Large shareholder monitoring and regulation: The Japanese banking experience

Kenneth A. Kim\textsuperscript{a,}\textsuperscript{*}, Sang-Hyop Lee\textsuperscript{b}, S. Ghon Rhee\textsuperscript{c}

\textsuperscript{a} School of Management, State University of New York at Buffalo, Buffalo, NY 14260, United States
\textsuperscript{b} Department of Economics, University of Hawaii, Honolulu, HI 96822, United States
\textsuperscript{c} Shidler College of Business, University of Hawaii, Honolulu, HI 96822, United States

Abstract

During a period where Japanese banks operated under a less restrictive regulatory environment, 1986–1988, we find positive relations between bank risks and ownership concentration. This empirical evidence suggests that shareholder monitoring is present when the potential return to monitoring is high (the “shareholder monitoring hypothesis”). During the periods before and after this particular period, we do not observe evidence of shareholder oversight. These results are consistent with the argument that regulation (an external governance mechanism) and shareholder monitoring (an internal governance mechanism) are substitutes for one another (the “substitution hypothesis”) because the pre- and post-periods are characterized by stricter regulatory environments. Finally, tests on bank performance lend supporting evidence to both hypotheses.

© 2007 Elsevier Inc. All rights reserved.

\textit{JEL classification:} G21; G28; G32

\textit{Keywords:} Large shareholders; Japanese banks; Bank risk; Shareholder monitoring; Regulation

1. Introduction

Researchers contend that regulation and shareholder monitoring are substitute governance mechanisms. For example, Demsetz and Lehn (1985) suggest that “systematic regulation restricts options available to owners” and “regulation also provides some subsidized monitoring and disciplining of the management of regulated firms”. Therefore, for example, financial firms and utility firms probably do not have active shareholders. Black (1998) also argues that regulation obstructs the potential for effective shareholder oversight. When a firm operates in a regulated industry
or environment, the gains to shareholder monitoring may be limited. The implication of these contentions is that an internal governance mechanism (e.g., shareholder monitoring) can be a substitute for an external governance mechanism (i.e., regulation).

Concentrated ownership is often used to identify shareholder monitoring (e.g., Demsetz & Lehn, 1985; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998; Shleifer & Vishny, 1986). When a public firm’s ownership is concentrated into the hands of a few large shareholders, then these large shareholders should have both the desire and the power to monitor the firm’s operations and management. For example, according to Shleifer and Vishny (1997, 1986), large shareholders have the incentive to collect information and monitor management for the purposes of profit maximization. If large shareholders are inactive, then there is an obvious cost as their inactivity (or shirking) is significantly borne to large shareholders (Demsetz & Lehn, 1985). As such, Demsetz (1983, 1986) argues that a shareholder’s ability to exercise oversight and control “must be the primary explanation for ownership concentration”. In a similar vein, Grossman and Hart (1986) contend that observed ownership concentration is, in effect, the same as observing the extent to which large shareholders have control. However, the benefits to control are unlikely to be equal across firms. Demsetz and Lehn (1985) contend that large shareholders will be present in risky firms, as the payoff potential to active monitoring of risky firms is high. The mere presence of large owners in risky firms strongly suggests they are monitoring, as the downside potential of not monitoring is also especially high in risky firms.

In empirical tests, Demsetz and Lehn (1985) find that firms in regulated industries have lower ownership concentrations. For unregulated firms, they find the relation between ownership concentration and firm risks to be positive. Their finding that ownership concentration and regulation are negatively related supports the “substitution hypothesis”. Their finding that ownership concentration and firm risks are positively related supports the “shareholder monitoring hypothesis”. Holderness, Kroszer, and Sheehan (1999), and Himmelberg, Hubbard, and Palia (1998) also find a positive relation between ownership concentration and firm risk. They too suggest that this evidence is indicative of monitoring by large shareholders.

Other researchers find support for the substitution hypothesis. Kole and Lehn (1999) find that controlling shareholders in the US airlines industry instituted numerous governance mechanisms after the industry was deregulated. Anderson and Fraser (2000) study US banks during more regulated and less regulated periods and find managerial shareholdings and risk-taking are positively related only during the less regulated period. Konishi and Yasuda (2004) study risk-taking by Japanese banks after its capital adequacy requirement was increased. They find that risk-taking by the banks’ stable shareholders declined after the capital adequacy requirement was increased. All of these papers’ findings can be viewed as being consistent with the substitution hypothesis. Owners are more active when there is less regulation. Booth, Cornett, and Tehranian (2002) find that two internal governance mechanisms, board quality (proxied by the fraction of independent directors) and officer/director stock ownership, are substitutes for each other. However, for regulated industries (banks and utilities), they find that independent boards and officer/director stock ownership are not substitute governance mechanisms. Therefore, they also contend that an external governance mechanism (i.e., regulation) serves as a substitute for internal governance mechanisms (i.e., independent directors and stock ownership).

La Porta et al. (1998) conduct a cross-country test of the substitution hypothesis. They find that firms in countries with relatively weak shareholder protection laws have relatively high ownership concentrations, which support the substitution hypothesis—shareholders look out for their own interests when laws do not. Caprio et al. (2003) also conduct a cross-country test while specifically focusing on the relation between bank governance and bank value. They find that
دریافت فوری
متن کامل مقاله

امکان دانلود نسخه تمام متن مقالات انگلیسی
امکان دانلود نسخه ترجمه شده مقالات
پذیرش سفارش ترجمه تخصصی
امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
امکان دانلود رایگان ۲ صفحه اول هر مقاله
امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
دانلود فوری مقاله پس از پرداخت آنلاین
پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات