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Governance and bank valuation ☆

Gerard Caprio [a,*], Luc Laeven [b,c], Ross Levine [d,e]

[a] *Williams College, Economics Department, Williamstown, MA, USA*
[b] *International Monetary Fund, Washington, DC, USA*
[c] *CEPR, UK*
[d] *Brown University, Providence, RI, USA*
[e] *NBER, USA*

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Abstract

This paper assesses the impact of the ownership structure of banks and shareholder protection laws on bank valuations while controlling for differences in bank regulations. Except in a few countries with very strong shareholder protection laws, banks are not widely held. Rather, families or the State control banks. Furthermore, (i) larger cash-flow rights by the controlling owner boost valuations, (ii) stronger shareholder protection laws increase valuations, and (iii) greater cash-flow rights mitigate the adverse effects of weak shareholder protection laws on valuations. These results suggest that ownership structure is an important mechanism for governing banks.

JEL classification: G21; G34; K22; G28

Keywords: Corporate governance; Securities law; Regulation; Banking; Financial institutions; International finance; Market structure

☆ This paper's findings, interpretations, and conclusions are entirely those of the authors and do not necessarily represent the views of the International Monetary Fund, its Executive Directors, or the countries they represent.

* Corresponding author.

E-mail addresses: Gerard.Caprio@williams.edu (G. Caprio), llaeven@imf.org (L. Laeven), ross_levine@brown.edu (R. Levine).

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1. Introduction

Research suggests that well-functioning banks promote growth.[1] When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms and accelerates capital accumulation and productivity growth. Furthermore, banks, as major creditors and in some countries as major equity holders, play an important role in governing firms. Thus, if bank managers face sound governance mechanisms, this enhances the likelihood that banks will raise capital inexpensively, allocate society's savings efficiently, and exert sound governance over the firms they fund.

Nevertheless, little is known about which laws and regulations enhance the governance of banks. One standard rationale for heavy government regulation of banks is that shareholders and creditors lack sufficient mechanisms for exerting sound governance over extraordinarily complex, opaque banks, especially in the presence of deposit insurance. But, as Fama (1985) famously asked, are banks different? Or, do the same corporate control mechanisms that work in non-financial corporations also work in banks? Research indicates that strong shareholder protection laws enhance the governance of non-financial corporations (La Porta et al., 2002), but there exists no evidence on shareholder protection laws and the governance of banks.

This paper assesses the impact of shareholder protection laws and ownership structure on bank valuations while controlling for international differences in bank regulations. By examining valuations, we directly analyze banks' cost of capital and indirectly assess the market's assessment of the governance of banks. That is, holding other things constant, we assess whether governance mechanisms that both reduce the ability of insiders to expropriate bank resources and promote bank efficiency tend to boost the market value of banks.

Research suggests that strong shareholder protection laws increase firm valuations (Claessens et al., 2000; La Porta et al., 2002). In short, investors pay more for equity when legal institutions effectively protect their rights. From this perspective, investor protection laws may provide the tools for small shareholders to stop large shareholders from expropriating bank resources. We define expropriation broadly to include theft, transfer pricing, asset stripping, the preferential hiring of family members, the allocation of credit in a manner that enriches bank insiders but hurts the bank, and other "perquisites" that benefit bank insiders but hurt the bank.

In the particular case of banks, however, not everyone agrees that shareholder protection laws will effectively thwart expropriation. Many argue that banks are extraordinarily complex and opaque (Morgan, 2002). From this perspective, investor protection laws alone may not provide a sufficiently powerful corporate governance mechanism to small shareholders. Put differently, even with strong investor protection laws, small stakeholders may lack the means to monitor and govern complex banks. Furthermore, bank regulations may be sufficiently pervasive that they render shareholder protection laws superfluous, or bank regulations may supersede standard investor protection laws. Thus, the impact of investor protection laws on banks may differ from their impact on non-bank corporations. We provide the first examination of the impact of shareholder protection laws on bank valuations under different bank regulatory regimes.

Official bank regulations may arise in part to stop bank insiders from expropriating or misallocating bank resources as argued in Caprio and Levine (2002). Thus, effective regulation may increase investor confidence regarding expropriation and boost market valuations. Of course, bank regulations arise for reasons other than reducing expropriation. Especially in the presence

[1] For example, Levine and Zervos (1998), Beck et al. (2000), Levine et al. (2000), Claessens and Laeven (2003), among others, provide evidence that bank operations affect economic growth. Levine (2006) reviews this literature.