Manager wealth concentration, ownership structure, and risk in commercial banks

Richard J. Sullivan a,∗, Kenneth R. Spong b

a Payments System Research, Federal Reserve Bank of Kansas City, 925 Grand Boulevard, Kansas City, MO 64198, USA
b Banking Studies and Structure, Federal Reserve Bank of Kansas City, 925 Grand Boulevard, Kansas City, MO 64198, USA

Received 25 October 2004
Available online 28 December 2006

Abstract

Of key importance in the governance structure of firms is the role of financial incentives for each major player. The main contribution of this article is an analysis of how an insider’s concentration of wealth in his or her bank investment affects incentives to take risk. Major empirical findings are that, first, bank earnings variation falls when bank managers have more of their wealth concentrated in their banks; second, hired-manager banks become less risky when a person who has significant motivation to monitor bank management has his or her wealth highly concentrated in the bank; and third, stock ownership by hired managers can increase total risk of a bank. Further analysis suggests that community banks in our sample control earnings variation by manipulating idiosyncratic risk, credit risk, and leverage but not systematic risk or the loan-to-asset ratio.

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JEL classification: G21; G34

1. Introduction

A critical issue in operating a business is the effectiveness of a company’s management and ownership structure and its corporate governance systems in determining appropriate risk-return
trade-offs. However, recent corporate scandals and the development and implementation of the Sarbanes–Oxley Act have revealed how little sound evidence there is on what constitutes a good corporate governance system and what type of management, ownership, and board structure will lead to strong performance and effective risk management. This article addresses such issues by looking at how risk-taking behavior is shaped by a bank’s management and ownership structure and the personal financial characteristics of its managers and owners. In particular, the main contribution of this article is an analysis of the extent to which a manager’s or major owner’s concentration of wealth in their bank investment influences risk-taking incentives.

The relationship among management and ownership structure, corporate governance systems, and risk taking is of special interest in banking. From a stockholder’s perspective, assessing the overall level of performance and risk of a bank may be more difficult than in many industries.¹ The liquid nature of many bank assets and liabilities creates a potential for risk exposures to change quickly. The confidential and proprietary information inherent in a bank’s operations also may keep investors from having a clear picture of the risk in a bank’s operations. Moreover, there are important public policy issues and externalities associated with this industry. Because financial crises can disrupt the payments system and the general economy, risk exposures in banking are a fundamental concern of bank supervisors. This task is further complicated by the fact that deposit insurance and other aspects of the public safety net used to protect banking customers may create incentives for bank managers and owners to take excessive risks.

This article will first discuss the theoretical relationship between bank risk, ownership structure, monitoring activity, and managerial and owner wealth, with previous research on these topics providing context to the discussion. The paper then describes the sample of banks to be analyzed and details ownership and management structure and the financial characteristics of managers and other key individuals. We then present a regression analysis relating bank risk to such variables as ownership and management structure and wealth diversification by bank managers. The final section summarizes results and discusses their implications.

2. The relationship between risk taking at banks and their ownership structure, managerial wealth concentration, and monitoring activity

Among factors that are likely to influence the risk position of individual firms are a manager’s ownership position in the firm, the authority exerted by directors and large outside stockholders in setting policies on bank risk-return trade-offs, and the extent to which each of these parties has their own wealth tied up in the firm.

The amount of stock a manager holds in his or her bank is important in determining whether the bank will be subject to the type of principal–agent problems identified by Jensen and Meckling (1976). Such principal–agent problems or agency costs arise when a manager holds little stock in the bank and thus may seek to maximize his or her own utility instead of maximizing the value of the bank and thereby serving the interests of stockholders. The manager does not benefit to the same extent as stockholders from successful outcomes, but could suffer much damage to his or her reputation and human capital investment from unsuccessful ventures. If other factors are comparable, hired managers with little or no ownership stake are likely to be more risk averse than managers with a significant ownership position.

¹ Morgan (2002) found bond raters disagreed more often in rating banks compared to other types of firms, which suggests that banks may be more opaque and have risk exposures that are harder to observe and evaluate.
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