Who’s minding the store? Motivating and monitoring hired managers at small, closely held commercial banks

Robert DeYoung a,⁎, Kenneth Spong b, Richard J. Sullivan b

a Economic Research Department, Federal Reserve Bank of Chicago, 11th Floor, Chicago, IL 60604, USA
b Federal Reserve Bank of Kansas City, Kansas City, MO 64198, USA

Received 20 April 1999; accepted 11 April 2000

Abstract

Small, closely held corporations must rely disproportionately on managerial shareholdings to mitigate the agency costs associated with hired managers, because market discipline and motivated outside monitors are typically absent for such firms. We study a random sample of 266 small, closely held US commercial banks with a broad range of ownership and management arrangements. Our results suggest that hiring an outside manager can improve profitability, but these gains depend on aligning hired managers with owners via managerial shareholdings. We find that over-utilizing this control mechanism results in entrenchment, while under-utilization is costly in terms of foregone profits. © 2001 Elsevier Science B.V. All rights reserved.

JEL classification: G34; G21

Keywords: Commercial banks; Corporate governance; Principal–agent problems; Profit efficiency; Small businesses

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Corresponding author. Tel.: +1-312-322-5396; fax: +1-312-322-2357.
E-mail address: robert.deyoung@chicfrb.org (R. DeYoung).
1. Introduction

The vast majority of US businesses are relatively small, not actively traded, and face little outside monitoring. In the prototypical small and closely held business, the top manager is generally drawn from the ranks of the firm’s primary owners. But as time passes a small business may reach a larger size or scope, or may encounter challenging business conditions, beyond these owners’ capabilities to manage effectively. Alternately, as time passes the owner manager might wish to retire or turn her attention to other business investments, and there may be no other insider or family member qualified to succeed her as manager. Under these or other circumstances, the owners of a closely held firm may decide to relinquish day-to-day control to a professional manager.

While hiring a manager from outside the ownership circle can solve a variety of problems for a closely held business, it can also lead to costly principal–agent problems. Without the incentive to maximize the value of the owners’ investment, the hired manager may act to enhance her own utility by consuming excess perquisites (expense preference), pursuing personal prestige and power (empire building), rejecting positive net present value projects that have particularly bad outcomes in some state of nature (risk aversion), or simply expending low amounts of effort (shirking). Thus, the owners must incur the costs of monitoring and motivating the hired manager – otherwise the expected financial gains from ceding their control over daily operations may never materialize, or these gains may be expropriated by the hired manager.

Mitigating this principal–agent problem may be more difficult at small, closely held firms than at large, widely held firms. At large corporations, individual shareholders typically have too little invested in the firm to justify the expense of directly monitoring management, but they can vote their displeasure with management ex post by selling their shares into a liquid market for corporate control. In addition, large corporations can rely on a variety of external claimants and specialized agents (e.g., large institutional shareholders, bond rating agencies) to monitor managers, and can use internal control mechanisms such as stock and stock options to motivate managers to act in a value maximizing way. Closely held firms have fewer tools at their disposal: there is no active market for corporate control, outside claimants are few and small, and there is typically only a single specialized agent (a bank lender) monitoring the firm from the outside. And while the primary owners’ large, illiquid equity investments give them an incentive to directly monitor the managers, direct monitoring may not be particularly effective: in many of these firms, the primary owners have ceded managerial control precisely because they no longer have the time, inclination, or ability to run the business themselves.

Thus, observing the performance of small business firms that hire professional outside managers may provide an especially pure test of the classic principal–agent problem. In these small, closely held firms – where market
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