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Risk management, corporate governance, and bank performance in the financial crisis

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ABSTRACT

The recent financial crisis has raised several questions with respect to the corporate governance of financial institutions. This paper investigates whether risk management-related corporate governance mechanisms, such as for example the presence of a chief risk officer (CRO) in a bank's executive board and whether the CRO reports to the CEO or directly to the board of directors, are associated with a better bank performance during the financial crisis of 2007/2008. We measure bank performance by buy-and-hold returns and ROE and we control for standard corporate governance variables such as CEO ownership, board size, and board independence. Most importantly, our results indicate that banks, in which the CRO directly reports to the board of directors and not to the CEO (or other corporate entities), exhibit significantly higher (i.e., less negative) stock returns and ROE during the crisis. In contrast, standard corporate governance variables are mostly insignificantly or even negatively related to the banks' performance during the crisis.

1. Introduction

This paper investigates whether the presence of a chief risk officer (CRO) in the executive board of a bank, the line of reporting of the CRO, and other risk management-related corporate governance mechanisms (which are also termed "risk governance") positively affect bank performance during the recent financial crisis. The paper combines and further develops relevant previous findings from three major areas of research: corporate governance, enterprise risk management (ERM), and bank performance.

Whereas scandals such as Enron and Worldcom gave primarily rise to new developments in accounting practices, the financial crisis following the subprime meltdown in the US has led to a further growing awareness and need for appropriate risk management techniques and structures within financial organizations.[1] In quantitative risk management, the focus lies on how to improve the measurement and management of specific risks such as liquidity risk, credit risk, and market risk. On a structural level, the issue of how to integrate these risks into one single message to senior executives is being addressed. Earlier literature on risk management focused on single types of risk while missing out on the interdependence to other risks (Miller, 1992). Consequently, only in the 1990s, the academic literature started to focus on an integrated view of risk management (e.g., Miller, 1992; Miccolis and Shaw, 2000; Cumming and Mirtle, 2001; Nocco and Stulz, 2006; Sabato, 2010).

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[1] There are also recent academic studies which emphasize that flaws in bank governance played an important role in the poor performance of banks during the financial crisis of 2007/2008 (e.g., Diamond and Rajan, 2009). Also a recent OECD report concludes that the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements (Kirkpatrick, 2009). Moreover, Acharya et al. (2009) argue that a strong and independent risk management is necessary to effectively manage risk in modern-day banks as deposit insurance protection and implicit too-big-to-fail guarantees weaken the incentives of debtholders to provide monitoring and impose market discipline. Moreover, the increasing complexity of banking institutions and the ease with which their risk profiles can be altered by traders and security desks makes it difficult for supervisors to regulate risks.

In addition, public policy makers around the world have started to question the appropriateness of the current corporate governance applied to financial institutions. In particular the role and the profile of risk management in financial institutions has been put under scrutiny. In many recent policy documents, comprehensive risk management frameworks are outlined in combination with recommended governance structures (e.g., Basel Committee on Banking Supervision, 2008; FSA, 2008; IIF, 2007; Walker, 2009). One common recommendation is to "put risk high on the agenda" by creating respective structures. This can involve many different actions. As already claimed by the Sarbanes-Oxley Act (SOX) in 2002, financial expertise is considered to play an important role. Other, more specific measures involve either the creation of a dedicated risk committee or designating a CRO who oversees all relevant risks within the institution (e.g., Brancato et al., 2006; Sabato, 2010).

Mongiardino and Plath (2010) show that the risk governance in large banks seems to have improved only to a limited extent despite increased regulatory pressure induced by the credit crisis. They outline best practices in banking risk governance and highlight the need to have at least (1) a dedicated board-level risk committee, of which (2) a majority should be independent, and (3) that the CRO should be part of the bank's executive board. By surveying 20 large banks, however, they find only a small number of banks to follow best practices in 2007. Even though most large banks had a dedicated risk committee, most of them met very infrequently. Also, most risk committees were not comprised of enough independent and financially knowledgeable members (see also Hau and Thum, 2009). And most of those large banks had a CRO but its position and reporting line did not ensure an appropriate level of accessibility and thus influence on the CEO and the board of directors.[2]

Whereas the role and importance of the CRO, and risk governance more generally, in the banking industry has been highlighted in the newspapers, in various reports (Brancato et al., 2006), as well as in practitioner-oriented studies (e.g., Banham, 2000), it has been largely neglected in the academic literature so far. The only exception we are aware of is the contemporaneous study by Ellul and Yerramilli (2011). They investigate whether a strong and independent risk management is significantly related to bank risk taking and performance during the credit crisis in a sample of 74 large US bank holding companies. They construct a Risk Management Index (RMI) which is based on five variables related to the strength of a bank's risk management, including a dummy variable whether the bank's CRO is a member of the executive board and other proxy measures for the CRO's power within the bank's management board. Their findings indicate that banks with a high RMI value in 2006 had lower exposure to private-label mortgage-backed securities, were less active in trading off-balance sheet derivatives, had a smaller fraction of non-performing loans, had lower downside risk, and a higher Sharpe Ratio during the crisis years 2007/2008.

Some other aspects of corporate governance in banks, such as board characteristics and CEO pay and ownership, have been addressed in a few recent academic studies (e.g., Beltratti and Stulz, forthcoming; Erkens et al., 2010; Fahlenbrach and Stulz, 2011; Minton et al., 2010). However, the literature on corporate governance and the valuation effect of corporate governance in financial firms is still very limited. Moreover, financial institutions do have their particularities, such as higher opaqueness, heavy regulation and intervention by the government (Levine, 2004), which require a distinct analysis of corporate governance issues. Consistently, Adams and Mehran (2003) and Macey and O'Hara (2003) highlight the importance of taking differences in governance between banking and non-banking firms into consideration.

Two recent studies by Beltratti and Stulz (forthcoming) and Fahlenbrach and Stulz (2011) analyze the influence of corporate governance on bank performance during the credit crisis. However, both studies rely on variables that have been used in the literature to analyze the relation between corporate governance and firm value of non-financial institutions. Fahlenbrach and Stulz (2011) analyze the influence of CEO incentives and share ownership on bank performance and find no evidence for a better performance of banks in which the incentives provided by the CEO's pay package are stronger (i.e., the fraction of equity-based compensation is higher). In fact, their evidence rather points to banks providing stronger incentives to CEOs performing worse in the crisis. A possible explanation for this finding is that CEOs may have focused on the interests of shareholders in the build-up to the crisis and took actions that they believed the market would welcome. Ex post, however, these actions were costly to their banks and their shareholders when the results turned out to be poor. Moreover, their results indicate that bank CEOs did not reduce their stock holdings in anticipation of the crisis, and that CEOs did not hedge their holdings. Hence, their results suggest that bank CEOs did not anticipate the crisis and the resulting poor performance of the banks as they suffered huge losses themselves.[3]

Beltratti and Stulz (forthcoming) investigate the relation between corporate governance and bank performance during the credit crisis in an international sample of 98 banks. Most importantly, they find that banks with more shareholder-friendly boards as measured by the "Corporate Governance Quotient" (CGQ) obtained from RiskMetrics performed worse during the crisis, which indicates that the generally shared understanding of "good governance" does not necessarily have to be in the best interest of shareholders. Beltratti and Stulz (forthcoming) argue that "banks that were pushed by their boards to maximize shareholder wealth before the crisis took risks that were understood to create shareholder wealth, but were costly ex post because of outcomes that were not expected when the risks were taken" (p. 3).

Erkens et al. (2010) investigate the relation between corporate governance and performance of financial firms during the credit crisis of 2007/2008 using an international sample of 296 financial firms from 30 countries. Consistent with Beltratti and Stulz (forthcoming), they find that firms with more independent boards and higher institutional ownership experienced worse stock returns during the crisis. They argue that firms with higher institutional ownership took more risk prior to the crisis which resulted in larger shareholder losses during the crisis period. Moreover, firms with more independent boards raised more equity capital during the crisis, which led to a wealth transfer from existing shareholders to debtholders. Minton et al. (2010) investigate how risk taking and U.S. banks' performance in the crisis are related to board independence and financial expertise of the board. Their results show that financial expertise of the board is positively related to risk taking and bank performance before the crisis but is negatively related to bank performance in the crisis. Finally, Cornett et al. (2010) investigate the relation between various corporate governance mechanisms and bank performance in the crisis in a sample of approximately 300 publicly traded US banks. In contrast to Erkens et al. (2010), Beltratti and Stulz (forthcoming), and Fahlenbrach and Stulz (2011), they find better corporate governance, for example a more independent board, a higher pay-for-performance sensitivity, and an increase in insider ownership, to be positively related to the banks' crisis performance.

[2] Previous to the financial crisis of 2007/2008, the vast majority of banks did not have a CRO, but only a Head of Risk usually reporting to the CFO with no access to or influence on the short- or long-term strategy (and the associated risks) of the bank.

[3] In another recent study, however, Bebchuk et al. (2010) provide evidence that the top-five executive teams of Bear Stearns and Lehman Brothers cashed out large amounts of performance-based compensation during the 2000–2008 period. Moreover, they were able to cash out large amounts of bonus compensation that was not clawed back when the firms collapsed, as well as to pocket large amounts from selling shares.