the board of directors within banks.

***Corresponding authors**

Dr Akram Belhadj Mohamed, Faculty of Economics and Management of Mahdia, Tunisia

Received: November 15, 2023; **Accepted:** November 24, 2023; **Published:** December 01, 2023

Keywords: Governance Interns, Control, Incitement, Board of Directors, Leader

Introduction

Recent years have been marked by numerous financial scandals that have highlighted multiple malfunctions in control mechanisms, especially at the top of the hierarchy. The quality and the respect of the tools of governances are in this case questioned. Indeed, the governance mechanisms are put in place to ensure a convergence between the interests of the executive and those of the board of directors (that is to say shareholders). Governance is defined by Charreaux (1997a) as "the set of mechanisms that have the effect of delimiting powers and influencing the decisions of leaders, their conduct and define their discretionary space". These mechanisms can be observed at two levels: internal, adopted and applied by the Board of Directors and external by means of regulations (the Sarbanes Oxley Act in the United States, the French Financial Security Act) or merger and management agreements. Partnership [7].

The general purpose of banking governance is to control the behavior of the leader whether through mechanisms internal or external to the organization. Internally, the success of this control depends partly on the degree of independence of the board of directors, and on the other hand on the status of the director. In fact Fama and Jensen (1983) have shown that a board of directors with independent members is better able to supervise the lead in its decision-making since in this case we speak of experts who have a reputation to safeguard. The leader is all the more likely to succeed in his mission because he is financially involved and does not wear a double hat of director and chairman of the board of directors, source of conflict of interest (Jensen, 1993). On the external level the regulation limits the decision-making freedom of the manager. Indeed, the intervention of the regulatory institutions in the conduct of the leader allows to limit his discretionary inclination [10,18].

The dissuasive nature of the regulation should not make us forget the role, just as important, played by the internal mechanisms of governance which pushes us to formulate the following problematic: how the internal governance mechanisms regulate and value the behavior of the leaders in the case of banking institutions?

To answer this question, our article will allow us to focus on the first part of the internal control mechanism and in the second part on the incentive role of governance for managers.

Effectiveness of the Board of Directors as the Main Instigator of the Manager's Internal Control

According to Jensen (1993), the role played by the board as an internal control system is vital because it sets the rules of the game with the leader. This role can only be effective under certain conditions, namely:

- A fluidity and a total access to the information held by the leader and their free circulation between the various members of the board
- A small board of directors broadens, from a number point of view, is an additional asset with a leader as the only internal member to avoid any risk of agreement and influence of the latter on other internal members at the bank'
- An involvement in the capital (holding of securities) of the members of the board of directors, including the manager, is a solution for a convergence of interests with a separation of the functions of director and chairman of the board for efficiency and consultation more broadened in the decision-making of the leader.

The Size of Board of Directors

Various works have attempted to understand the relationship between the number of board members and the performance of the banks. In the first place, Jensen (1976) asserts that banks with a reduced board of directors are de facto more efficient since in this case the decision-making process is shorter. This is contradicted by the work of Booth et al. (2002), who note that banks' boards of directors are larger in size. Similarly, for mutual and cooperative banks, important boards of directors are an obligation to allow everyone to express themselves and defend their interests (Crepi et al., 2004). These divergences lead us to say that the size of the board of directors is the result of compromises between different stakeholders who represent different interests to be respected in the final decision. It can thus be deduced that there is no difference in performance between the banks having a restricted board and those having an enlarged board (Laurence G, 2001). We now turn to the presentation of the separation of the functions of director and chairman of the board as another mechanism of internal control [6,9,20].

Accumulation of Functions for the Leader: Contradictory Debate

The first position regarding the dual function of CEO and president for a leader is defended by various authors such as Fogelberg and Griffith (2000). The latter denounce the perverse character of this accumulation of function for a leader, which reduces the effectiveness of the internal control mechanisms. Similarly, Simpson and Gleason (1999) believe that the combination of these two functions can create a synergy that strengthens the internal control mechanisms, capable of reducing the risk of Bankruptcy, by protecting itself from the drift of decision-making that tries to satisfy shareholders despite the protection of human capital. In summary and despite his inclination to act in his own interest, the leader is obliged to limit excessive risk taking to protect his human capital. Finally, we move to the intrinsic characteristics of the board of directors as the last internal control mechanism [26].

Characteristics of the Board of Directors

In this case, the composition of the board of directors and the holding of the bank's shares by the director are examined. For Prowse (1995), boards of directors have shown their limits as an instrument of internal control over the behavior of managers in relation to the role played by regulatory authorities. This trend is inversely related to performance measures, whether in terms of securities held by the executive or the presence of significant shareholders. Simpson and Gleason (1999) stated that the variables that express the agency theory (the percentage of shares held by directors or officer, the number of directors or the percentage of internal directors at the bank) have no significant impact on the bankruptcy risk of a bank.

We now go through the shortcomings of the control mechanisms used by the Board of Directors. The first deficiency is that relating to the state of rooting. Jensen and Meckling (1976) hypothesize that the owner's capital holding shows a convergence of his interests with those of the shareholders combined with a negative relationship between managerial ownership and agency costs, thus pushing the CEO to maximize the value. In addition, Morck et al. (1988) show that the increasing acquisition of securities for the benefit of the leader facilitates its rooting which will have a direct impact on the performance of the bank [23].

This impact, as pointed out by Fogelberg and Griffith (2000), is explained both by the convergence of interests and by the rooting of the leader. Nevertheless, Hirschey (1999) does not accept the rooting hypothesis and its effect on performance measures (accounting and market value of securities). A summary of the traits shaping the board and the capital structure is presented by Belkhir (2005) whose purpose is to limit agency problems [11,13].

Table 1: Summary Table of Work on Control Mechanisms

Authors	Data of the sample	Variable (s) explained (s)	Explanatory variables	Main results
Prowse (1995)	234 holdings banking of 1987 to 1992. Data from Compustat and annual reports.	Evolution of mechanisms of control of leader: replacement of leader, merger, intervention of authorities regulation	Performance (abnormal returns cumulative, ROE), % of capital held by the manager, % of capital held by the independent directors % of capital held by shareholders having more than 5%, director / chairman of the board, logarithm of the market value of FP	Weakness of the turnover and of the threat of external buyout as mechanisms of discipline of behavior of leader of the bank.
Simpson et Gleason (1999)	287 banks in 1989, data from SNL Quarterly bank digest.	Evaluation of risk of bankruptcy from the bank on a scale of 4 items (1 for no risk of bankruptcy and 4 for risk of bankruptcy high)	% of capital held by Board members Size of turnover % of in-house executive directors or chairman of the Board or not % capital held by the manager	The presence of a leader also chairman of the board helps to limit the risk of bankruptcy form the bank. For other variables composition of the CA, there is no no links significant with the risk of bankruptcy.
Fogelberg et Griffith (2000)	100 holdings in 1996. Data from Stern Stewart and Co and Corporate data exchange.	economic Performance measured by EVA (Economic value added)	CEO / Board Chair, Officer's Age, number of years as CEO,% internal directors	The duality of the office of director and chairman of the board has no impact on the performance

Booth, Cornett et Tehranian (2002)	100 larger firms of 3 sectors whose banks. Data from Fortune's website custom ranking feature for 1999	% administrators Outside, CEO and President turnover (variable binary)	Size of the firm Rate of endettement Market value of the firm Net profit Profitability CEO / Chairman of the Board % of external administrators % of securities held by the officer	Regulations is a mechanism of discipline substituting mechanisms internal control
Authors	**Data of the sample**	**Variable (s) explained (s)**	**Explanatory variables**	**Main results**
Adams et Mehran [1] (2005)	35 holdings banking of 1986 to 1999. Data from various bases of data.	Performance (Q de Tobin)	Size of turnover, % of independent directors, number of committees under the direction of CA, number of annual meetings of the CA,% of capital held by the leader.	The size of the turnover important in the banks is not linked to a performance more low.
Belkhir (2005)	260 banks commercial and savings banks Data from Research Insight from Standard and Poor's	Structure of property, composition of Board of Directors and performance (Q of Tobin)	% of capital held by the team of direction, % of shareholders holding more than 5% capital, % of independent directors, duality of the leader's position or no chairman of the board, number of years of the leader performance variables and others financial variables (risk, size ...)	Substitution des mécanismes internes de gouvernance. Pas d'effets significatifs des variables de la théorie de l'agence sur la performance

Belkhir (2005)

As a conclusion for this first part of our article, we can say that the nature as well as the effects of the different control mechanisms are generally the same, regardless of the authors with visions sometimes contradictory depending on the field of study. We are now studying incentive mechanisms and their influence on the leader's behavior [1].

Incentive Mechanisms

Positively influencing the behavior of the leader can be done through actions that target the compensation paid as well as the replacement of the leader, as pointed out by Jensen and Murphy (1990). In this second part, we seek to understand the relationships that link the sensitivity to remuneration to the performance of banks as well as those that link executive compensation to the composition of the board of directors and the factors that guide the replacement of directors [24].

Relationship Between the Sensitivity to Executive Compensation and the Performance Achieved

Be it at the general level (Jensen and Murphy, 1985) or that of the banking sector (Barro and Barro, 1992), the various studies underline the positive effect of the remuneration of the manager on the performance of the firm. The latter sees his remuneration increase if the performance of the firm believes. Similarly Lewellen et al. (1992) show that the composition of the executive compensation package reduces agency costs. Nevertheless, the practices that guide the remuneration of different leaders according to the size (higher qualification levels required and a significant de facto salary), the industrial sector or the country (sensitivity to remuneration greater in Europe than in Africa for example)), (Murphy, 1999). That said, the impact of compensation on performance is achieved with the increase in capital / experience within the financial institution [3,21].

At the sectoral level, Hubbard and Pali5 (1980) explained that the relationship between remuneration and the bank's performance is all the stronger as this sector is in the process of deregulation. Other factors have been cited in the literature such as risk-taking, financial leverage and the size of the bank as influencing this relationship. This results, for example, in an agreement between managers and shareholders, which increases the financial leverage, which is important for the banks (lower capital levels), and riskier investments [15,22,23].

Table 2: Work Explaining Performance Based on Executive Compensation

Authors	Data of the sample	Variable (s) explained (s)	Explanatory variables	Main results
Lewellen, Loderer, Martin et Blum (1992)	49 American firms between 1964 and 1969 Data from Compustat and Fortune 500 Regressions on data of panels	Performance (ROE and profitability of the action in value market)	Financial leverage (debts / funds own) Size of the bank, Logarithm of the three highest managerial salaries, % of securities held by the team direction, % of securities held by the three highest wage earners.	There is a positive correlation between the remuneration of leader and the performance of the firm
Barro et Barro [3] (1990)	83 American banks from 1982 to 1987. Data from Compuserve, Business Week's and Standard and Poor's Reports Regressions on panel data	Performance	Results of the first year of the leader, variation executive compensation, manager's years of experience, industry performance, log of total assets, executive turnover, manager's age.	

Bouaiss, Marsal, (2009)

Holthausen and Larcker (1993) have shown in their article that executive compensation is all the more important if the size of the board of directors is large and the number of external directors present is significant. Hwang and Anderson (1993) highlight the concept of "elevator referral" in the setting of executive compensation by board members. They will set a significant salary for the latter and will wait for a return of politeness of this leader when he will be a member of the board of directors. In the case of the banking sector, Angbazo and Narayanan (1997) point out that a significant percentage of the executive's remuneration takes a form of long-term incentives, which is a difference compared to the unregulated firms [14,17,2].

These incentives become more and more important when the leader has been in office for a long time and therefore has a job that makes it difficult to constrain. In fact, the other directors of the board of directors will then seek to influence the behavior of these entrenched managers by remunerating them by means of securities or stock options whose value depends on the performance of the firm. In the same vein, Becher and Frye (2004) raise the issue of the manager's bargaining power with the board of directors. They have shown that bank managers have more power than those of other firms, while when their bargaining power outweighs that of the board, the power of motivation through pay becomes weak [4,5,8,16].

Table 3: Summary of the Work on the Relationship Between the Board of Directors and Executive Compensation

Authors	Data of the sample	Variable (s) explained (s)	Explanatory variables	Main results
Angbazo et Narayanan (1997)	97 banks commercial in 1989. Data from Compustat and Center Research in security prices (CRSP).	Remuneration of the leader	Independence of turnover (size of turnover, share of independent directors, CEO and Chairman of the Board, presence of interconnection between the directors independent and leading, existence of business relations between directors independent and the leader, number of directorships held by directors independent) Appointment of internal and external directors (average number of years of seat, share of securities held) Variables of control (size of the firm, performance, risk, other financial ratios)	Prevalence of long-term incentives to discipline the behavior of the leader and correlation positive between incentives of the leader and the performance of the bank.
Becher et Frye (2004)	13843 observations of which 700 banks between 1992 and 1999. Data from Execucomp		Size of turnover, shareholders> 5%,% independent directors, duality of the position of the officer, shares held by the officer, number of years of mandate executive, financial variables (leverage financial, risk ...)	Bank managers have power of negotiation more important with the directors compared to other firms in terms of remuneration. Discretionary latitude more significant does not lead to a decline in the value of the bank.
Ryan et Wiggins (2004)	600 firms from 1995 to 1997.	Remuneration of the leader	CA Characteristics (Size of CA, composition of the board), characteristics of the leader (rooting of the leader, longevity of its mandate), duality of the position of leader (director / chairman of the board)).	The more senior officer has significant bargaining power with the directors, less remuneration (in particular in the form of securities indexed to the performance of the firm) is an effective form of incentive.

(Bouaiss, Marsal, 2009)

The Turnover of the Leader

Putting pressure on the leader by brandishing the threat of replacement can be stimulating in more than one respect. This is especially true for leaders over 64, as Murphy (1999) asserts. The impact on the bank's performance is visible in this case. The executive replacement rate is all the more important in a period of sectoral deregulation and is directly related to its capacity and bargaining power. This ability to negotiate depends on the anticipation of a future replacement and the balance of power with the board. The turnover of the leader is also sensitive to the performance achieved as mentioned by Jensen and Murphy (1990) while Weisbach (1988) states that a weak performance supposes a board of directors unable to control the leader hence a need to have use of experts. Finally, the independence of the board towards the leader decreases with the longevity of the latter's mandate and this according to the hypotheses formulated by Hermalin and Weisbach (1998). In general, the most important factor at this level is the performance of the bank (Anderson et al, 2004) [25,27,12].

Conclusion

Governance is dependent on multiple external and internal mechanisms that are complementary and whose importance varies across sectors, firm sizes and countries. At the external level the impact of deregulation is all the more important in a crisis situation, which increases the frequency of replacement of directors and alters the independence of the board of directors. This regulation is all the more important in the banking sector. Internally, we have seen that different mechanisms that sometimes have contradictory effects shape the behavior of the leader. The size of boards and their diversification into banking institutions are generally larger than in other sectors. Nevertheless the effects of the cumulation of the mandates of CEO and the chairman of the board are generally the same all sectors combined. The same is true when one speaks of rootedness and sensitivity to the remuneration of the leader's behavior. However, several questions come to mind: can shareholders' demands hinder the decision-making independence of managers? Can we compromise between the demands of these funds and those of human capital? These issues deserve to be further explored in the specific cases of the governance mechanisms of Tunisian banks.

Classification JEL: G21, G32, G34

References

1. Charreaux G (1997) "Vers une théorie du gouvernement des entreprises", chapitre 15, in G. Charreaux (ed.), Le gouvernement des entreprises, Économica 421-469. https://repec-crego.u-bourgogne.fr/images/stories/wp/0960501.pdf
2. Fama E, Jensen MC (1983) "Separation of Ownership and Control", Journal of Law and Economics 26: 301-325.
3. Jensen MC (1993) "The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems", Journal of Finance 48: 831-880.
4. Booth JR, Cornett MM, Tehranaian H (2002) "Boards of Directors, Ownership, and Regulation", Journal of Banking and Finance 26: 1973-1996.
5. Crepi R, Garcia-Cestona MA, Salas V (2004) "Governance Mechanisms in Spanish Banks: Does Ownership matter?", Journal of Banking and Finance 28: 2311-2330.
6. Laurence G (2001) "La taille du conseil d'administration : déterminants et impact sur la performance", Architecture et Gouvernance des Organisations, Centre de recherche en Finance, Cahier du FARGO n° 101. https://repec-crego.u-bourgogne.fr/images/stories/wp/1010702.pdf
7. Simpson WG, Gleason AE (1999) "Board Structure, Ownership, and Financial Distress in Banking Firms", Internantional Review of Economics and Finance 8: 281-292.
8. Morck R, Shleifer A, Vishny R (1988) "Managerial Ownership and Market Valuation: An Empirical Analysis", Journal of Financial Economics 20: 293-316.
9. Fogelberg L, Griffith JM (2000) "Control and Bank Performance", Journal of Financial and Strategic Decisions 13: 63-69.
10. Hirschey M (1999) "Managerial Equity Ownership and Bank Performance: Entrenchment or size effects?", Economics Letters 64: 209-213.
11. Adams R, Mehran H (2005) "Corporate Performance, Board Structure and its Determinants in the Banking Industry", Working Paper 1-42.
12. Murphy KJ (1999) "Executive Compensation", Chapter 38 in Handbook of Labor Economics 3: 2485-2563.
13. Barro JR, Barro RJ (1990) "Pay, Performance, and Turnover of Bank CEOs", Journal of Labor Economics 8: 448-481.
14. Lewellen W, Loderer C, Martin K, Blum G (1992) "Executive Compensation and the Performance of the Firm", Managerial and Decision Economics 13: 65-74.
15. Hubbard RG, Palia D (1995) "Executive pay and performance: Evidence from the U.S. banking industry", Journal of financial economics 39: 105-130.
16. Marcus AJ (1984) "Deregulation and Bank Financial Policy", Journal of Banking and Finance 8: 557-565.
17. Morck R, Shleifer A, Vishny R (1988) "Managerial Ownership and Market Valuation: An Empirical Analysis", Journal of Financial Economics 20: 293-316.
18. Holthausen R, Larcker D (1993) "Board of Directors, Ownership Structure and CEO Compensation", Working paper, University of Pennsylvania.
19. Hwang C, Anderson D (1993) "Board Room Back-scratching in Setting CEO Compensation", Working paper, University of Pittsburgh.
20. Angbazo L, Narayanan R (1997) "Top Management Compensation and the Structure of the Board of Directors in Commercial Banks", European Finance Review 1: 239-259.
21. Becher DA, Frye MB (2004) "Are Bank CEOs More Powerful? The Effect of CEO Power on Compensation and Performance", Working paper 1-41.
22. Belkhir M (2005) "Board Structure, Ownership Structure, and Firm Performance: Evidence from Banking", Working Paper of University of Orléans.
23. Lewellen W, Loderer C, Martin K, Blum G (1992) "Executive Compensation and the Performance of the Firm", Managerial and Decision Economics 13: 65-74.
24. Booth JR, Cornett MM, Tehranaian H (2002) "Boards of Directors, Ownership, and Regulation", Journal of Banking and Finance 26: 1973-1996.
25. Ryan HE, Wiggins RA (2004) "Who is in whose Pocket? Director Compensation, Board Independence, and Barriers to Effective Monitoring", Journal of Financial Economics 73: 497-524.
26. Weisbach M (1988) "Outside Directors and CEO Turnover", Journal of Financial Economics 20: 431-460.
27. Hermalin BE, Weisbach MS (1998) "Endogenously Chosen Boards of Directors and their Monitoring of the CEO", The American Economic Review 88: 96-118.