Bank CEO materialism: Risk controls, culture and tail risk

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ABSTRACT

We investigate how the prevalence of materialistic bank CEOs has evolved over time, and how risk management policies, non-CEO executives’ behavior and tail risk vary with CEO materialism. We document that the proportion of banks run by materialistic CEOs increased significantly from 1994 to 2004, that the strength of risk management functions is significantly lower for banks with materialistic CEOs, and that non-CEO executives in banks with materialistic CEOs insider trade more aggressively around government intervention during the financial crisis. Finally, we find that banks with materialistic CEOs have significantly more downside tail risk relative to banks with non-materialistic CEOs.

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1. Introduction

Imprudent risk-taking and ethical lapses associated with the recent global financial crisis damaged public trust in the financial system and resulted in cumulative fines for global banks exceeding $300 billion (McLannahan, 2015). A range of explanations for the pre-crisis behavior of banks has been explored including financial deregulation, failure of risk management functions, and flawed corporate cultures. But many open questions remain. Through what specific channels does bank
deregulation operate to shape the behaviors and tail risk of banks? Why do some banks choose weaker risk management functions than others? What factors drive differences in corporate culture across banks?

To shed light on these questions, we build on research that investigates the proposition that CEOs are heterogeneous and exert substantial influence over corporate decisions and outcomes (e.g., Hambrick and Mason, 1984; Bertrand and Schoar, 2003; Bertrand, 2009). We focus on one specific CEO characteristic, materialism, as measured by a CEO’s relative ownership of luxury goods. The psychology literature defines materialism as a way of life where an individual displays an attachment to worldly possessions and material needs and desires. As noted by Richins and Rudmin (1994), materialism, perhaps more than any other attribute, describes an individual’s real and desired relationship with economic goods. It is tied to the satisfaction an individual derives from the acquisition and possession of goods and is related to the manner by which one pursues economic objectives.

The extant CEO heterogeneity literature focuses primarily on the implications of CEO style at the individual firm level. A distinguishing feature of our paper is that we consider CEO characteristics at the banking sector level by investigating whether the prevalence of materialistic CEOs leading banks increases significantly around major bank deregulation. We also explore individual bank level consequences by considering two key channels through which materialistic CEOs can influence a bank’s behavior and outcomes: the choice of risk management architecture and corporate culture. Finally, allowing that CEO materialism can exert influence through risk control choices, corporate culture and other unobservable channels, we directly examine relations between CEO materialism and both an individual bank’s tail risk and the sensitivity of a bank’s tail risk to aggregate tail shocks.

CEO materialism is particularly pertinent to the banking sector. First, banks must balance the demands of being value-maximizing entities against serving the public interest. High leverage combined with deposit insurance, government guarantees, and bank opacity creates motives and opportunities for decisions that may be optimal for shareholders with limited liability, but not for the economy as a whole if systemic risk is increased. Relevant here is evidence that materialistic people are less sensitive to behaviors that might negatively affect others. For example, Kilbourne and Pickett (2008) find that materialism is associated with reduced concern about the environment, while Davidson et al. (2017) provide evidence consistent with materialistic CEOs pursuing profits at the expense of the environment and other elements of corporate social responsibility. This raises the possibility that materialistic bank CEOs embody values that predispose them to pursue profits while subordinating concerns for negative externalities imposed on other banks and the overall economy.

Second, the financial crisis exposed numerous occurrences of misbehavior, ethical lapses and compliance failures at banks (e.g., Dudley, 2014). In this regard, there is evidence that materialistic individuals are more likely to bend ethical rules to gain possessions (Cohn et al., 2014; Muney and Eastman, 1998).

Third, flawed corporate cultures have been posited as a significant contributor to the financial crisis (Dudley, 2014; Financial Stability Board, 2014; Group of Thirty, 2015). If materialistic CEOs influence a bank’s organizational values and norms of behavior then employees may exhibit heightened propensity for opportunistic behavior (Cohn et al., 2014; Davidson et al., 2015). While a strong control environment can counter such behavior, Davidson et al. (2015) examine non-financial firms and find that materialistic CEOs lead firms in which non-CEO insiders have relatively high probabilities of perpetrating fraud, and where the probability of erroneous financial reporting is relatively higher. Building on these results, we consider the possibility that materialistic bank CEOs oversee relatively lax risk control environments in which incentivized employees can exploit loose oversight to assume tail risks that enhance short run performance at the cost of downside tail risk exposure, and to engage in opportunistic insider trading activities. While such behavior may be in the interests of a bank’s shareholders (e.g., Stulz, 2016), associated negative externalities are nevertheless of significant concern to prudential regulators charged with overseeing the banking system.

Considering the alleged role of deregulation in fomenting the financial crisis (e.g., Stiglitz, 2010), our first analysis explores connections between bank deregulation and the hiring of materialistic bank CEOs. This inquiry into the post-deregulation entry of materialistic individuals into bank CEO positions extends Philippon and Reshef (2012) who provide evidence that financial deregulation spurs the flow of human capital into the finance sector. The 1990s saw significant deregulation of the U.S. financial sector, including branch banking deregulation in 1994 via the Interstate Banking and Branching Efficiency Act, and the Gramm-Leach-Bliley Act in 1999. These regulatory changes significantly increased bank competition (e.g., Rice and Strahan, 2010) and expanded banks’ growth and risk-taking opportunities (e.g., DeYoung et al., 2013). Given an absence of formal theory linking CEO materialism to deregulation, intensity of competition or growth opportunities, we

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3. While for the reasons discussed below our main focus is on CEO materialism, it is plausible that a CEO’s arrest record would be associated with risk management choices and tail risk (Davidson et al., 2015). We show in our analysis that all of our results are robust to controlling for a CEO’s arrest record. In fact, we find that a CEO’s arrest record is unrelated to CEO materialism and has no explanatory power for risk management choices or tail risk.


5. As noted in the survey evidence reported in Graham et al. (2017), a majority of executive officers believe that the current CEO is the most influential person responsible for setting the firm’s current culture, 84% believe that a poorly implemented, ineffective culture increases the chances that an employee might do something unethical or even illegal, and 70% believe executive culture is an important reason their firm takes on the appropriate amount of investment risk, while 29% indicate that ineffective culture leads them to take on too little investment risk to achieve their firm’s goals.

6. The Gramm-Leach-Bliley Act allowed banks to more fully compete in insurance underwriting, securities brokerage, and investment banking.
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