Journal of Banking & Finance 35 (2011) 1327–1340

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Ownership structure and risk in publicly held and privately owned banks

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ARTICLE INFO

Article history:
Received 21 November 2009
Accepted 5 October 2010
Available online 20 November 2010

JEL classification:
G21
G32

Keywords:
Ownership structure
Bank risk
European banks
Market discipline

ABSTRACT

Using detailed ownership data for a sample of European commercial banks, we analyze the link between ownership structure and risk in both privately owned and publicly held banks. We consider five categories of shareholders that are specific to our dataset. We find that ownership structure is significant in explaining risk differences but mainly for privately owned banks. A higher equity stake of either individuals/families or banking institutions is associated with a decrease in asset risk and default risk. In addition, institutional investors and non-financial companies impose the riskiest strategies when they hold higher stakes. For publicly held banks, changes in ownership structure do not affect risk taking. Market forces seem to align the risk-taking behavior of publicly held banks, such that ownership structure is no longer a determinant in explaining risk differences. However, higher stakes of banking institutions in publicly held banks are associated with lower credit and default risk.

1. Introduction

The past three decades have been characterized by repeated banking crises, such as the financial crisis of 2008, the US savings and loans debacle of the 1980s, the 1994–1995 Mexican crisis, and the 1997 Asian and 1998 Russian financial crises. Such episodes highlight the inherently unstable nature of banking and the tendency of banks toward excessive risk taking. In this paper, we focus on a driving force behind the risk-taking incentives of banks—namely, shareholders' behavior and their incentives to take higher risk. The issue of ownership structure is of particular interest for the banking industry because several factors interact with and alter governance, such as the quality of bank regulation and supervision and the opacity of bank assets. Moreover, banking systems have faced major changes during the past 20 years. With financial deregulation and market integration, the scope of banks' activities has been completely reshaped, from traditional intermediation products to an array of new businesses. These trends have led to substantial consolidation in the banking industry and, consequently, to significant changes in ownership and capital structure. In addition, institutional ownership of common stock has increased substantially over the past 20 years, which also implies changes in corporate governance and banks' behavior in terms of risk taking.

However, because of greater separation of ownership and control, firms with publicly held equity face different agency problems than privately owned firms.[1] Indeed, in publicly held banks, ownership is more likely to be dispersed among a large number of shareholders. This implies that the separation between shareholders and managers is more effective for publicly held banks than for privately owned banks. Such separation between shareholders and managers can increase information asymmetry and therefore create divergence in incentives (Jensen and Meckling, 1976). Privately owned banks are usually characterized by less separation between owners and managers. The latter have a relatively larger equity stake, and therefore their incentives are more closely aligned with those of shareholders. Moreover, in privately owned banks, shareholders can more easily gain access to managers' private information that facilitates the monitoring of their actions. The choice to be publicly held or privately owned also implies differences in terms of market discipline and access to capital markets. For publicly traded banks, market forces can influence risk-taking incentives. On the one hand, the market is expected to monitor or influence banks' risk behavior, and therefore the impact of ownership changes on risk cannot be assessed without considering incentives driven by financial markets in terms of discipline (Bliss and Flannery, 2002; Flannery, 2001). In the Basel II Capital Accord, market discipline is one of the three pillars, along with capital regulation (first pillar) and banking supervision (second pillar). The idea is to rely on market forces to enhance banking supervision or to mitigate shareholders' risk-taking incentives, and consequently market discipline should play an important role for publicly held banks and, to some extent, for privately owned

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[1] Publicly held banks are banks that are publicly quoted (i.e. banks whose stocks are traded on a stock exchange). Privately owned banks are all other banks.

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doi:10.1016/j.jbankfin.2010.10.004

banks that strongly rely on market debt. On the other hand, banks that are publicly held might have different objectives in terms of growth and risk-return strategies. Public equity is more liquid than private equity and thus can be raised at a lower cost. Therefore, if publicly held banks' purpose to access capital markets is to finance faster growth opportunities, they are likely to take on more risk than privately owned banks.

To our knowledge, no research has addressed whether risk may be different for privately owned banks and publicly held banks under specific ownership profiles. Working with a sample of US bank holding companies (BHC), Kwan (2004) finds no difference in loan quality and earnings variability between traded BHCs and privately owned BHCs, whereas Nichols et al. (2009) find that publicly held banks exhibit relatively larger loan loss allowances and loan loss provisions than privately owned banks. Thus, our aim herein is to assess banks' risk-taking behavior by combining the two interrelated dimensions of ownership structure and market discipline.

According to theoretical and empirical literature, agency problems and risk-taking behavior are different depending on the nature of the shareholder. A first issue is the conflict of interest between managers and shareholders identified by Jensen and Meckling (1976). Theory indicates that shareholders with a diversified portfolio are motivated to take more risk for a higher expected return whereas managers take less risk to protect their position and personal benefits and to preserve their acquired human capital (Galai and Masulis, 1976; Jensen and Meckling, 1976; Demsetz and Lehn, 1985; Esty, 1998). Empirically, Saunders et al. (1990) were the first to test the relationship between banks' ownership structure and their risk-taking incentives. They find a positive relationship between managerial stock ownership (proportion of stock held by managers) and risk taking. Moreover, they find that banks controlled by shareholders take more risk than banks controlled by managers. In line with Saunders et al. (1990), several studies find a significant effect of ownership concentration on risk taking but without any consensus on the sign of such a relationship. That is, some studies find a negative relationship, whereas others obtain a U-shaped relationship (or inverse U shape) between ownership concentration and risk (Gorton and Rosen, 1995; Chen et al., 1998; Anderson and Fraser, 2000), which could be explained by managers' entrenchment. Moreover, Sullivan and Spong (2007) show that stock ownership by hired managers is positively linked with bank risk, meaning that under certain conditions, hired managers operate their bank more closely in line with stockholder interests.

Existing research also analyzes how the level of ownership concentration affects bank performance. The effects of ownership concentration on firm performance are theoretically complex and empirically ambiguous. Shleifer and Vishny (1986) and Aghion and Tirole (1997) show that a concentrated ownership may improve firms' performance by increasing monitoring and alleviating the free-rider problem in takeovers. Conversely, other theoretical works show that large shareholders may exercise control rights to create private benefits and sometimes to expropriate smaller investors (Shleifer and Vishny, 1997). Another potential cost of concentration may result if managerial initiative is repressed by excessive monitoring (Burkart et al., 1997). Empirically, Boubakri and Ghouma (2010) find that expropriation by controlling shareholders affects bond performance both in terms of yield spreads and ratings. Working with the 10 largest publicly listed banks in 48 countries, Laeven and Levine (2009) find that banks with more powerful owners tend to take higher risks. This is consistent with the study of Haw et al. (2010) who find that concentrated ownership control is associated with higher insolvency risk and greater return volatility for a sample of listed commercial banks in East Asia and Western Europe. In contrast, working with a panel of 50 countries, Shehzad et al. (2010) find that when ownership concentration is greater than 50%, the volume of non-performing loans decreases. Their results further reveal that when shareholder protection rights are weak, ownership concentration is beneficial for the bank.

Another well-developed issue in the literature involves comparing the performance (profitability and asset quality) of state-owned banks with that of their private counterparts. Agency costs within government bureaucracy can result in weak managerial incentives and misallocation of resources. According to the agency cost view, managers exert less effort than their private counterparts or divert resources for personal benefits, such as career concerns. From the political view of state ownership, government-owned banks are inefficient because of politicians' deliberate policy of transferring resources to their supporters (Shleifer and Vishny, 1986; Shleifer, 1998). According to prior research, state-owned banks have poorer loan quality and higher default risk than privately owned banks (Berger et al., 2005; Iannota et al., 2007). Iannota et al. (2007) also suggest that mutual banks and government-owned banks are less profitable than privately owned banks. Moreover, they find that government-owned banks have poorer loan quality and higher default risk, whereas mutual banks have better loan quality and lower asset risk than both privately owned and government-owned banks. In addition, some research has shown that foreign-owned banks exhibit better performance than other banks, particularly in developing countries (Claessens et al., 2001; Bonin et al., 2005; Micco et al., 2007).

In addition to the issues of the manager/owner conflict and the differences between state-owned and privately owned firms, other aspects have been well established in the literature on non-financial firms but not on financial firms. First, institutional investors (e.g., investment companies, investment advisors, pension funds) who exercise significant voting power can shape the nature of corporate risk taking. In terms of shareholder size and expertise in processing information and monitoring managers, such investors are different from atomistic individual investors because they can exert greater control for reasons of economies of scale in corporate supervision. Pound (1988) shows that institutional investors can exercise control at a lower cost because they have more experience. However, managers and institutional investors may also form an alliance, in which insider interests take priority over the maximization of firm value. At the same time, because institutional investors have a diversified portfolio of investments, they may have lower incentives to exercise control. Empirical evidence (Acker and Athanassakos, 2003) based on non-financial firms does not provide conclusive results on the effect of control by institutional investors on firm value. Second, family-owned firms are perceived not only as less willing to take risk but also as less profitable. More generally, firms with large, undiversified owners such as founding families may forgo maximum profits because their wealth is not sufficiently diversified. Families also limit executive management positions to family members, suggesting a restricted labor pool from which to obtain qualified and capable talent, potentially leading to competitive disadvantages relative to non-family-owned firms (Morck et al., 2000). However, James (1999) posits that families have longer investment horizons that lead to greater investment efficiency. Stein (1988, 1989) shows that the presence of shareholders with relatively long investment horizons can mitigate the incentives for myopic investment decisions by managers. Regarding the banking industry, little research has analyzed this issue. Laeven (1999) considers different forms of bank ownership, including state-owned, foreign-owned, company-owned and family-owned banks, but not banks owned by institutional investors. Working with a panel of Asian banks before the Asian crisis of 1997, he finds that family-owned banks were among the most risky banks, along with company-owned banks, whereas foreign-owned banks took little risk relative to other banks.

The objective of this paper is to extend the current literature regarding how ownership structure affects bank risk taking and