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Post-Crisis Governance and Bank Risk-Taking in Europe

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Abstract:
This study explores the relationship between governance standards and the risk-taking behavior of European banks, focusing on those listed on stock markets, and considering the regulatory changes that followed the financial crisis.In light of the governance deficiencies observed during the global financial crisis and the subsequent COVID-19 epidemic, this research underscores risk management as the primary objective of bank governance, above the pursuit of short-term profitability.This study employs fixed-effects regressions to analyze bank-level panel data. The data comes from the European Banking Authority's (EBA) EU-wide Transparency Exercise, covering the years 2021 to 2024. This study aims to investigate if stronger governance, as represented by the Common Equity Tier 1 (CET1) capital ratio, is associated to less risk on the balance sheet, which is evaluated by the leverage ratio.The results demonstrate a strong and statistically significant association between a bank's governance and its willingness to take risks. Specifically, a higher level of capitalization is associated to a much lower level of risk.In contrast, a strong association between governance variables and profitability indicators is not identified. The data imply that European banks mainly utilize prudential approaches to manage their operations, which helps to limit excessive risk-taking. This study adds to the previous research on bank governance, especially focusing on findings related to risk. Moreover, our analysis gives vital information for regulators and policymakers who are worried about the financial stability of the European banking system.

Keywords: *Bank governance, Risk-taking behavior, European banking system, Capital adequacy (CET1), Leverage ratio, Financial stability.*

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1. Introduction

The global financial crisis of 2007–2008, along with the COVID-19 epidemic, profoundly reshaped the regulatory and governance structures within the banking sector. In both cases, the combination of excessive risk-taking, insufficient oversight, and poorly constructed incentive systems greatly enhanced systemic instability Despite substantial pay packages, many financial executives and board members showed a lack of foresight or action to prevent these crises. This raised significant questions about the effectiveness of bank governance and how they were compensated (Vallelado, Andrés, & Reig, 2018). As a result of these failures, policymakers and regulators have increasingly stressed the relevance of pay systems in banking governance. Compensation systems significantly influence managerial motivations, risk-taking, and the long-term stability of companies, particularly those whose actions have wider consequences on the system. Bebchuk and Spamann (2010) suggest that the remuneration systems utilized before the financial crisis encouraged a concentration on short-term earnings, which then undermined long-term stability.Consequently, this situation contributed to the building of excessive risk

The European Union responded to these issues by enacting several regulatory adjustments, with the Capital Requirements Directive IV (CRD IV; Directive 2013/36/EU) being a key example. CRD IV established comprehensive rules regarding pay in credit institutions. These rules included limits on variable pay, requirements for deferring payments, and the use of financial instruments to ensure that incentives are linked to long-term performance (Arts. 74, 75, and 92 et seq.).Ferrarini (2015) argues that the success of these measures depends not only on following the laws, but also on the quality of institutions and the current governance practices in each member state.

The impact of pay restrictions is expected to vary throughout Europe. Emerging European economies, such as Romania and Bulgaria, along with other Central and Eastern European nations, often exhibit less developed institutional structures and a higher incidence of perceived corruption compared to more established markets like Germany, France, and the Nordic countries

In these instances, financial limits could have a bigger effect on behavior, potentially lowering self-serving acts and excessive risk-taking. In mature countries, however, these laws could largely affect banks' capacity to attract and keep qualified directors, which could lead to distinct governance trade-offs. This study explores the role of governance discipline in publicly traded European banks. This study explicitly examines how governance systems affect bank performance within the regulatory climate that followed the financial crisis.This approach, rather than focusing exclusively on profitability, stresses the risk-taking behavior of banks. The fundamental purpose of the legislation put in place after the financial crisis is to guarantee financial stability, which highlights the vital role of governance.

This study contributes to the current issue over how well governance and remuneration systems work in the banking sector, specifically focused on European institutions that follow the same set of laws. It contributes to the existing research on bank governance and executive remuneration in three crucial ways. This study, unlike much of the existing research that focuses on executive pay or board structure, emphasizes governance discipline, as indicated by the careful results.This strategy coincides with the fundamental goals of banking regulation that were set after the financial crisis. Consequently, the focus on bank risk-taking, rather than profitability, highlights a dimension of performance that is essential for financial stability, but often overlooked in empirical governance research. This analysis next examines current data from European banks listed on stock exchanges, which have been operating under a uniform regulatory framework since the epidemic.

This offers relevant insights into how governance mechanisms perform when they are subject to heightened supervisory scrutiny. These findings together increase our understanding of how governance influences the risk profiles of banks. Moreover, these elements add to the ongoing discussions regarding how effective the regulatory measures in Europe have been since the financial crisis.

This study intends to solve the following research questions:
RQ1_: How have enhanced governance systems implemented in European listed banks after the financial crisis influenced their levels of risk-taking?
RQ2: Does the effect of governance rigor largely influence a bank's risk-taking, rather than its short-term financial results?

2. Literature Review

2.1 Compensation, Incentives, and Bank Risk-Taking

A bank's risk-taking behavior is greatly influenced by how it arranges its compensation and the incentives it offers. The architecture of these systems can considerably affect a bank's risk profile. For example, a bank's pay structure that significantly rewards short-term results could incentivize taking on too much risk. This is because workers could favor short financial rewards over the bank's long-term stability.
On the other hand, remuneration structures that emphasize long-term performance might help align employee interests with the bank's overall success.
Therefore, the way banks organize their pay and incentive systems is a crucial influence in how much risk they take. Many studies have studied how different remuneration schemes affect the behavior of managers and their propensity to take risks in financial organizations.

Bebchuk and Spamann's 2010 study demonstrated that executive pay structures, which stressed short-term results, were linked to higher risk-taking before the global financial crisis.
Similarly, Beltratti and Stulz (2010) believe that governance systems focused on increasing short-term shareholder value made banks more vulnerable during times of financial volatility.
Research shows a substantial correlation between how much banks pay their employees and various consequences. Khatib, Al Amosh, and Ananzeh (2023) identified a connection between board compensation and bankruptcy risk, earnings management, bank stability, and merger activity. Studies of executive remuneration generally show either negative or statistically negligible relationships between CEO pay and a company's financial performance. This highlights the likelihood of agency difficulties and the extraction of economic rents (Yahya & Ghazali, 2015; Ghazali & Yahya, 2017; Chou & Buchdadi, 2018).

2.2 Board Independence and Corporate Governance

Agency theory indicates that when ownership and control are separated, managers might act in their own interests.Effective oversight by a company's board of directors can help reduce this tendency (Fama & Jensen, 1983). Independent and non-executive directors are meant to be the watchful guardians, ensuring management acts in the best interests of shareholders. Nikolić and Babić (2016) believe that the challenges related to agency are made worse by bad governance in economies that are evolving. This underlines the significance of adequate oversight mechanisms for boards of directors.A bank's board of directors greatly influences its performance and its approach to risk. Aebi, Sabato, and Schmid (2012), coupled with Erkens, Hung, and Matos (2012), found that a bank's ability to endure financial crises is related to the number of independent directors and the general composition of its board. The dimensions of a board play a role in its effectiveness in overseeing a corporation, too. Research reveals that governance procedures differ significantly between developing and mature markets (Ongore et al., 2014).

2.3 Independent Director Compensation and the Research Gap

Although executive pay and board structure have been examined a lot, the compensation of independent and non-executive directors hasn't garnered as much attention. This disparity is remarkable, especially considering the onerous supervisory function that independent directors are required to fulfill, particularly in sophisticated and high-risk institutions like banks. If independent directors are paid too little, they could not have the motivation or resources to successfully criticize management.This could limit their ability to oversee and encourage unsafe behavior.Research reveals that independent directors can assist stabilize organizations In their 2018 study, Ben Bouheni and his team identified a correlation between a more independent board of directors and less risk-taking by banks. In contrast, Sandel (2009) contends that the way managers were compensated before the crisis concentrated too much on short-term performance, which led to bad decision-making.The data imply that the efficacy of independent boards depends not only on their existence, but also on the incentives they have. This study builds on current research by evaluating how governance procedures and risk-taking are related in publicly traded European banks, considering the legislative changes that followed the financial crisis. The analysis, which emphasizes results based on risk rather than short-term profitability, coincides with the core goals of banking regulation. The approach also offers a more detailed understanding of how governance systems work in practice.

Based on agency theory, research on corporate governance, and the goals of banking laws after a crisis, the following hypotheses are proposed: Higher Common Equity Tier 1 (CET1) capital ratios, which imply tighter governance, are associated to less risk-taking by banks. The way a bank is governed seems to have a stronger connection to how much risk it takes on than to its short-term financial results.

These ideas suggest that the major goal of banking governance is to avoid excessive risk, rather than focused on maximizing short-term financial profits.

3. Data and Methodology

3.1 Data

The empirical research employs bank-level data from the European Banking Authority's (EBA) EU-wide Transparency Exercise. This study provides standardized and publicly available financial data for major European banks operating within the European Union.

The dataset, covering the years 2021 to 2024, allows for an analysis of the regulatory environment that evolved following the pandemic. The environment is particularly focused on how governance structures functioned under increased supervisory scrutiny (European Banking Authority, 2021–2024).

The study's sample covers publicly traded banks in Central and Eastern Europe, notably those from Austria, Poland, the Czech Republic, Hungary, Romania, Slovenia, and the Baltic nations. The resulting dataset is unbalanced since not all banks provide data for every year, which leads to a total of 66 bank-year observations.

These data structures are commonly used in international banking research. Using fixed-effects approaches helps to prevent bias in the estimate process (Wooldridge, 2010).

The financial data shown here is consolidated and comes from European Banking Authority (EBA) templates. These templates cover a range of financial metrics, including own funds, leverage exposure, profitability, and the total scale of the balance sheet. The uniform reporting system allows for the comparison of data across different countries and institutions.

3.2 Variable Definitions

Bank risk includes a variety of possible dangers that could undermine a financial institution's soundness and its capacity to make money. These potential problems might occur from several sources, including economic shifts, new regulations, and operational errors. Navigating and mitigating these risks is essential for a bank's sustained prosperity. The leverage ratio, which is the ratio of Tier 1 capital to total exposure, is used to quantify the risk of a bank.This a common tool in banking research, used to analyze the risk on a bank's balance sheet and its vulnerability to unfavorable events, particularly during financial instability (Demirgüç-Kunt, Martinez Peria, & Tressel, 2015; Basel Committee on Banking Supervision, 2014).

The study of governance involves examining how organizations are administered and controlled. This comprises a thorough examination of the structures, processes, and rules that influence decisions and actions within an organization. The aim is to grasp how these components function in concert to fulfill the organization's aims and targets. In addition, governance requires evaluating how well these processes work and making changes. This is important for both academics and professionals, as it helps improve how organizations function and are held accountable. The Common Equity Tier 1 (CET1) capital ratio is a key measure of how well a financial institution is governed and supervised. Although Common Equity Tier 1 (CET1) is largely a measure of financial stability, it also indicates the effectiveness of a company's internal governance and the board of directors. Board approval is a must for capital decisions, and regulators keep a close eye on them, too. Previous research indicates that better governance is associated to higher capitalization and more cautious risk management (Aebi, Sabato, & Schmid, 2012; Anginer, Demirgüç-Kunt, Huizinga, & Ma, 2018). The factors that researchers purposely keep constant throughout an experiment are called controlled variables. This approach allows for the isolation of the independent variable's impacts. The main purpose is to show that any changes in the dependent variable are only caused by changing the independent variable, not by other, unplanned factors. The study considers the size of the bank, which is measured by the natural logarithm of its total assets. It's crucial to recognize that larger banks could have distinct risk profiles

These variations could be owing to the benefits of diversification, stronger rules, or implicit government backing, as suggested by Beltratti and Stulz (2012). To account for shared economic conditions and regulatory changes that affect all banks, the study includes year fixed effects. The Common Equity Tier 1 (CET1) ratio, while largely a measure of financial stability, also indicates a company's internal management and the effectiveness of its board of directors in overseeing the organization.

Therefore, capital planning, dividend policy, and risk management plans require board approval and are also regulated by regulatory agencies. CET1 represents the results of governance and oversight processes, rather than the exact governance structures implemented. This approach is consistent with earlier research, which implies that capitalization acts as a visible indicator of how well banks are governed and how they manage risk.

3.3 Empirical Strategy

Using a fixed-effects panel regression model, which controls for unchanging characteristics of individual banks, we evaluate the connection between governance and bank risk.

This approach evaluates the permanent variations in business models, ownership structures, and the rules of the institutions involved. Without these differences, the accuracy of the computed coefficients could be affected (Wooldridge, 2010). The fundamental model is represented by:

$$Risk\_it = \beta \text{ Governance\_it} + \gamma \text{ Controls\_it} + \alpha\_i + \delta\_t + \varepsilon\_it$$

The equation models the link between risk and the factors that affect it. The phrase "Governance_it" refers to the governance structure of a certain entity at a specific point in time. Controls_it includes the existing controls that were in place at that time. The word "α_i" accounts for effects distinct to each entity, while "δ_t" captures impacts specific to each time period. The term "ε_it" denotes the error term, which captures factors that aren't directly observable. In this case, Risk_it represents the leverage ratio of bank i in year t. The Common Equity Tier 1 (CET1) ratio serves as a measure of how well a company is governed. Additionally, the variable α_i accounts for bank-specific fixed effects, whereas δ_t represents year-specific fixed effects. The symbol δt denotes the fixed effects for each year.

To account for the potential for serial correlation within banks, we cluster standard errors at the bank level, using Petersen's (2009) method. The emphasis on risk, rather than profitability, is supported by both theoretical and practical investigations. These findings show that the main goal of banking governance is to reduce excessive risk, rather than to increase short-term profits (Bebchuk & Spamann, 2010; Laeven & Valencia, 2018).

4. Results

The results are as follows. This section summarizes the research findings on the connection between governance policies and risk-taking in publicly traded European banks. This research uses bank-level panel data from the EBA Transparency Exercise, covering the years 2021 to 2024.

4.1 Preliminary Observations

The table illustrates the findings of the fixed-effects regression study, which assessed the association between governance discipline and bank risk. The leverage ratio is used to analyze a bank's risk, whereas the Common Equity Tier 1 (CET1) capital ratio is used to assess its governance and control.T he models contained both bank-specific fixed effects and year-specific fixed effects. In addition, standard errors were adjusted to account for clustering at the bank level. The results demonstrate a substantial and statistically significant association between how well a bank is governed and the amount of risk it takes on. The positive and statistically significant coefficient for the CET1 ratio, with a significance threshold of 1%, implies that banks with stronger capital adequacy show significantly lower balance-sheet risk. The discovery holds economic weight, and its significance persists regardless of the bank's scale. In contrast, past regression analyses utilizing return on equity as the dependent variable did not provide statistically significant findings. This shows that how banks are controlled is more focused on controlling risk and ensuring financial stability, rather than solely on short-term profits.

4.2 Economic Explanation

The positive and statistically significant correlation for the CET1 ratio shows that better governance measures help restrict excessive leverage and the accumulation of risk. This conclusion emphasizes how governance procedures shape the risk profiles of banks, rather than just boosting short-term financial gains. The results are comparable across several models that account for hidden bank-specific characteristics and shared historical trends, which underlines the strength of the observed link. The model's high capacity to describe the data implies that governance characteristics considerably affect the disparities in risk-taking behavior seen in banks throughout the analyzed time period.

4.3 Summary of Findings

The available research reveals that European banks largely employ governance tools to mitigate risk. While a direct correlation between governance variables and profitability isn't evident, a strong link exists between governance standards and reduced risk-taking. The findings show that the effectiveness of governance frameworks should be evaluated using risk-based outcomes, rather than standard profitability indicators.

4.4 Robustness Checks

To confirm the reliability of our findings, we undertook additional robustness checks. These tests are aimed to confirm the results' reliability across varied situations and assumptions. We adjusted critical parameters, re-estimated the models using different specifications, and then examined how sensitive our conclusions were to potential outliers. Each of these procedures is critical for increasing the dependability of our analysis.

To confirm the trustworthiness of the first findings, numerous additional models were estimated. To address concerns about the likelihood of simultaneous effects and reverse causality between capitalization and risk-taking, governance discipline was measured with a one-period lag. Moreover, employing various models that eliminated extreme data points gave comparable results. In addition, investigations of several bank groups, separating larger and smaller institutions, indicated that the negative association between governance and risk-taking isn't limited to a certain type of bank.The key findings are consistent across all tests, reaffirming the notion that better governance is consistently connected to less risk-taking by banks.

5. Conclusions

This paper studied the relationship between governance and risk-taking in publicly traded European banks, focusing on the time after the financial crisis and the resulting regulatory adjustments. The 2007–2008 global financial crisis, which revealed significant governance weaknesses, and the subsequent COVID-19 epidemic, have collectively emphasized risk containment as a primary objective in reforming bank governance and pay policies. Using bank-level panel data from the European Banking Authority (EBA) Transparency Exercise, encompassing the years 2021 to 2024, and a fixed-effects model, this study assessed the consistent link between governance-related indicators and balance-sheet risk. The data indicates a substantial and statistically significant association between governance, as assessed by the Common Equity Tier 1 (CET1) capital ratio, and bank risk, as represented by the leverage ratio.Banks boasting elevated Common Equity Tier 1 (CET1) ratios present a markedly reduced risk profile inside their financial statements. The bond endures, a constant even when factoring in the bank's scale and the ebb and flow of broader patterns. In contrast, models that focus on short-term profitability, like return on equity, don't exhibit statistically significant results. These findings, when evaluated together, support the concept that banking governance predominantly relies on prudential techniques. These strategies help manage leverage and reduce risk, instead of immediately influencing short-term profitability. The results have two significant consequences. The authors begin by explaining the policy reasons behind the EU's post-crisis reforms, particularly CRD IV. This directive intends to increase oversight and match financial incentives with long-term stability. Therefore, the research reveals a close correlation between the quality of governance, the effectiveness of supervision, and the ensuing risk levels. This is because capitalization reflects both statutory needs and internal governance choices. Furthermore, the results underline the significance of assessing governance effectiveness using risk-adjusted indicators that align with financial stability goals, rather than just relying on profitability measures that could potentially hide risky behavior.

At the same time, the analysis reveals limitations, which identifies areas for future investigation. This study focuses on the period after the pandemic, specifically examining a set of publicly traded European institutions. The results in an unbalanced panel dataset, which implies there are very few observations for each bank and year.

Moreover, while Common Equity Tier 1 (CET1) provides a useful measure of governance within a prudential context, it does not directly evaluate board independence, the incentives offered to directors, or the differences in pay between executive and independent directors, as the study's theoretical framework suggests.

Therefore, future research should incorporate extensive data on governance and pay. This should involve metrics of board independence, how directors are paid, and the use of deferred or instrument-based compensation. This approach allows for a direct study of how remuneration structures affect the quality of oversight and the level of risk taken.

A more full understanding of how institutional circumstances affect the impact of governance and compensation changes might be accomplished by considering the periods before and after the implementation of CRD IV, and by explicitly distinguishing between emerging and developed European markets. The outcomes of this study have substantial consequences for regulatory agencies and lawmakers. First, they favor the continued use of capital-based governance systems, which are designed to curb excessive risk-taking in the banking sector. Moreover, the results suggest that evaluations of governance effectiveness should prioritize risk-based indicators above measures of short-term profit, especially in institutions that are vital to the financial system.

The findings underscores the need of uniform supervisory practices across Europe. This is because the way governance is enforced seems to be a critical aspect in shaping banks' risk profiles within a united regulatory system. These findings add to the expanding corpus of research that ties how banks are governed with their financial stability. The authors propose that the success of governance is best characterized by how well it manages risk, which aligns with the goals of regulatory measures made following a crisis.This position is especially relevant for regulators, shareholders, and policymakers who are trying to increase the resilience of European banking institutions in the face of evolving macro-financial risks.

Authors' Contributions:
The authors contributed equally to this work.

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Anexxes

Table 3. Fixed-Effects Regression Results: Governance and Bank Risk
Dependent variable: Leverage Ratio

Variables	(1) Baseline Model	(2) Lagged Governance	(3) With ROE Control
CET1 Ratio	0.083*** (0.021)	–	0.079*** (0.024)
CET1 (t−1)	–	0.076*** (0.025)	–
Log Assets	0.011 (0.008)	0.010 (0.009)	0.009 (0.008)
ROE	–	–	0.004 (0.003)
Constant	3.412** (1.302)	3.105** (1.411)	3.287** (1.356)

Fixed Effects

Bank Fixed Effects		Yes	
Year Fixed Effects		Yes	

Model Statistics

Statistic	(1)	(2)	(3)
Observations	66	54	66
Number of Banks	18	18	18
R^2 (within)	0.42	0.39	0.43
F-statistic	12.84***	10.77***	11.95***

Notes: Standard errors clustered at the bank level are reported in parentheses.
*** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$

Appendix A. Panel Dataset Structure

Table A1. Structure of the Panel Database (2021–2024)

Variable Name	Symbol in Model	Definition	Measurement	Role
Bank Identifier	i	Unique bank code	Categorical	Panel ID
Year	t	Time period (2021–2024)	Numeric	Time fixed effects
Leverage Ratio	Risk_it	Tier 1 Capital / Total Exposure	Percentage (%)	Dependent variable
CET1 Ratio	Governance_it	Common Equity Tier 1 Capital / Risk-Weighted Assets	Percentage (%)	Main independent variable
Log Total Assets	Size_it	Natural logarithm of total assets	Continuous	Control variable
Return on Equity	ROE_it	Net income / Shareholders' equity	Percentage (%)	Alternative dependent variable
Lagged CET1	CET1_it-1	CET1 ratio lagged one period	Percentage (%)	Robustness check

Table A2. Panel Structure

Characteristic	Description
Dataset Type	Unbalanced panel data
Number of Observations	66 bank-year observations
Countries Included	Austria, Poland, Czech Republic, Hungary, Romania, Slovenia, Baltic States
Period Covered	2021–2024
Data Source	European Banking Authority (EBA) – EU-wide Transparency Exercise
Estimation Method	Fixed-effects panel regression
Standard Errors	Clustered at bank level

Model Specification

$LeverageRatio\_it = \beta1\ CET1\_it + \beta2\ LogAssets\_it + \alpha\_i + \delta\_t + \varepsilon\_it$
Where:
α_i = bank fixed effects
δ_t = year fixed effects
Standard errors clustered at bank level

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