Journal of Contemporary Accounting & Economics 9 (2013) 83–99

Contents lists available at SciVerse ScienceDirect

Journal of Contemporary Accounting & Economics

journal homepage: www.elsevier.com/locate/jcae

Corporate governance and risk management: The role of risk management and compensation committees

Ngoc Bich Tao, Marion Hutchinson *

School of Accountancy, Queensland University of Technology, Australia

ARTICLE INFO

Article history:
Received 24 February 2012
Revised 4 February 2013
Accepted 6 February 2013
Available online 4 April 2013

Keywords:
Corporate governance
Risk management
Compensation committee
Risk management committee
Firm performance

ABSTRACT

This paper examines the role of compensation and risk committees in managing and monitoring the risk behaviour of Australian financial firms in the period leading up to the global financial crisis (2006–2008). This empirical study of 711 observations of financial sector firms demonstrates how the coordination of risk management and compensation committees reduces information asymmetry. The study shows that the composition of the risk and compensation committees is positively associated with risk, which, in turn, is associated with firm performance. More importantly, information asymmetry is reduced when a director is a member of both the risk and compensation committees which moderate the negative association between risk and firm performance for firms with high risk.

© 2013 Elsevier Ltd. All rights reserved.

1. Introduction

Recent corporate scandals of financial institutions worldwide have raised considerable concern among investors and regulators. Regardless of whether the global financial crisis resulted from excessive risk-taking (Kashyap et al., 2008), or is attributable to the increasing levels of risk faced by firms (Raber, 2003), both views identify risk as the major contributor, and highlight the importance of an appropriate corporate governance structure for managing risk. Consequently, the focus of this paper is on identifying factors associated with monitoring risk in the Australian financial sector. The financial sector in Australia is the largest industry sector based on capitalisation. As of June 2011 the 288 companies in the financial sector of Australia have a market capitalisation of AU$455.7 billion. The financial sector consists of trading and investment banks, asset managers, insurance companies, real estate investment trusts (REIT) and other providers of financial services. In Australia, employers in all sectors are required to contribute to a compulsory employee superannuation scheme.[1] This means Australia has the 4th largest pension fund pool in the world, creating enormous opportunities for banks, asset management, financial planning and insurance companies.[2] Consequently, the governance practices of this sector are important to the economic welfare of Australia.

Agency theory suggests that there are divergent risk preferences of risk-neutral (diversified) shareholders and risk-averse managers which necessitates monitoring by the board (Jensen and Meckling, 1976; Subramaniam et al., 2009). Consequently, without monitoring, risk-averse managers may reject profitable (but more risky) projects which are attractive to shareholders who prefer the increased return from the higher level of risk. Excessive managerial risk-taking is not considered

* Corresponding author. Address: Queensland University of Technology, School of Accountancy, P.O. Box 2434, Brisbane, Australia. Tel.: +61 7 3138 2739; fax: +61 7 3138 1812.

E-mail address: m.hutchinson@qut.edu.au (M. Hutchinson).

[1] Employers are required by law to pay an additional amount based on a proportion of an employee's salaries and wages (currently 9%) into a complying superannuation fund.

[2] http://www.asx.com.au/documents/research/financial_sector_factsheet.pdf.

1815-5669/$ - see front matter © 2013 Elsevier Ltd. All rights reserved.
http://dx.doi.org/10.1016/j.jcae.2013.03.003

problematic for nonfinancial firms because one firm's failure will not affect a diversified investor's portfolio in any directional way. Pathan (2009) suggests that bank shareholders prefer excessive risk due to the moral hazard problem of limited liability and the associated convex pay-off (Jensen and Meckling, 1976).[3] However, Gordon (2011) suggests that this may not be the case in the financial sector. The failure of a systemically important financial firm increases the likelihood that other financial firms will fail due to the cascading effects from the contraction of the financial sector such as occurred in the Global Financial Crisis. Consequently, monitoring excessive risk-taking by management is particularly important in the financial sector. The risk management committee and the compensation committee are both responsible for monitoring and oversight of firms' risk-related activities. Thus, a compensation or risk committee that reduces excessive risk-taking and the probability of the failure of a systemically important financial firm will benefit diversified shareholders.

This paper investigates the association between the risk management committee (RC) and compensation committee (CC) and the risk and performance level of financial firms. We suggest that certain characteristics of committees (size, composition and function) reflect the committees' motivation and ability to increase risk-taking that is aligned with shareholders' interests. The paper therefore predicts a positive association between risk and the structure of the RC and CC. Further, we suggest that firms experiencing increasing levels of risk require a RC and CC that manage and monitor risk to ensure a positive association between risk and performance. The results of the research show that RC and CC characteristics have an important role in the risk level of the firm. Using a principal components analysis we derive a factor score for the characteristics of the committees and use beta as the measure of risk.[4]

This paper also investigates the risk and performance relationship when directors occupy positions on both committees (hereafter, "dual membership"). The study finds a positive association between risk and performance when committee members simultaneously serve on the RC and CC. This result demonstrates lower information asymmetry when directors have responsibilities in both committees as they are able to oversee the association between the firm's risk exposure and the proportion of risk-taking incentives in compensation packages. Subsequently, more informed decisions result in a positive association between risk and performance. The result persists when controlling for endogeneity.

This paper contributes to the literature in several ways. To our knowledge, no other study has empirically tested whether directors' dual-membership on the RC and CC co-ordinates monitoring the risk level of the firm with monitoring the riskiness of compensation packages. Literature on dual committee membership is limited to theory and minimal analysis (Chandar et al., 2012; Hoitash and Hoitash, 2009; Laux and Laux, 2009). Co-ordination between RC and CC functions reduces information asymmetries which affect firm performance. While some research establishes that board committees improve the performance of the firm (e.g., Klein, 1998), there is little research into these committees in Australian companies, and in particular their effect on risk and firm performance. Unlike the US where establishing an audit, nomination and compensation committee is mandated, there is no mandatory requirement for companies to establish committees in Australian firms (apart from Listing rule 12.7).[5] Instead, corporations can choose not to comply with the recommendations as long as they can justify any non-compliance. Consequently, Australia provides an interesting setting to explore the costs and benefits of board sub-committees.

Further, financial sector firms (banks, diversified financial companies, insurance and real-estate investment trusts) have explicitly been excluded from previous research due to the higher level of risk when compared to other firms (Wallace and Kreutzfeldt, 1991) which causes generalisability and transferability problems. In that regard the Australian Prudential Regulation Authority (APRA, 2009) has implemented a framework which regulates financial institutions (see Appendix A). Prudential Standard APS 510 outlines the skills, knowledge and experience requirements for directors involved in risk management.[6]

In recent years, many banks and financial institutions have been widely criticised for paying excessive bonuses to some executive directors and senior management at a time when the world is suffering the consequences of a global financial crisis, said to be a result of irresponsible risk-taking by financial institutions (Pathan, 2009). This study contributes to the literature as there is a paucity of research on whether the compensation and risk management practices of the financial sector are associated with the level of risk and related return. Given that the adoption of RC and CC by Australian companies is voluntary, it is not surprising that the influence of these committees has not been fully explored.

The paper proceeds as follows. In Section 2 we review the relevant literature and present a number of hypotheses. Section 3 describes the research methodology and Section 4 provides the results of the analysis. The final section provides a summary and conclusion.

2. Background and hypothesis development

Financial firms have become large, complex organisations involving significant delegation of decision-making and risk-taking responsibility. Consequently, it is difficult to design internal systems that ensure delegated decision-making outcomes align principal and agent's divergent goals (Devis, 1999). Although information asymmetries can be found in all

[3] Pathan (2009) also suggests that poor bank governance is more catastrophic than non-bank firms as bank failure has more significant costs.

[4] We exclude committee size from the principal components analysis as research finds inconclusive results on the effects of board or committee size.

[5] Listing rule 12.7 requires companies included in the All Ordinaries Index to have an audit committee, whereas companies in the top 300 of the index are required to have their audit committee constituted in terms of recommendations provided by the ASX CGC. These recommendations are on the composition, operation and responsibilities of the audit committee.

[6] "*. . . the requirement for directors, collectively, to have the necessary skills, knowledge and experience to understand the risks of regulated institution, including its legal and prudential obligations, and to ensure that the regulated institution is managed in an appropriate way taking into account these risks*" (APS 510: 3).

متن کامل مقاله

دریافت فوری

ISIArticles
مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات