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Corpoate control, bank risk taking, and the health of the banking industry ☆

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Abstract

We present evidence that managerial shareholdings are an important determinant of bank risk-taking. Managerial shareholdings are positively related to total and firm specific risk in the late 1980s when banking was relatively less regulated and when the industry was under considerable financial stress. However, following legislation in 1989 and 1991 designed to reduce risk-taking and also reflecting substantial improvements in bank franchise value, managerial shareholdings and total and firm specific risk became negatively related in the early 1990s. In contrast, systematic risk was unrelated to managerial ownership in both periods. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

The finance literature abounds with attempts to quantify and explain risk taking behavior at commercial banks. Following Merton (1977) much of this research focuses on the incentives created by the fixed-rate deposit insurance system for banks to increase the amount of risk in their asset and liability portfolio (an incentive system referred to as the moral hazard problem). More recently, Keeley (1990, p. 1183) finds evidence to support the hypothesis that "increases in competition caused bank charter values to decline, which in turn caused banks to increase default risk through increases in asset risk and reductions in capital." While there are other explanations of risk-taking focusing on bank (or shareholder) behavior, there is little explicit consideration of the role of bank management in these decisions. Yet it is management rather than shareholders who make the portfolio decisions that determine the risk structure of a bank.

Identifying the link between managerial risk preferences and share ownership is a complex task. Conceptually, it might be expected that managers with small ownership stakes in their banks would behave in a risk averse rather than value maximizing way, as they seek to protect the value of their firm-specific human capital. As their shareholdings increase, however, they have more incentives to engage in risk taking, especially under a fixed rate deposit insurance system that existed prior to 1993 and in a period such as the late 1980s when charter or franchise values were diminished. At some substantial levels of shareholdings, however, managers may become entrenched and no longer make value maximizing decisions. To the extent that managerial entrenchment becomes important, the risk/share ownership relationship may thus become curvilinear.

We provide evidence on the managerial shareholdings-risk relationship from bank stock price data drawn from two distinct time periods with quite distinct regulatory regimes and bank charter values. We conjecture that a positive relationship should exist in the 1987–1989 period as the fixed rate deposits system, lax regulation, and low charter-values encouraged managers to take on additional risk. In contrast, in the latter period, 1992–1994, management risk taking was constrained by additional regulations, including risk-adjusted deposit insurance premiums and also by substantially increased bank charter values.

Our evidence is generally consistent with these arguments. We find that:

1. Total and firm specific risk are positively and significantly related to managerial holdings between 1987 and 1989.
2. Total and firm specific risk are negatively and significantly related to managerial holdings between 1992 and 1994.
3. Systematic risk is unrelated to ownership in both periods.

Existing evidence on the relationship between managerial shareholdings and risk is inconclusive, perhaps reflecting differences in risk measures, different