Journal of Business Research 76 (2017) 52–66

Contents lists available at ScienceDirect

Journal of Business Research

Do financial experts on audit committees matter for bank insolvency risk-taking? The monitoring role of bank regulation and ethical policy

Isabel-María García-Sánchez [a], Emma García-Meca [b,*], Beatriz Cuadrado-Ballesteros [a]

[a] University of Salamanca, Business Faculty, Accounting and Finance Department, Spain
[b] Technical University of Cartagena, Business Faculty, Accounting and Finance Department, Calle Real 3, 30201 Cartagena, Spain

ARTICLE INFO

Article history:
Received 13 May 2016
Received in revised form 8 March 2017
Accepted 9 March 2017
Available online xxxx

Keywords:
Banking sector
Banking regulation
Banking risk
Insolvency
Ethical policies

ABSTRACT

This paper analyses the relationship between the presence of financial experts on audit committees and the levels of insolvency risk in the banking sector. The main contribution is the introduction of banking sector regulation and ethical policies as moderators of this relationship. By using a sample of 159 banks from different countries for the period 2004–2010, empirical results suggest that the presence of financial experts on audit committees is useful to reduce insolvency risk, supporting the monitoring advantage hypothesis of financial expertise. This relationship is stronger when banking sector regulation is weaker and also in banks with stronger policies against unethical practices. These findings suggest that financial expertise *substitutes* regulation and *complements* ethical policies in reducing insolvency risk.

1. Introduction

One of the main concerns about the causes of the current financial crisis is that banks engaged in excessive risk-taking (Minton, Taillard, & Williamson, 2014). Particularly, the insolvency risk management is essential in financial institutions, because failures are very costly at the micro- and macroeconomic levels. Risk management is a fundamental role of the board of directors (Basel Committee on Banking Supervision, 2005, p. 163–164), and particularly of audit committees, whose roles are commonly to oversee financial reporting, internal controls, auditor activity, as well as risk management and exposures.

For these tasks, financial expertise is crucial because a good understanding of generally accepted accounting principles and financial statements will lead to better oversight and more efficient risk-taking behaviour (Güner, Malmendier, & Tate, 2008; Minton et al., 2014). Accordingly, we wonder if the presence of financial experts on audit committees reduces bank insolvency risk-taking. This question is very relevant because it is said that the lack of financial expertise played a key role in the crisis faced by financial institutions like Citigroup, Merrill Lynch and UBS, among others (Strebel, 2009).

Additionally, we take into account two other relevant features that may affect the behaviour of financial experts in risk management, such as banking sector regulation and the level of banks' ethical commitment. Firstly, the banking industry is characterised by very intense regulation due to the crucial role of financial institutions in any economy (Millineux, 2006), so regulatory environment should be taken into account. Secondly, since several scandals in the banking sector came to light, financial institutions have adopted a more social orientation in their businesses (Paulet, Parnaudeau, & Relano, 2014), incorporating policies against corruption, bribery, and fraud; thus, every management decision (e.g., risk-taking) could be affected by the extent of the ethical commitment.

Therefore, the aim of this paper is to study the role of financial experts on audit committees on the levels of banking insolvency risk, and extending the study to control for banking sector regulation and internal ethical policies. Thus, we use a sample of individual banks from economies with different regulations, yielding a database of 159 banks from nine countries over the period 2004–2010.

Our findings indicate that the presence of financial experts on audit committees reduces the insolvency risk taken by banks. In addition, this effect is stronger in banks with higher levels of policies against unethical practices; thus, these two governance mechanisms are complementary in controlling insolvency risk levels. Furthermore, the reduction of insolvency risk by financial expertise of audit committees is stronger in countries with weaker regulatory environments, suggesting that financial expertise substitutes regulation as a governance mechanism by controlling insolvency risk.

The main contribution of this study is the introduction of bank regulation and ethical policies as moderators of the relationship between audit committee effectiveness and bank risk-taking, previously studied by Sun and Liu (2014), Minton et al. (2014), Fernandes and Fich (2016), among others. According to Ciancanelli and Reyes (2001), we show that regulation and ethical policies may alter the parameters of

* Corresponding author.
E-mail address: emma.garcia@upct.es (E. García-Meca).

http://dx.doi.org/10.1016/j.jbusres.2017.03.004
0148-2963/

governance in banks. In addition, the role of audit committees in the banking sector is highlighted, beyond the role of the board of directors in general (Minton, Taillard, & Williamson, 2011; Pathan, 2009).

Our findings have relevant practical implications, as they suggest that board independence is not enough to make boards accountable and effective, showing that financial experience is a more important key issue for banks, especially in environments with weak banking sector regulation. This leads to relevant implications for several parties, such as auditors, institutional investors, regulators, potential new board members and other corporate governance reform proponents who frequently examine board characteristics to assess the effectiveness of boards in monitoring bank risk-taking, providing important policy implications for the design of corporate boards.

This study also contributes to the growing empirical literature that has documented the effects of banks audit committee composition on fraud and earnings restatements (e.g., Abbott, Parker, & Peters, 2004; Agrawal & Chadha, 2005), financial reporting quality (Felo, Krishnamurthy, & Solieri, 2003) and earnings management (Carcello, Hollingsworth, & Neal, 2006; Xie, Davidson, & DaDalt, 2003). This study provides additional evidence in terms of insolvency risk, documenting an effect of banks audit committee composition on the levels of solvency. Concretely, the presence of financial experts seems reducing the insolvency risk taken; although our findings suggest that benefits of having financial experts on boards are higher in banks with high ethical standards than in those set in countries with strong regulatory and supervisory practices.

The remainder of the paper is organised as follows. Section 2 reviews the main theoretical ideas and states our hypotheses about the effect of financial expertise of audit committees on the level of insolvency risk-taking, setting different regulatory environments and different degrees of ethical commitment. Section 3 describes the sample, data and empirical methods. Section 4 contains the empirical results and Section 5 provides some concluding remarks.

2. Theoretical framework and research hypotheses

2.1. The role of financial experts in managing risk

There is a high debate on the requirements for being considered a 'financial expert'.[1] Now, it is generally accepted that financial experts have notably knowledge, skills and experience in financial and accounting issues. Thanks to their abilities and know-how, they are able to understand accounting techniques and financial instruments, which are technically complicated, and that other members are not able to understand (Dhaliwal et al., 2010). They are usually investment bankers and financial analysts, who have considerable experience in carrying out due diligence with regard to mergers, acquisitions and equity offerings, as well as having a strong background in estimating earnings forecasts and providing stock recommendations (Dhaliwal et al., 2010). The benefit from financial experts is their ability to oversee accounting controls and financial reporting, thus preventing possible reporting failures, litigation and scrutiny from policymakers, and assisting the audit committee to assess the bank's exposure to different risks.

Thanks to their knowledge and experience, financial experts may lead the board to be better able to understand the complexity of projects and their associated risks; thus they may avoid risks that are unsound for the solvency of the firm. Empirically, Fernandes and Fich (2013) find that more financial experts serving as outside directors tend to limit the risk exposure of banks, in terms of Tier 1 ratio, loans-to-deposits ratio, loans-to-assets ratio, annual beta, etc. They refer formally to this result as the *monitoring advantage hypothesis* of financial expertise – i.e., such directors would be endowed with the knowledge, incentives, and abilities required to monitor, discipline and advise managers, enabling them to alleviate conflicts of interest between insiders and shareholders.

However, it is precisely the financial knowledge of experts that may lead board members to encourage risky activities, with the aim of increasing the residual claims of shareholders (Acharya, Philippon, Richardson, & Roubini, 2009; Merton, 1977). In this respect, Minton et al. (2014) find that the level of financial expertise among independent directors is positively related to banks' risk-taking both before and during the financial crisis. Due to bank shareholders' preferences for 'excessive risk', under the *moral hazard hypothesis* (Fernandes & Fich, 2013), a more financially knowledgeable board is also better equipped to understand more complex investments. This might encourage increasing their risk-taking activities if they believe that doing so will increase firm value.

However, this orientation is less probable when we speak about audit committees because one of their fundamental roles is, precisely, the identification and handling of risks and evaluating effectiveness of operations in risk management, assuring the risk policies are being followed (Van Greuning & Bratanovic, 2009). In this task, qualified members are essential, who ensure risk management through their diligent oversight efforts (DeZoort, Hermanson, Archambeault, & Reed, 2002). Thus, we expect that the presence of financial experts on audit committees tends to reduce insolvency risk levels in banks, as we propose in the following hypothesis:

Hypothesis H1. *Financial experts on bank audit committees reduce the level of insolvency risk-taking.*

2.2. The role of banking regulation

Apart from the large opacity of the banks' balance sheet, they are characterised by intense regulation (Mecheli, Cimini, & Mazzocchetti, 2017). Since the payment system and economic development depend on the bank's financial health, and banking failure may result in systemic crisis, regulation plays a relevant role in the financial sector (Flannery, 1998). Indeed, a number of studies have pointed to weakness in regulation and supervision as one of the factors leading to the credit crisis (Barth, Caprio, & Levine, 2012; Chan-Lau, 2010; Levine, 2010; Merrouche & Erland, 2010).

Regulation should be understood as the way for governments to signal their intent about good practices and commitment to enforce, instead of just a narrow set of rules (Mahoney, 2001). Accordingly, monitoring the functioning of banks is usually considered an external corporate governance mechanism, limiting the level of risk-taking, and securing the pay-out for each depositor. Regulation could increase the visibility of corporate governance through enhanced public scrutiny (Joskow, Rose, Shepard, Meyer, & Peltzman, 1993), thus strong regulatory environments may coerce banks into adopting effective governance structures (Adams & Ferreira, 2012).

Typically, regulation and other internal corporate governance mechanisms (e.g., board of directors) are viewed as complementary tools (Becher & Frye, 2011). However, such a relationship is not clear yet (Adams & Ferreira, 2012); regulation could also substitute traditional monitoring mechanisms (Becher, Campbell, & Frye, 2005; Caprio, Laeven, & Levine, 2007; Kole & Lehn, 1999). As regulators can fine or

[1] Generally, financial experts are those with knowledge, skills and experience in financial and accounting issues (Blue Ribbon Committee, 1999, p. 25), but there is controversy regarding a more formal definition, especially in terms of accounting versus non-accounting (financial) expertise (see Carcello et al., 2006; Davidson, Xie, & Xu, 2004; Dhaliwal, Naiker, & Navissi, 2010). For instance, SOX provided a narrow definition of financial experts, including only accounting and auditing experience, but the SEC adopted the broader definition of the Blue Ribbon report (Blue Ribbon Committee, 1999, p. 25), including not only accountants but also professionals with non-accounting financial background: '… past employment experience preparing, auditing, analysing, or evaluating financial statements or experience actively supervising one or more persons engaged in such activities' (SEC, 2003). This broad definition is generally accepted, and national securities commissions require experience in preparing, auditing, analysing or evaluating financial statements and the ability to assess the application of accounting principles.