The Importance of Corporate Governance in the Financial Crisis Period

Professor Huimin Chung (鍾惠民)
Graduate Institute of Finance, National Chiao Tung University
Associate Editor, Corporate governance: An International Review
chunghui@mail.nctu.edu.tw

May 27, 2010
Agenda

- Recent Development of Corporate Governance
- Corporate Governance and Performance Variability
- Banking Governance and Performance during Financial Crisis
SME

Corporate governance mechanisms help SMEs to transit from relationship based management to rule based management. Hence, it helps to create a sustainable growth business model for SME.

Corporate governance provides a balance among growth, profit, finance and control for SME.

- Strategic goals varies in different periods during the lifecycle of SME
- Without corporate governance, goals can be reached through inconsistent actions that put the organization at risk.
SME

CG recommends the use of input and process measures to reduce the possibility of a faulty implementation and a bad investment decision.

A typical reaction to employees doing “wrong” things is to blame them as “unethical” rather than accepting that a poorly designed incentive system may be the cause for it.
Align incentives through earn-out, …
SME managers focus on some of the right measures: sales growth, but they might completely forget costs and profits.

- Revenue portion of new product/ last year RD
- Market share
- Profit per product line
- Increases in sales/ selling and admin expenses

SME Profit plan with good corporate governance

- Negotiate the level of discretionary expenses (RD)
- Force the company to articulate a long term vision and balance the short term orientation of the earn-out.
- Be able to evaluate whether the actual level of expenses was appropriate or too high. (CONTROL)
• KPI
  • There is a need to balance the short run goal and the long run goal.

• Output control + process control
  • The current earnout structure only focus on output control
  • ROA, ROE, OI/head; gross margin, growth rate, RD; Customer satisfaction, QC
Key concepts

- Controlling innovation and entrepreneurial activity
- Selecting measures for control and performance evaluation
- Designing interactive systems to adapt to market conditions
- Managing business and franchise risk
- Monitoring implementation of strategy
With good corporate governance
  • Maximize shareholder value.
  • Motivate and compensate employees
  • Build a good relationship with suppliers and customers
  • Be responsible to corporate social responsibility

Less vulnerable in financial crisis periods; low probability of financial distress
Recent Development of Corporate Governance
Governance Systems

- Board structure
- Director and officer labor markets
- Ownership structure
- Compensation and incentives
- Debt and agency costs
- Antitakeover market
- Capital market governance
- Fraud
- Lawsuits
- Regulation
Corporate Governance and Balance Sheet
Internal Governance

- Management
  - making decisions on in which assets to invest, and how to finance those investments
- The Board of Directors
  - being charged with advising and monitoring management and has the responsibility to hire, fire, and compensate the senior management team (Jensen, 1993)
External Governance

- The elements of external governance arising from firm’s need to raise capital
  - It highlights that in the publicly traded firm, a separation exists between capital providers and those who manage the capital
- The diagram also captures the link between shareholders and the board
  - Shareholders
    - The residual claimants, elect board members.
  - Boards
    - As established in state law, owe a fiduciary obligation to shareholders
The figure provides a more comprehensive perspective of the firm and its corporate governance

- The figure depicts *other participants* in the *corporate structure* in, including employees, suppliers, and customers.

When added to participants outlined in the figure, we have the *nexus of contracts* view of the firm

By incorporating the community in which firms operate, the political environment, laws and regulations, and more generally the markets in which firms are involved
Internal Governance - Boards of Directors

- Traditionally, research on corporate boards has focused on links between board structure and firm value, governance choices, and investment and financing decisions.
  - While board size and the independence of the board from corporate management play central roles in the research to date (Rosenstein and Wyatt, 1990; Yermack, 1996).

- Recent empirical work focuses on the evolution of board structure over time, and changes in board structure post-Sarbanes–Oxley (SOX).
  - Chhaochharia and Grinstein (2007) focus on recent changes in board structure, finding that board size and independence have increased since SOX.
During the 1990s, academics and practitioners alike argued in favor of equity-based compensation (particularly stock options) as a mechanism for aligning the incentives of managers and shareholders (e.g. Jensen, 1993).

Denis et al. (2006) ask: Is there a dark side to incentive compensation?

- YES.

- The authors find a positive association between option use and the likelihood of fraud allegations.

Expanding the analysis to include ownership structure, they find the link between option use and alleged fraud is stronger in firms with high outside block ownership and institutional ownership.
A number of papers examine multiple classes of stock, which typically entail different voting and cash-flow rights, and corporate performance.

My primary focus here, however, is on governance and debt.

- Debt can act as a self-enforcing governance mechanism

Recent empirical work on corporate governance and capital structure focuses on the association between governance and the cost of debt

- Bryan et al. (2006) observe that while the agency costs of debt, which include underinvestment, asset substitution, and financial distress became less likely during the 1990s, firms became more difficult to monitor, and thus the agency costs of equity rose
Internal Governance - Bylaw and Charter Provisions

- The Bylaw and Charter pertain to those governance features that serve as potential barriers to the market for corporate control.

- Early empirical work suggests that antitakeover measures (ATMs), on average, entrench managers, given the negative abnormal returns surrounding their adoption.

- Recently, papers by Daines and Klausner (2001), Field and Karpoff (2002), Bebchuk and Cohen (2005), Bebchuk et al. (2003), and Gompers et al. (2003) have raised concerns about the use of antitakeover measures.
  - These papers suggest that increased use of antitakeover measures is associated with poor performance.
External Governance - Law/Regulation

- There is a broad literature, starting with La Porta et al. (1997) focusing on corporate governance and how it relates to the legal protections afforded shareholders and creditors.
  - The authors suggest that legal differences account for differences in the breadth and depth of financial markets, and in the ability of firms to access external finance.

- In an interesting addition to this area, Daouk et al. (2006) examine the link between capital market governance (CMG) and several key measures of market performance.
  - The findings that improvements in the CMG index are associated with decreases in the cost-of-equity, increases in market liquidity, and increases in market pricing efficiency.
Markets 1: Capital, Control, Labor, and Product Markets

- In this section, I discuss the importance of ownership structure to corporate governance.
- The monitoring role of institutional investors.
- The role of blockholders.
- The market for corporate control may be double-edged in that it also provides a means by which inefficient managers may indulge in empire building through ill-advised acquisitions (Bittlingmayer, 2000).
- The finance literature on labor markets focuses on CEOs, board members, and members of senior executive teams.
- A number of papers focus on product market competition and its relation to different aspects of corporate governance, including compensation structure and CEO turnover.
Markets 2: Capital Market Information and Analysis

- Chung and Jo (1996) argue that securities analysts reduce agency costs by monitoring corporate management and providing information about firms to the market.
- Bethel and Gillan (2002), Morgan and Poulsen (2001), and Morgan et al. (2006) provide evidence that negative voting recommendations from governance analysts are associated with significantly lower levels of voting support.
Markets 3: the Market for Services

- Early work in this area, link between director and officer (D&O) liability insurance and corporate governance.
- Recent work also focuses on the relationship between firms and their external auditor.
  - Payments from firms to external auditors for non-audit services compromise the integrity of the audit process, as some critics suggest was the case with Arthur Andersen and Enron.
Private Sources of External Oversight

- The media clearly plays an important role in reporting on corporate America and its corporate governance.
  - Dyck and Zingales (2002) conclude that the media affects corporate policies toward the environment and the extent to which corporate resources are diverted to the advantage of controlling shareholders.
- Plaintiffs’ bar – or lawsuits.
  - Haslem (2005) examines a broad range of suits including antitrust, breach of contract, labor-related, patent infringement, and shareholder class actions.
  - He reports that going to court appears to dominate settling litigation from a shareholder wealth perspective.
A Broad Perspective on the Issues

- Gompers et al. (2003) examine the relation between 24 different antitakeover measures and firm performance, amongst other issues.
- Danielson and Karpoff (1998) examine both antitakeover measures and board independence.
- Gillan et al. (2003) study the relation between industry characteristics and board size, independence, board committee structure, and the use of antitakeover provisions.
- Black et al. (2006) find that Korean firms’ corporate governance practices are strongly influenced by regulatory considerations, particularly for larger firms because they are subject to more stringent rules.
Discussion and Conclusion

- The papers in this issue, and governance research more generally, fall into one of three broad classifications:
  - **Performance** as a function of governance
    - e.g., Tobin’s Q as a function of board structure
  - **Governance** as a function of governance
    - e.g., CEO pay in relation to ownership structure
  - Increasingly, the impact of governance on performance
    - Explaining variation in governance structures as a function of **firm and industry characteristics**
Discussion and Conclusion

- Traditional empirical research is increasingly under attack from critiques of endogeneity.
  - Coles et al. (2003), Zingales (2000) and Himmelberg (2003) amongst others, to further develop structural models or quantitative theories of the firm to guide empirical work.
- Researchers must continue to be careful with their experimental design – particularly with regard to issues of endogeneity and omitted variable biases.
- Careful modeling of transactional events (e.g., mergers and acquisitions, CEO turnover, etc.) and how they relate to governance characteristics will continue to be a staple of governance research.
Corporate Governance and Performance Variability
CEO Power in Decision Making

- Decision making
  - The CEO makes all the major decisions
  - The decisions are the results of consensus among the top executives and directors’ discussions
- The distribution of decision-making power within firms affects which decisions are made
  - In a firm in which the CEO makes the most relevant decisions, the risk arising from judgment errors is not well diversified
  - The likelihood of either very good or very bad decisions is higher in firms with powerful CEO than in firms with many executives involved
CEO Power and Performance

- Consensus
  - CEO compensation provide incentives for performance
  - CEO turnover lead to higher operating outcomes

- Controversies
  - CEO options or other compensation arrangements may lead to higher risk-bearing
  - CEO characteristics may affect the performance
  - CEO duality may provide efficient strategic decisions
  - CEO power against board of directors may lead to severe agency conflicts
Mechanisms of CEO Power

- Project-selection aspect
  - Larger groups are more likely to reject bad projects because a project will only be accepted if several group members agree that it is good
  - Performance should be less variable when a greater number of executives have influence over decisions

- Cost-of-Information-process aspect
  - Managers may disagree the projects based on costly communication or inability to process information
Mechanisms of CEO Power

- Discretion aspect
  - Managerial impact on organizational outcomes depends on how much discretion they have
  - In situations in which the CEO is more powerful, he has more discretion to influence decisions

- Consensus aspect
  - Group consensus represents an averaging, a compromise among individual positions

- Agency theory
  - An inverse aspect suggesting that when uncertainty (performance variability) exists, principals will put more constraints on agent’s behavior
Measurement of Performance Variability

• Most of the governance-related literatures focus on the effects on the level of corporate performance, whilst the variability is a new factor to consider when evaluating governance mechanisms

• Absolute value of residuals of stock returns, ROA, or Tobin’s Q residuals

• Standard deviation of
  • Stock returns, ROA, or Tobin’s Q
  • Total or abnormal accruals and extraordinary items
  • Analyst forecast inaccuracy
  • R&D and capital expenditure
  • Acquisition, divestitures, spin-offs, restructuring and acquisition from other industry
Measurement of CEO Power

- CEO power
  - The formal or informal sourced ability of CEO to influence, to control, and to overcome resistance
  - CEO is one of the founders
  - CEO is the only insider on the board
  - CEO is the chair or the president
  - CEO’s ownership is relatively large
  - CEO’s tenure is long
# CEO Power and Performance Variability

<table>
<thead>
<tr>
<th>CEO is …</th>
<th>Excess stock returns</th>
<th>ROA residual</th>
<th>Tobin’s Q residual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Only insider on the board</td>
<td>+</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>Chair and president</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Ownership</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Ownership$^2$</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Tenure</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Tenure$^2$</td>
<td>-</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

Note: the data is from the sample of Fortune 500 companies from 1992 to 1999
CEO Power and Performance Variability

- Adams, Alemeida and Ferreira (2005, RFS) find that CEO power↑
  The degree to which the performance deviates from the average↑
- Although the CEO power may bring operating performance, such power could lead to extremely higher or extremely lower operating performance
CEO Power and Performance Variability

- Adams, Alemeida and Ferreira (2005, RFS) also find that CEO ownership↑ and CEO ownership^2 ↓
  The degree to which the performance deviates from the average↑
- CEO will tend to maximize the benefits of their shareholdings by engaging in risk-taking investments and businesses, further leading the larger performance variability
- However, as their ownership increase to a certain level, they may be faced with even larger uncertainties. They will recognize and keep away from the potential risks by stbalizing the growth in performance
## CEO Power and Performance Variability

<table>
<thead>
<tr>
<th>CEO is...</th>
<th>Stock returns</th>
<th>ROA</th>
<th>Tobin’s Q</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Only insider on the board</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Chair and president</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Ownership</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Ownership$^2$</td>
<td>-</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Tenure</td>
<td>-</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>Tenure$^2$</td>
<td>-</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: the data is from the sample of Fortune 500 companies from 1992 to 1999
CEO Power and Performance Variability

- CEO power↑
  - The standard deviation of performance↑
- Higher CEO power lead to higher performance variability
  - The performance variability is caused by CEO power through the position of
    - Founder
    - Only insider
    - Chair and president
- The CEOs ownership can be benefited through the increase in stock returns caused by their powerful influence on decisions
CEO Power and Performance Variability with Subsample of Varied Discretions

<table>
<thead>
<tr>
<th>CEO is ... in high discretion industry</th>
<th>Absolute value of</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Excess stock</td>
<td>ROA residual</td>
<td>Tobin’s Q residual</td>
</tr>
<tr>
<td>Founder</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Only insider on the board</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Chair and president</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CEO is ... in high discretion industry</th>
<th>Standard deviation of</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Stock returns</td>
<td>ROA</td>
<td>Tobin’s Q</td>
</tr>
<tr>
<td>Founder</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Only insider on the board</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Chair and president</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

Note: the data is from the sample of Fortune 500 companies from 1992 to 1999
CEO Power and Performance Variability with Subsample of Varied Discretions

- For firms where managers are provided with more discretion to influence the corporate decisions, CEO power $\uparrow$

  The standard deviation of performance $\uparrow$

- The effect of CEO power on performance variability is particularly true for those firms providing larger discretions for their CEOs
Other Unanswered Questions

- Based on the previous evidence, the higher CEO power leads to performance variability.

- The question to be answered is whether there is any internal governance mechanism that can balance the power from executives and board of directors, further reducing the performance variability.

- Is it possible that
  - Larger board members could strengthen the shareholders’ interests?
  - Independent directors play a crucial role against CEO power?

- Cheng (2008, JFE) provides empirical evidence on the research questions.
Controversies over the Board Size

- Benefits of smaller board size
  - Board members can speak out their thoughts freely by frank discussions
  - Decision making process is more efficient
- Drawbacks of smaller board size
  - Lack of directors with expertise and/or experiences
  - Insufficiency in monitoring the management
  - The board is more easily controlled by powerful CEO
  - Mutual favor behaviors are more prevalent
Controversies over the Board Size

- Benefits of larger board size
  - Providing suggestions from different point of view to the business strategies
  - Acquiring more advices
  - Committee members are more experienced experts
  - Making less extreme decisions

- Drawbacks of larger board size
  - Communication/coordination problem: it takes more effort to reach consensus
  - Agency problem: free riding behaviors
Potential Problems of Board Meeting

- Agency problem
  - Directors normally do not criticize the policies of top managers or hold candid discussions about corporate performance, particularly pronounced in larger boards

- Free riding problem
  - The cost to any individual director of not exercising diligence in monitoring management falls in proportion to the total number of board directors

- Communication/coordination problem
  - When a board becomes larger, it is more difficult to arrange meetings and to reach a consensus
  - Larger boards are less efficient and slower in decision-making
Effects of Board Size

- Communication/coordination problem
  - A larger board size moderate the extremity of board decisions
  - Larger boards’ decisions tend to be less extreme, neither very good or very bad

- Aspect of social psychology
  - Group decision making gives rise to diversified opinions, as individuals’ judgment entails errors, communication is costly, and individuals differ in their abilities to process information
  - A group’s final decision is a compromise that reflects the different opinions
  - Larger groups have a greater likelihood to reject risky projects because a project has to be considered as good by several group members
# Internal Governance Mechanisms and Performance Variability

<table>
<thead>
<tr>
<th></th>
<th>Absolute value of stock returns residuals</th>
<th>ROA residuals</th>
<th>Tobin’s Q residuals</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board size</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Proportion of independent director on the board</strong></td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td><strong>CEO is founder</strong></td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td><strong>CEO ownership</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Standard deviation of stock returns</th>
<th>ROA</th>
<th>Tobin’s Q</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board size</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Proportion of independent director on the board</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>CEO is founder</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>CEO ownership</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>
Internal Governance Mechanisms and Performance Variability

- Using the absolute value of performance residuals and standard deviation of performance as the proxy of variability,
  - Board size $\uparrow$
    - Performance variability $\downarrow$
  - Proportion of independent director on the board $\uparrow$
    - Performance variability $\downarrow$
  - CEO power (CEO is founder) $\uparrow$
    - Performance variability $\downarrow$
  - CEO ownership $\uparrow$
    - Performance variability $\downarrow$
Other Factors of Performance Variability

- Total accruals
  Earnings from continuing operations minus cash flows from continuing operations

- Abnormal accruals
  The residuals obtained from regressing total accruals on the difference between changes in sales and changes in receivables, as well as the gross value of property, plant, and equipment (the modified Jones model in Dechow, Sloan, Sweeney, 1995)

- Extraordinary items
  Unusual items designated by the company as extraordinary and presented after net income from continuing and discontinuing operations
## Internal Governance Mechanisms and Other Factors of Variability

<table>
<thead>
<tr>
<th></th>
<th>Mean of Total accruals</th>
<th>Abnormal accruals</th>
<th>Extraordinary items</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board size</strong></td>
<td>-</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td><strong>Independent director</strong></td>
<td>-</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td><strong>CEO is founder</strong></td>
<td>-</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td><strong>CEO ownership</strong></td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Standard deviation of Total accruals</th>
<th>Abnormal accruals</th>
<th>Extraordinary items</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board size</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Independent director</strong></td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td><strong>CEO is founder</strong></td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td><strong>CEO ownership</strong></td>
<td>-</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>
## Internal Governance Mechanisms and Other Factors of Variability

<table>
<thead>
<tr>
<th>Mean of Analyst forecast inaccuracy</th>
<th>R&amp;D expenditure</th>
<th>Capital expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board size</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Independent director</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>CEO is founder</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>CEO ownership</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Standard deviation of Analyst forecast inaccuracy</th>
<th>R&amp;D expenditure</th>
<th>Capital expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board size</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Independent director</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>CEO is founder</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>CEO ownership</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>
Internal Governance Mechanisms and Other Factors of Variability

- Operating cash flow
  - Larger board size reduce variation in accounting accruals
  - The effects of independent directors and CEO ownership on accounting accruals remains controversial

- Investing cash flow
  - Larger board size reduce variation in R&D expenditures
  - CEO power (CEO is founder) and ownership will reduce the uncertainty caused by variation in R&D expenditures
  - Larger CEO ownership is more likely to take varied capital expenditures
# Internal Governance Mechanisms and Other Factors of Variability

<table>
<thead>
<tr>
<th>Mean of</th>
<th>Mean of Acquisition</th>
<th>Mean of Acquisition, divestitures, spin-offs, restructuring</th>
<th>Mean of Acquisition from other industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board size</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Independent director</td>
<td>-</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>CEO is founder</td>
<td>+</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>CEO ownership</td>
<td>-</td>
<td>-</td>
<td>+</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Standard deviation of</th>
<th>Mean of Acquisition</th>
<th>Mean of Acquisition, divestitures, spin-offs, restructuring</th>
<th>Mean of Acquisition from other industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board size</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Independent director</td>
<td>-</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>CEO is founder</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>CEO ownership</td>
<td>-</td>
<td>-</td>
<td>+</td>
</tr>
</tbody>
</table>
Internal Governance Mechanisms and Other Factors of Variability

- Financing cash flow
  - Larger board size lead to lower inaccuracy of analyst forecasts
  - Larger board size is incapable of deciding whether it satisfies the interests of the firm to acquire (or to be acquired by) other firms
  - Such phenomenon is also prevalent in discussing the decisions on divestitures, spin-offs, or restructuring
Practical Implications

- Lower CEO power and larger board size lead to lower performance variability
- One of the main reasons of causing financial crisis is the selling (initializing, packaging, or securitizing) of extremely complex derivatives
- During the financial crisis, banks using less credit-linked derivatives for creating performance are burdened with lower costs
- Such governance mechanism is due to the reason that the board of directors make decisions based not only on the future profits suggested by executives, but also on potential risks arise from the compromised opinions provided by directors with different expertise
Banking Governance and Performance during Financial Crisis
Extended Questions on Board Independence

- The effects of independent directors on performance (variation) is insignificant and inconsistent in the past literatures.
- However, internal governance mechanisms are indeed crucial to preventing the crisis.
  - Hellwig (2009 De Economist) suggest that the incentives, the external governance (market discipline) as well as the internal governance (risk control), were too weak to force the people to take a comprehensive account for the overall risk exposure of the institution.
- The research question of whether the board independence is helpful of diminishing the reduction in operating performance during the credit crunch remains controversial.
Moral Hazard in Banking Business

- Business Model in Banking Industry
  - Large commercial banks had been transitioning their retail businesses away from the traditional “originate-and-hold” lending model that relies on interest income generated from repeat borrower-lender relationships, and toward an “originate-and-distribute” loan securitization model that relies heavily on the fee income generated by non-repeat, arms-length financial transactions (e.g.: MBS).
  - These bundles of relatively risky business policies exposes high pay-risk sensitivity banks to greater systemic risk, and thus exacerbates the financial stress.
Moral Hazard in Banking Business

- Hellwig (2009, De Economist)
  - Because the banks responsible for origination did not hold any equity shares, they did not have much of an incentive to take care in borrower creditworthiness assessments
  - Similarly, the banks involved in securitization did not have much of an incentive to impose and enforce creditworthiness standards to be met by originators
  - Both, originating and securitizing institutions, were more interested in volume than in quality control
Governance and Financial Crisis

- Laeven and Levine (2009, JFE)

Using the data of 10 largest listed banks in 48 countries over 1996-2001, they find that

- Banks with powerful owners will take higher risks
- Equity owners have stronger incentives to increase risks than the non-shareholding managers and debt holders
- The effect of bank regulations on risk taking depends critically on the ownership structure
- The dependence is also significant for the restriction on bank activities and deposit insurance policies
Governance and Financial Crisis

- Pathan (2009, JBF)
  Using the data of 212 largest bank holding companies in US over 1997-2004, they find that
  - Smaller board size leads to bank risk-taking
  - Less restrictive (non-staggered) board leads to bank risk-taking
  - Proportion of independent directors who view themselves as the role in balancing the interests of shareholders and other stakeholders (e.g.: depositors and regulators) negatively relates to bank risk-taking
  - CEO power negatively relates to bank risk-taking
Erkens, Hung and Matos (2009) Using the data of 306 financial firms in 31 countries over 2007-2008, they find that

- CEO turnover was more sensitive to poor performance for firms with
  - more independent boards of directors
  - larger institutional ownership
  - less insider ownership
- Compared with the equity-based remuneration, firms providing CEO compensation with higher annual bonus took more risk before the crisis, and experienced larger losses during the crisis
Governance and Financial Crisis

- Erkens, Hung and Matos (2009)
  - Consistent with the argument that the crisis is partially attributable to pressure for short-term profit for outsiders, the find that
    - Firms with higher institutional ownership took more risk before the crisis, and experienced larger losses during the crisis
    - Firms with more independent directors experienced larger losses during the crisis
Governance and Financial Crisis

Why discussing internal governance?

- Hellwig (2009, De Economist)
  - The focus on yield at the expense of risk may be reinforced by external governance mechanisms that rely heavily on market discipline

- Illueca, Norden and Udell (2008)
  - Using the Spanish government-owned saving banks during the deregulation period of 1996-2004, they find that the board of directors limits their ex ante risk-taking behaviors
Governance and Financial Crisis

Why using independent directors as the proxy of governance?

- Hellwig (2009, De Economist)
  - The best governance for risk control at the level of the individual institution will not be able to forestall a crisis if the participants do not have the information they need for a proper assessment of risk exposure.

- OECD (2009a, 2009b)
  - The most important policy issue concerns the normative proposal that boards be capable of independent judgment.
  - We suggest that the independent directors on the board are capable of acquiring sufficient information needed, further limiting excess-risk-taking business.
Arguments

- If a bank appoints more independent directors on the board, the monitoring power would increase, further limiting excess-risk-taking behaviors. Such balancing involvement for the interests between owners and other stakeholders leads to better operating performance.

- **Hypothesis 1**: Firms appointing more independent directors on the board (auditing committee, nominating committee, compensation committee and risk committee) will have higher operating performance.

- **Hypothesis 2**: Firms appointing more independent directors on the board (auditing committee, nominating committee, compensation committee and risk committee) will have lower losses in operating performance during the period of 2007-2008 credit crunch.
Arguments

Proportion of independent directors on the
- Board
- Auditing Committee
- Nominating Committee
- Compensation Committee
- Risk Committee

Dummy of the period of Financial Crisis

Stock returns ROA ROE
Methodologies – Model

Stock Returns (ROA, ROE) = \( f(\text{IND, MF, P, CC, CR, LR, TA, LLR, LOR, RSB, PM, RTR, SR, Y08}) \)

IDP: Proportion of Independent directors
MF: Proportion of shares held by mutual funds
P: Proportion of shares held by private firms
CC: Coefficient of Correlation (Ri,Rm)
CR: Current ratio
LR: Liability ratio
TA: Total assets
LLR: NPL coverage ratio
LOR: Loan to value ratio
RSB: No. of subsidiaries
PM: Profit Margin
RTV: Turnover ratio
SR: Servicing ratio
Y08: Year-dummy of financial crisis
Methodologies – Data

• Sample: the largest 20 banking institutions in 11 countries (US, UK, Canada, France, German, Italy, Japan, Switzerland, Hong Kong, Singapore, Australia)

• Period: from 2005 to 2008
  - Ordinary subsample: from 2005 to 2006
  - Credit-crunch subsample: from 2007 to 2008

• Database: OSIRIS
Banking Board Independence and Operating Performance

<table>
<thead>
<tr>
<th>Proportion of independent director on the:</th>
<th>05 ~ 06</th>
<th>07 ~ 08</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board</td>
<td>Returns (+)</td>
<td>Returns (+)</td>
<td>Returns</td>
</tr>
<tr>
<td></td>
<td>RSR</td>
<td>ROA, ROE</td>
<td></td>
</tr>
<tr>
<td>Auditing Committee</td>
<td>Returns</td>
<td>Returns (+)</td>
<td>Returns (+)</td>
</tr>
<tr>
<td></td>
<td>RSR</td>
<td>ROA, ROE</td>
<td></td>
</tr>
<tr>
<td>Nominating Committee</td>
<td>Returns</td>
<td>Returns (+)</td>
<td>Returns</td>
</tr>
<tr>
<td></td>
<td>RSR</td>
<td>ROA, ROE</td>
<td></td>
</tr>
<tr>
<td>Compensation Committee</td>
<td>Returns</td>
<td>Returns (+)</td>
<td>Returns (+)</td>
</tr>
<tr>
<td></td>
<td>RSR</td>
<td>ROA, ROE</td>
<td></td>
</tr>
<tr>
<td>Risk Committee</td>
<td>Returns</td>
<td>Returns (+)</td>
<td>Returns (+)</td>
</tr>
<tr>
<td></td>
<td>RSR</td>
<td>ROA, ROE</td>
<td></td>
</tr>
</tbody>
</table>

Note: The **bold** indicates significant effect
Concluding Remarks

- The likelihood of very good or very bad decision being made is higher if the decision or the board is controlled by the CEO.
- CEOs with larger power will tend to make decisions with higher risks. Such risks cause higher performance variability.
- Larger board size provides strengths against CEO power, further reducing agency problems caused by being incapable of opposing CEO’s bad decisions.
- Board independence and independent directors on the committees play crucial roles in monitoring and opposing risk-bearing business in banking industry, further reducing the losses during financial crisis.
Thank you for Your Attention