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Ownership concentration of three large Belgian banks during the crisis

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Abstract

Purpose – *In this paper, two different ownership structures in Belgian banks are studied to see whether this had an impact on how these banks went through the financial crisis of 2007-2008. On the one hand, there is the concentrated ownership structure with a number of major shareholders, while on the other hand, the ownership can be really dispersed with no shareholder having a significantly large stake and ability to influence management's decisions.*

Design/methodology/approach – *The authors study three large Belgians banks. Dexia and KBC followed the first model (concentrated ownership), while Fortis' ownership was really dispersed since the year 2000. The authors perform several interviews with people involved with these banks during the crisis and analyze several external sources of information.*

Findings – *The mitigating impact that major shareholders could have had on the – in hindsight – wrong decisions of Belgian banks' top managers is found to be very limited. Therefore, it can be concluded that the dispersed ownership structure of Fortis was not an important factor in its collapse. Nevertheless, a concentrated ownership structure has been found out to help in case of financial distress, mainly because governments will be more inclined to participate to bailouts when a sound rescue strategy, elaborated with the help of a stable and concentrated ownership structure, is present.*

Originality/value – *By performing interviews, the authors get an insider's point of view of these banks during the crisis.*

Keywords *Financial crisis, Corporate governance, Banking, Ownership*

Paper type *Research paper*

Introduction

In 2008, Belgium's largest bank, Fortis (now BNP Paribas Fortis), had to be bailed out by the Belgian government. During the same crisis, Dexia (now Belfius) and KBC also needed strong government support and cash injections. Today, the lawsuits resulting from these events are far from over and seven members of Fortis' top management are accused of having misinformed shareholders. The Fortis case is very sensitive in Belgium because the bank was deeply anchored in the country's economy and its history goes back to the nineteenth century. Furthermore, its stock was known for being safe and paying regular dividends, which made it popular among the small Belgian investors. Hence, many small investors who were shareholders lost a significant part of their savings due to the 2008 events. *Ex post*, the bank's management made two errors according to Limbos and Phillips (2010): overinvesting in collateralized debt obligations (CDOs) and acquiring the Dutch bank ABN Amro. All of this was accompanied by "[a] financial communication [that] was poor and vague" (Limbos and Phillips, 2010).

Earlier studies have shown that a bank's ownership structure is a factor that should certainly not be underestimated when analyzing aspects, such as corporate governance, performance or risk-taking (Iannotta *et al.*, 2007; Barry *et al.*, 2008; Kobeissi and Sun, 2010). In 1999, the year of Fortis' creation, the bank experienced a critical change in control, as it went from having only one important and controlling shareholder (Société

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Générale de Belgique) to a much dispersed ownership structure[1]. In this paper, we investigate the extent to which this change in ownership structure affected the company and whether it was a reason for the 2008 issues. Two other large Belgian banks, KBC and Dexia, had more concentrated ownership structures during the period of interest and are, therefore, used as a basis for comparison in this study.

Contrary to large sample studies that provide a generalizable set of findings related to a few pre-determined constructs, in-depth case studies produce much more detailed information, but about a limited number of people and cases (Patton, 2002). We believe that a case study methodology is appropriate in this context because of a number of reasons:

- the complicated nature of the events of 2008 in Belgium;
- the complex relations and influences that characterize the relationship between shareholders and management; and
- the large amount of company-specific data.

The empirical part of the paper is based on interviews. To provide a view that is as broad and objective as possible, we have interviewed people who represent both shareholders and management. In both cases, the interviewed persons are well-known, commonly respected and recognized as having played or still playing an important role within the Belgian financial sector. Because of their extensive experience in this industry, and more specifically in dealing with Fortis, KBC and Dexia, we believe they are able to provide us with useful information. More information about the preparation for the interviews and the interviews themselves can be found in Appendix I. For reasons of confidentiality, the names of the persons interviewed are not disclosed but short profile descriptions are included as follows:

- Person A is a Belgian shareholder activist and is present at a significant number of annual general meetings of Belgian companies. This person has an extensive experience in dealing with listed companies' management, especially in the financial industry.
- Person B has a top position in a Belgian company that defends the rights of minority shareholders. He is very active in the Fortis case and frequently deals with top management of (actual and former) Belgian banks.
- Person C has a long career in the banking sector and reached top executive positions within the Fortis group.
- Person D represents one of the main shareholders of KBC and is a member of the bank's supervisory board, which provided this person with a lot of experience in the functioning of KBC's supervisory board.
- Person E has a top position in the investor relations department of KBC. This person has considerable experience in dealing with smaller (non-reference) shareholders.
- Person F has a long career in the banking sector and reached top executive positions within the Fortis group.

Due to reasons of professional privilege of knowledge and ongoing litigation, representatives of the regulators and supervisors wished not to be interviewed.

This paper focuses on two different ownership structures in Belgian banks:

1. on the one hand, a concentrated ownership structure with a number of major shareholders; and
2. on the other, a dispersed ownership structure in which no shareholder has a significantly large stake and (as a result) the ability to influence management's decisions.

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Dexia and KBC are included in the first model, while Fortis evolved toward the second around the year 2000. Because major shareholders have a stronger incentive to monitor management, they could – theoretically – influence its behavior and decision-making.

Based on the interviewees, we conclude that the mitigating impact that major shareholders could have had on what, in hindsight, we deem to be poor decisions on the part of Belgian banks' top managers is very limited. The dispersed ownership structure of Fortis was not an important factor in its collapse. In other words, for banks, a concentrated ownership structure in itself is not an obstacle to serious management mistakes and corporate governance failures. Nevertheless, a concentrated ownership structure has been found to be beneficial during times of financial distress, mainly because governments are more inclined to participate to bailouts when a sound rescue strategy is elaborated with the help of a stable and concentrated ownership structure. Moreover, the interviewees were convinced of the considerable ineffectiveness of the supervisory boards, particularly in the case of Dexia. Despite the earlier corporate governance reforms in Belgium, vital mistakes at the supervisory board level still occurred. The role of the non-executive directors is very important, and due to the complexity of the industry, non-executives should have extensive financial knowledge and experience to be able to exercise their functions adequately, which turned out not to be the case.

The remainder of this paper is structured as follows: in the next section, the institutional context is described, followed by a third section on ownership structure and the impact of ownership structure on control, risk and performance. The fourth section describes the background of the Fortis case. The fifth section discusses the insights gathered during interviews, and the sixth section concludes.

Institutional context

The banking sector has a crucial role in Belgium, representing 5.8 per cent of the total economy and 60,000 jobs in 2012 (Febelfin, 2014). In 2013, banks lent €86 billion to public authorities, €186.9 billion to households and €117.8 billion to enterprises (Febelfin, 2014). One should therefore not be surprised that the country's economy is highly dependent on the health of its financial sector. In past decades, the Belgian banking sector has been highly concentrated, with the top three banks representing as much as 80 per cent of the country's banking assets in 2011 and a Herfindahl–Hirschman Index value of 0.27 (IMF, 2011). This index is especially high when compared to other countries, and it reinforces the contamination effect in the event that one of the banks faces financial problems[2]. Furthermore, the Belgian banking sector is very internationally oriented. This reflects the fact that Belgium, a small country in the middle of Europe, has an economy that is highly reliant on foreign countries, as 80 per cent of its gross domestic product (GDP) depends on exports.

As of this writing, there are four important players in the Belgian banking sector: BNP Paribas Fortis, Belfius, KBC and ING Belgium. These so-called universal banks offer a full range of financial services to both private individuals and companies. This includes retail banking, corporate banking, asset management and private banking. In recent decades, the sector has changed considerably due to mergers and acquisitions, and according to a recent report by Matthys and Thibeault (2013), it is not unexpected that the Belgian banking sector will experience a new wave of consolidations in the years to come. This is mostly because the minimum size that the banks are required to have in order to benefit from the critical economies of scale of the sector.

Literature review

Factors influencing ownership structure

According to La Porta *et al.* (1999), the finance literature largely follows the view of Berle and Means (1932), who defended that the modern corporation should be held by a large

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number of small shareholders. However, according to the former authors, this is “only a common organizational form for large firms in the richest common law countries, one of which, the USA”. Therefore, one should question what factors influence firms’ level of ownership concentration.

Demsetz and Lehn (1985) find that the specific economic nature of a company is relevant, as firms with more volatile cash flows tend to have a more concentrated ownership structure. The reasoning is that the higher the cash flow volatility, the more difficult it is for outside monitors to determine whether it is the firm’s management or outside factors that affect performance. Therefore, “inside monitoring by large shareholders attenuate this problem and reduces agency costs accordingly”. Larger firms tend to have a less concentrated ownership structure because the price per fraction of equity is higher than for smaller firms. With respect to market power, the authors state that profitable firms rely less on external equity financing, as they are able to finance growth with their high earnings. Therefore, existing shareholders do not get diluted, which contributes to ownership concentration.

Daniels and Iacobucci (2000) conclude that protectionism by countries’ governments (in case: Canada) and market power (defined by the authors as “the ability of firms to earn supracompetitive returns in their product markets”) may influence the ownership structure of companies. With respect to protectionism, the authors state that restrictions in the free movement of goods and capitals can – for example – reduce the size of a country’s firms.

La Porta *et al.* (1999) state that the legal environment – especially the protection of minority shareholders – is also an important factor in understanding concentration, as poor legal protection of minority shareholders encourages ownership concentration. Richter and Weiss (2013) confirm this by stating, for example, that “[. . .] countries with a common law tradition appear to have lower levels of ownership concentration than countries with a civil law tradition”.

Ownership structure and shareholder activism

Since its origins, the separation of ownership and control of companies has led to agency costs and possibilities of moral hazard in a company, both of which come at the expense of the owners of the company, the shareholders. Therefore, one should not be surprised by the existence of shareholder activism. That is, shareholders proactively monitor, and even influence, management when they feel that certain objectives are not being met or when they do not agree with the manner of pursuing those objectives. The mechanisms of exit, voice and loyalty (Hirschman, 1970) are related to shareholder activism. Shareholders can either “vote with their feet” and sell the stock of the company that they hold, exercise their voice and try to change what they perceive as wrong or remain in the company complacently, disguising their dissatisfaction. As this last option cannot really be considered as an active solution, it is not taken into account in most shareholder activism research.

When it comes to the reasons behind shareholder activism, Hendry *et al.* (2007) find that although an important part of the studies in this area assume that shareholder activism is driven by the desire to maximize share prices, there is also evidence of what they call “a feeling of responsible ownership”. The amount of shareholder activism and its underlying reasons will be influenced by the two dimensions of ownership structure as suggested by Iannotta *et al.* (2007):

- the ownership stake, as large investors typically have more financial incentives to monitor management; and
- the type of shareholders (e.g. governments, banks and insurance companies, pension funds, hedge funds and family trusts).

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Additionally, the type of company in which they invest will influence the activism of shareholders. According to Westman (2010), this is especially the case for financial institutions, as the legal protection of bank depositors may encourage risk-taking by the bank's managers.

The influence of ownership concentration on control

Berle and Means (1932) defend that the separation of ownership and control is the reason for conflicts of interest between management (who controls the company) and shareholders (who ultimately own the company). Corporate governance has the objective of solving these conflicts and allowing for incentive alignment between shareholders and managers by, for example, appointing independent directors or letting managers participate in equity. According to Berle and Means (1932), ownership concentration can be another solution to this problem. The logic is easy to follow: a shareholder owning a larger part of a company will have more incentive to monitor it, as he/she has more financial interests at stake and lower costs (per share) of monitoring management. One could argue that if there is no such block holder in a company, minority shareholders could still band together and monitor management. However, this does not take into account the fact that while only the shareholders who engage in monitoring bear the costs of doing so, the non-active shareholders also benefit from their efforts. Therefore, this situation leads to a free rider issue (Grossman and Hart, 1980), in which no shareholder may have sufficient incentive to monitor management.

The influence of ownership concentration on risk and performance

As far as the influence of ownership concentration on bank risk is concerned, only a few studies have been performed. Magalhaes *et al.* (2010) find that risk has a U-shaped relationship with ownership concentration. From the moment that the main shareholder owns a 25 per cent stake, a bank's risk-taking increases with ownership concentration. However, Iannotta *et al.* (2007) conclude that a concentrated ownership structure causes better loan quality, lower asset risk and lower insolvency risk. Sullivan and Spong (1998) address an important issue when they state that bank risk is also dependent on the diversification of the owners' portfolios. When these are more diverse, their owners care less about the specific risk of one single investment. On the contrary, when these owners have a large part of their wealth in the same company, they have a stronger incentive to monitor the firm and limit risk-taking. As one can see, the influence of ownership concentration on risk-taking is unclear. This is confirmed by one of the most recent studies on the subject, performed by Becht *et al.* (2011), which states that "The attitude to risk-taking by blockholders is ambiguous [. . .]. [Previous findings] would suggest that countries with blockholder-dominated banks should fare worse in the crisis. This was not the case".

Concerning the link between ownership concentration and performance, Thomsen and Pedersen (2000) report that a majority of the existing studies conclude that ownership concentration and profitability have a positive relationship[3]. However, all of these studies were conducted on a heterogeneous sample of companies, not focusing on banks. Consequently, we should be cautious when generalizing their results. This need for caution is confirmed by the studies of Magalhaes *et al.* (2010; Iannotta *et al.*, 2007). The former finds evidence of a cubic relationship (positive, negative and positive) between a bank's ownership concentration and its performance, while the latter finds no significant relationship between these two variables. We can therefore deduce that there is no general consensus regarding the link between bank profitability and ownership structure.

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The Fortis case: background

From AG to Fortis Bank

Fortis Group was created in 1990 in a merger between Amev, a large Dutch insurer with limited banking activities, and AG Group, a large Belgian insurer (Fassin and Gosselin, 2011). Fortis' Chairman Maurice Lippens strongly believed in the so-called "bank-assurance model" (combining banking activities with insurance activities to profit from synergies between the two industries) and, therefore, pursued solid external growth through the acquisition of banks and insurance companies in the 1990s.

Fortis Bank – fully owned by Fortis Group – was created in 1999 in the merger of five banks, one of which was the *Société Générale de Banque*. The latter was a part of the prestigious *Société Générale de Belgique*, the most important holding company Belgium ever had. It is important to know that the acquisition of the *Société Générale de Banque* by Fortis was not straightforward. After Fortis' first bid, the Dutch bank ABN Amro made a higher counteroffer, ultimately forcing Fortis to buy *Société Générale de Banque* for 14.2 billion USD, representing a 16 per cent premium compared to its original offer (The New York Times, 1998). These events had drastic implications on the shareholder structure of the group, as it evolved from a model with a limited number of controlling shareholders in 1997 to a model with only one minor shareholder in 2006.

CDOs, ABN Amro and the end of Fortis Bank

Since 1999, Fortis was seen as the flagship of the Belgian financial industry. Its Chairman, Maurice Lippens, was even named Count by King Albert II (Delvaux and Michielsen, 1999). Unfortunately, two things changed this position: Fortis' exposure to the subprime crisis and the acquisition of ABN Amro (Limbos and Phillips, 2010).

Following the general trend among its peers, Fortis decided to acquire a team specialized in the construction of CDOs, in the case of Fortis from the French bank *Société Générale*, in 2005. The aim was to increase the revenue coming from the merchant banking department by investing in this highly profitable activity. One year later, in 2006, the bank increased the budget allocated to the construction of CDOs from €4.8 to €7.7 billion (Condijts *et al.*, 2009). There is no mention of the corresponding risks in Fortis' 2006 annual report. When the main credit-rating agencies lowered their ratings for these securities in 2007, Fortis became trapped with a considerable number of them on its balance sheet. In the financial statements for that year, the bank reports a €2.8 billion impairment related to these CDOs (Fortis Bank, 2008). This is surprising, given that on September 21 of that year – just before the raising of additional equity – Fortis made a press release with an "update on the good risk management" of the bank, stating among other things that "Approximately 95 per cent of these MBS and ABS-portfolios are AAA and AA rated. The impact on Fortis's full-year 2007 results is expected to be non-material [. . .]". The bank also states that:

> Fortis Investments [the asset management department of Fortis] is active in both CDO and CLO markets and manages around 9 billion euros in third-party closed-end funds. It is also active in CDOs within the sub-prime market, although there is no significant direct risk in its exposure (Fortis, 2007b).

Exposure to mortgage-related assets was not Fortis' only concern. In October 2007, a syndicate composed of Royal Bank of Scotland, Banco Santander and Fortis itself bought the Dutch bank ABN Amro for €71.1 billion, the world's largest financial takeover. The three acquirers split ABN Amro between them, Fortis getting the bank's Dutch and Belgian activities, for which it paid €24 billion. From a strategic point of view, the deal was an excellent fit, as it would allow Fortis to establish a strong retail presence in The Netherlands. Furthermore, the parts that were taken over by Fortis were the less risky ones (mainly retail and private banking) and would, thus, reduce the total risk of the Fortis group. The deal was approved in an Extraordinary General Meeting (August 6) by nearly 95 per cent of Fortis' voting shareholders. Ultimately, the bank financed this acquisition by raising €13.4 billion of equity, selling some of its assets and cancelling the payment of the interim dividend of €1.3 billion.

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Ex post, critics argue that Fortis misinformed its shareholders by not correctly describing the risks that were related to the mortgage-related products. The price of the acquisition was also severely criticized, as ABN Amro was acquired for three times its book value (The Independent, 2009). Additionally, some people argue that a reason for this acquisition resides in the *hubris* of Fortis' management, in being asked by two well-renowned international banks to participate in their consortium and having an opportunity to take its revenge on ABN Amro for the 16 per cent premium it had to pay – because of that bank's earlier (1998) counteroffer for the *Société Générale de Banque* (mentioned above).

According to Limbos and Phillips (2010), the financial communication of the company was poor and vague. On January 27, 2008, Fortis stated that its solvency was far above the required 8 per cent Tier 1 capital requirements; that it would maintain its dividend policy; that all requirements concerning the solvency of the bank were met, even under very severe scenarios on the effect of the subprime crisis; and that there was no need to issue share-diluting instruments (Fortis, 2008a). This was confirmed at the bank's annual meeting of the general assembly in April, together with the promise of an interim dividend of €0.586 per share.

Fortis had to break these promises two months later, as it wished to "accelerate the execution of its solvency plan" by adding €8.5 billion to its solvency (Fortis, 2008b). The bank did this through a share offering, cancelling the interim dividend and paying the 2008 dividend in shares instead of cash (Limbos and Phillips, 2010). On September 26, 2008, the bank confirmed that there were no severe problems (Fortis, 2008c). Nevertheless, it had to be bailed out by the Belgian, Dutch and Luxembourgian governments three days later for a total amount of €11.2 billion. The Belgian State acquired nearly 100 per cent of Fortis Bank, of which it sold 75 per cent to the French bank *BNP Paribas* in the beginning of October 2008 and the remaining 25 per cent to the same bank at the end of 2013.

Interview findings

Two different models

An analysis of the ownership structures of the three largest Belgian banks in 2006 shows two different models of ownership concentration, as shown in Table I.

The first is the model followed by KBC and Dexia, in which there are a significant number of major shareholders, each owning a sizable stake in the bank. The second model, followed by Fortis, is one in which these major shareholders are nearly absent and most of the shares are on free float. The bank had its capital highly dispersed because it took the opportunity of growth prospects that showed up through time, thereby diluting its shareholder basis. Person C, who occupied top positions within the Fortis Group,

Table I Ownership structures of the three largest Belgian banks in 2006

Bank	*Shareholder*	*(%)*
KBC	KBC Ancora	20.90
	Cera	6.40
	MRBB (Investment branch of the Belgian farmers' association)	11.70
	Other core shareholders (some wealthy Flemish families)	11.80
	KBC Group Companies	4.30
	Free-float	45.00
Dexia	*Caisse de dépots et consignations*	11.82
	Arcofin	17.52
	Municipal Holding	16.44
	Ethias	6.36
	CNP Assurances	1.98
	Own shares	0.04
	Employees	4.27
	Free-float	41.57
Fortis	*Stichting VSB Fonds*	4.99
	Free-float	95.01

emphasized that "This [the dilution of the shareholder structure] was a choice that was made deliberately and which, considered afterwards, was probably the wrong one". The two interviewees related to KBC (Persons D and E) confirmed that it was also a deliberate choice of that bank to make the choice opposite to that of Fortis, by maintaining a number of major shareholders, thereby limiting the bank's growth opportunities.

These two different models also impact the way in which the company is run. It could be argued that when a bank has a diluted ownership structure, management has more freedom to make decisions. However, according to Person C, this is not necessarily an easier situation, as it is less complicated to explain your strategy and performance to major shareholders than to explain it to the very specialized analysts of investment funds, which generally hold a considerable amount of the bank's free-float equity. Furthermore, as person E mentioned, a bank with a high percentage of free float is much more dependent on the short-term vision of the markets:

> If we had listened to the markets six to nine months ago, we would have had a real retail-strategy, the so-called Scandinavian model. This involves very little growth and a maximal payout ratio. Today, this is already completely different, as the markets tell us that because of possible takeover threats, we should leave place for growth. Opinions can change very fast.

This market dependence is a threat for industrial companies, but it is even more so for banks. Because of the high leverage that is typical in the banking industry, rumors of possible problems can lead to real and very serious problems, as was the case for Bear Stearns in 2008 (Meagher and Stowell, 2008).

The path to the crisis

In the interviews, we discussed the possibility that the dispersed ownership structure that characterizes Fortis influenced the two factors that led to the bank's fall: the acquisition of ABN Amro and the exposure to the subprime crisis.

As stated above, Fortis chose to grow in such a way that it abandoned its concentrated ownership structure. In doing so, it became the leading financial player in Belgium since 1998. This ownership structure also helped the bank to take over ABN Amro in 2007, something that Person C thinks would not have been possible in a bank with major shareholders, because these would probably have opposed the transaction. However, according to the same person, this opposition would not have been related to the ABN Amro deal itself, but to the fact that the major shareholders wished to keep their large stake in the bank and would not be in favor of a strongly dilutive transaction. Everything should thus be placed in perspective. At that time, the acquisition of ABN Amro was seen as very positive, as it was approved by nearly 95 per cent of Fortis' shareholders (Fortis, 2007a). Therefore, we cannot conclude that the diluted ownership structure of Fortis was the reason for what can later be considered as the wrong decision to acquire ABN Amro.

The second factor that led to the fall of Fortis was the heavy exposure to the subprime crisis. One might think – following the reasoning of Iannotta *et al.* (2007) – that banks with major shareholders would have seen more reluctance from them to engage in this risky activity. However, neither at Dexia nor at KBC did these major shareholders show significant resistance to their respective management concerning the investment in subprime credits. As Person D, representative of one of KBC's shareholders, states:

> In the years before the crisis, banks had a very high return on capital. It will seem surprising, but we had to tell [KBC's] management to calm down, to be really careful and not to be too optimistic. However, it is very difficult for managers to resist the huge pressure from the analysts. Considered afterwards, we probably did not provide enough opposition to this as major shareholders. But it is very difficult to say to [KBC's] management that they should have a lower return when you are not aware of the risks that are being taken [due to unknown large off-balance sheet positions].

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The interviews suggest that opposition from hypothetical major shareholders in the takeover of ABN Amro would have been due to merely the dilution effect and not due to specific aspects of the deal itself. Furthermore, a concentrated shareholder structure did not prevent KBC and Dexia from engaging in the – in hindsight risky – CDO business, and both banks also needed financial injections from the government. Therefore, we believe there is no association between the dispersed ownership structure of Fortis and the path taken by the bank that ultimately led to its financial issues in 2008. Given the mixed findings of previous literature, we did not have a prior expectation for this.

The role of supervisory boards[4]

Shareholder representatives on the supervisory board, as non-executive directors, should theoretically act the same way regardless of whether or not they represent a specific major shareholder or the community of free-float shareholders. Because of their concentrated ownership structures, it goes without saying that there were more non-executive directors directly representing specific major shareholders on the supervisory board of KBC and Dexia than there were at Fortis. Previous managers of Fortis (Persons C and F) did not have a very pronounced opinion about a difference in the behavior of a non-executive director in these two models. Nevertheless, according to the interviewees related to KBC (Persons D and E), it makes an enormous difference and this is also what seems most likely. The main reason for this is that when a non-executive director directly represents a shareholder, he/she is financially linked to the company and, therefore, will pay more attention to its business and devote more time to it. As person D states: "I usually spend four to five working days a month studying KBC and these are not days from nine to five".

The events in Belgium during the financial crisis show that supervisory boards did not always play the role they were supposed to. The case of Dexia, where some board members lacked the necessary financial competencies, is remarkable and probably the best example of this. As Person B states:

> At Dexia, there were people on the supervisory board who did not understand anything [. . .] I met [a person on the supervisory board], who told me that they [the members of the board] did not understand anything of what was discussed. But that is normal, it was uncontrollable [. . .] people who are for example in politics, who do other things and who are on many boards, how do you want them to understand?

Person A reinforced this idea by stating that:

> [. . .] [at Dexia] there were the French directors and the Belgian directors. The former ones all came from very renowned universities, were counselors of presidents and all had top-functions, while the latter ones did not understand anything and could not cope with all of this.

Maurice Lippens, Fortis Bank's former chairman even admitted in 2012 that he "was not a banker and only had superficial knowledge in the field of banking" (Mediafin, 2013). This is confirmed by the evidence gathered by Becht *et al.* (2011), which state that as far as European banks are concerned, the crisis has shown that "[. . .] boards of failed institutions did not understand what some employees of the bank were doing".

Supervisory boards were certainly partly responsible for the risks banks took. However, even leaving off-balance sheet items aside, banks are extremely complicated institutions to understand. In light of the interviews, we believe that if banks' supervisory boards want to be effective, then they should be composed of a majority of persons that have a very strong knowledge and experience in the financial sector; enough time to devote to study the bank's business; and a continuous willingness and courage to challenge management and make sure that nothing is kept away from their supervision. This is aligned with recent proposals of reform on corporate governance by institutions, such as the Bank for International Settlements (BIS) and the OECD. The former insists on the qualifications and training of board members as well as the need for them to – collectively – have the adequate knowledge and experience[5]. The latter emphasizes the same matters,

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recognizing that "[. . .] it is often asserted that bank boards lack banking and financial experience" (OECD, 2009). The role of the supervisory board is also stressed by Aebi *et al.* (2012), as they state that executive directors, and especially the Chief Risk Officer (CRO), should be reporting directly to the supervisory board. In practice, the CRO reports to the Chief Executive Officer (CEO), and this represents an inherent conflict of interest.

Bailouts

The interviews showed that there was no difference between Belgian banks with a concentrated ownership structure and their counterparts with a dispersed ownership structure in the period that the foundations for the financial crisis were laid. In this section, we examine the consequences of these different ownership structures in the event that the bank faces financial distress.

Fortis was the first Belgian bank to suffer the impact of the subprime crisis. The Benelux governments reacted very quickly, injecting the necessary capital. Very soon thereafter, the Belgian government sold Fortis to the French bank *BNP Paribas*. The approach was completely different for KBC, which was bailed out by the different Belgian governments by a €7 billion cash injection. In fact, KBC needed three injections from the government in the October 2008 to May 2009 period. These injections were in the form of subordinated debt, which had to be paid back by KBC within a certain time frame.

This difference in treatment is criticized by the two former top managers of Fortis (Persons C and F), who argue that Fortis was not granted the opportunity to work itself out of the crisis. According to Person F, this could have been possible with government guarantees only, but the government went a bridge too far by selling the bank directly to *BNP Paribas*. According to Person C, Fortis did not benefit from the same treatment as KBC because of the strong lobbying and political connections of that bank's major shareholders. Referring back to Table I, we can cite the MRBB (the investment branch of the Belgian farmers' association) or some wealthy Flemish families as examples. Having these major shareholders, KBC was in a better bargaining position toward the different governments. Recognizing its past errors, it managed to show a strong and – more importantly – stable strategy with unconditional support from its major shareholders. This was different in the case of Fortis. According to Person D, the absence of major shareholders led to the fact that no shareholder wished to support management and everyone was trying to leave the sinking ship as fast as possible. Therefore, Fortis could not present a stable story to governments, which was a major argument against financial support such as that received by KBC.

Conclusion

In this study, we analyze two different ownership structures in Belgian banks:

1. the concentrated ownership structure, with a number of major shareholders; and
2. the dispersed ownership structure, with no shareholder having a significantly large stake or the ability to influence management's decisions.

Dexia and KBC followed the first model, while Fortis evolved toward the second around the year 2000.

The mitigating impact that major shareholders could have had on what in hindsight we see as poor decisions of Belgian banks' top managers is found to be very limited. We therefore conclude that the dispersed ownership structure of Fortis was not an important factor in its collapse. Nevertheless, a concentrated ownership structure can help in case of financial distress, mainly because governments are more inclined to participate in bailouts when there is a sound rescue strategy elaborated with the help of a stable ownership structure.

Concerning the ownership structure of banks, a (nearly) 100 per cent free-float structure is probably not ideal, as it allows too much dependence on the market's opinions and these

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have shown too often to be short-term focused. An ownership structure with a number of shareholders owning a stake large enough to bring incentives to actively monitor management seems more appropriate on the condition that the shareholders' representatives perform their role adequately. Of course, because these shareholders would not wish to see their positions diluted, this could limit the bank's growth opportunities.

We also find evidence of considerable ineffectiveness of the role of the supervisory boards, particularly in the case of Dexia. Despite the previous corporate governance reforms in Belgium, crucial mistakes still occurred. This ineffectiveness may stem from the fact that the members of the supervisory boards spend little time performing a detailed analysis of the bank, lack the necessary financial skills to understand what transactions are occurring and place too much trust in management regarding the risk exposure of the bank. Therefore, further research is needed to assess how supervisory boards can really be effective and control management in an industry as complex as the banking sector.

Failures in corporate governance have been recognized in a considerable number of institutions. This has led to several initiatives insisting on the need for stronger corporate governance, such as the action plan launched by the OECD, the principles for enhancing corporate governance established by the BIS and the Walker Review in the UK. More closely related to this case study, the Belgian parliament voted a law on April 24th, 2014, which emphasizes the characteristics the nomination committee should focus on when assessing non-executive directors. These include individual and collective expertise, integrity, reputation, independence of mind and availability (Law of April 24th, 2014 related to the status and the control of credit establishments).

Lessons learnt from this study are that bank shareholders:

- should remain skeptical when it comes to the effectiveness of banking supervisory boards, especially because of the complexity that characterizes the financial sector;
- have to understand that the type of ownership structure is not neutral in case of a crisis event;
- should take into account that shareholders with a significant stake in the bank have the potential to influence management decisions if they wish to do so; and finally
- should push their company to exercise higher standards of corporate governance if needed, as it proves to be of crucial importance.

A solid corporate governance framework lays the basis for banks to be reliable financial intermediaries and enables them to exercise the key role they have in an economy.

Possible policy implications to obtain this solid corporate governance framework would be twofold:

1. Entry tests or other types of assessment to test candidates for board mandates on their understanding of the financial industry as well as on their ability to master financial principles, when this is not mandatory. In countries where such measures are already mandatory, we suggest requiring an external annual review of the board's composition. This should be provided to regulators for them to act on it if necessary; and
2. Reward supervisory boards differently to provide them with the right incentives to dissuade them from excessive risk-taking by including a measure of default risk in board remuneration, for example by linking it to credit default swaps (as suggested concerning executive compensation by Becht *et al.*, 2011).

Even if some reactions have seen the light in the aftermath of the financial crisis, barriers to these policy implementations still exist. Those could consist of lobbying efforts from related parties to limit political reforms; or more broadly, a sentiment that the financial crisis is over and the need for corporate governance reforms is less urgent now.

A limitation of this paper is a relatively small number of testimonies, which can be a source of possible bias. However, we believe this risk has been mitigated by combining different data sources, being:

- interviews with people having different interests (representatives from the different shareholders as well as from management); and
- relying extensively on external documentation.

Furthermore, the fact that no shareholder or manager from Dexia has been interviewed is also a limitation. Nevertheless, some of the interviewees were very close to the Dexia case and can therefore be considered as reliable sources of information.

Notes

1. Fortis Bank was created in 1999 in a merger of five banks, the largest of which was Société Générale de Banque. When we refer to Fortis Bank before 1999, we refer to Société Générale de Banque.
2. The Herfindahl–Hirschman Index (HHI) is a common measure of market concentration. It can range from 0 to 1.0, moving from a huge number of very small firms to a single monopolistic player. Increases in the Herfindahl index generally indicate a decrease in competition and an increase of market power, whereas decreases indicate the opposite. The Netherlands: 0.18; France: 0.13; UK: 0.06; USA: 0.04.
3. See Short (1994; Lloyd *et al.*, 1987; Leech and Leahy, 1991) for studies confirming the positive relationship between ownership concentration and performance. See Demsetz and Lehn (1985) for a study finding no relationship between these two variables.
4. Belgian banks typically operate in a two-tier board structure, which separates the management board from the supervisory board. The former is responsible for the day-to-day management of the company, while the latter has the responsibility of supervising the management board and taking long-term and strategy-related decisions.
5. The BIS report states that “Board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank” and that “Independence can be enhanced by including a large enough number of qualified non-executive members on the board who are capable of exercising sound objective judgment” (Bank for International Settlements, 2010).

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Appendix I

As a preparation for the interviews, an important amount of information about the Belgian banking sector, the Fortis case and the financial crisis in Belgium was collected. This was done to obtain a "big picture" of the 2008 issues; be able to challenge interviewees on the spot; and adopt a critical point of view on interviewees' answers.

Specific individual preparation was also made for each interviewee related to their academic and professional background as well as to their experience in the financial sector. Existing links with other major actors, be them interviewees included in the panel or not, were also identified. This allowed us to be able to critically interpret each interviewees' answers. More specifically, questions for interviewees on the "shareholder side" (Persons A, B, D and E) included the following aspects:

- Their personal view on the 2008 issues in Belgium.
- The interactions they had with bank management.
- The influence of the different types of shareholder structures they experienced and influence on management behavior, corporate governance and risk.
- Their behavior as shareholders and a possible evolution of shareholder activism after the 2008 issues.
- The influence of the different types of shareholder structures during crisis events.

Questions for interviewees on the "management side" (C and F) included following aspects:

- Their personal view on the 2008 issues in Belgium.
- Management communication toward shareholders and the general public.
- The influence shareholders in practice have on management, together with possible differences in this with regard to the ownership structure. The implications

of a concentrated (or non-concentrated) ownership structure on the functioning of the bank.

- The role and effectiveness of non-executive directors, as well as the possible differences in the role of non-executive directors, taking into consideration whether they represent specific shareholders or not.
- The influence of the different types of shareholder structures during crisis events.

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