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Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jaccecoCEO turnover in large banks: Does tail risk matter?[☆]Abhishek Srivastav^a, Kevin Keasey^a, Sabur Mollah^b, Francesco Vallascas^{a,*}^a Leeds University Business School, Maurice Keyworth Building, The University of Leeds, LS2 9JT, UK^b Hull University Business School, University of Hull, Hull HU6 7RX, UK

ARTICLE INFO

Article history:

Received 12 July 2015

Revised 12 May 2017

Accepted 15 May 2017

Available online 19 May 2017

JEL classification:

G21

G28

Keywords:

Tail risk

CEO turnover

Bank governance

ABSTRACT

In a cross-country setting we show the probability of a forced CEO turnover in large banks is positively associated with idiosyncratic tail risk. This finding is strengthened the greater the competition in the banking industry and when stakeholders have more to lose in the case of distress. Overall, the exposure to idiosyncratic tail risk offers valuable signals to bank boards on the quality of the choices made by CEOs. In contrast, systematic tail risk becomes important for forced CEO turnovers only in the presence of a major variation in the costs this risk generates for shareholders and the organization.

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1. Introduction

It is widely accepted that the CEOs of large banks have incentives to implement business policies that increase their organizations' exposure to risks (Cohen et al., 2014; Ellul and Yerramilli, 2013; Gandhi and Lustig, 2015). These business policies are motivated by the highly levered nature of banks that provides CEOs with risk-taking incentives given the convexity of their stock and option holdings.

While shareholders are not against executives taking risks, because equity is an out-of-the-money call option whose value is increasing with risk (Acharya and Ryan, 2016; Jensen and Meckling, 1976), they do not have a preference for risks that can be detrimental to the survival of the bank (Stulz, 2015). A bank's growing exposure to tail risks, measuring the possibility of suffering extremely large losses, could be dangerous for the organization (Cordella and Yeyati, 2003; Ellul and Yerramilli, 2013; Hellmann et al., 2000; Keeley, 1990; Park and Peristiani, 2007). While an exposure to tail risks tends to reward shareholders with positive returns in many scenarios, it can also be associated with a small probability of extremely large losses that undermine a bank's longer-term survival (Cohen et al., 2014; Ellul and Yerramilli, 2013; Thanassoulis, 2013).

The purpose of this paper is to understand whether increases in tail risk are associated with an increased likelihood of a forced CEO turnover in large banks. To this end, we present the first cross-country study of CEO turnovers in the banking industry based on a sample of 261 large banks selected from 46 countries for the period 2004–2013.

[☆] We thank John Core (the editor) and Robert Bushman (the reviewer) for their many insightful comments and suggestions. We acknowledge the financial support from Jan Wallanders and Tom Hedelius Stiftelse, Handelsbanken, Sweden (Project ID P2010-0144:1). We are grateful to Andreea Bordianu, Shakwat Hossain, Sharifur Rahman, and Omar Sikder for their helpful research assistance.

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Whether any link exists between tail risk and the likelihood of a CEO turnover in large banks lacks empirical evidence. This is particularly unfortunate given that dismissal is potentially an important mechanism to discipline CEOs by bank boards and reduce the chances that they overly expose their banks to extreme risks. In fact, dismissal might lead not only to the loss of current employment but also the loss of unvested equity-based compensation (Dahiya and Yermack, 2008) and reduced future career opportunities (Brickley et al., 1999).

Our analysis is guided by conventional theoretical models proposed for non-financial firms where boards employ performance, volatility and other signals to evaluate CEO choices (Bushman et al., 2010; Gibbons and Murphy, 1990; Holmstrom, 1982; Jenter and Kannan, 2015). When these signals indicate bad outcomes for the corporation that are imputable to a lack of CEO ability or effort in the decision making, the dismissal of the CEO is a likely consequence. Along these lines, we argue that tail risk conveys different and additional signals, as compared to stock performance and volatility, of possible bad outcomes for the bank that can be related to CEO choices.

An increasing exposure to tail risks, making a bank more vulnerable to events that can lead to extremely large losses and to a financial distress (Ellul and Yerramilli, 2013), signals that the bank might find it more difficult and costly to conduct its business (Stulz, 2015). For instance, increases in tail risks lead to additional costs for shareholders related to the monitoring role of bank creditors and regulators. Both creditors and regulators do not benefit from the upside gains deriving from bank risk-taking while they bear the cost of the downside. It follows that especially in the presence of a growing tail risk exposure, creditors can significantly increase the risk-premium charged on bank debts and reduce the amount of available funds for the bank (Flannery, 2001; Schaeck et al., 2011; Stulz, 2015). At the same time, regulators might more closely monitor banks and offer negative signals on their financial health with the consequence of reducing share prices and further increasing borrowing costs (Berger and Davies, 1998; DeYoung et al., 2001; Slovin et al., 1999).

In our study we follow Ellul and Yerramilli (2013) and Van Bakkum (2016) and use *Expected Shortfall (ES)* as our primary measure of bank tail risk. *ES* quantifies the downside of bank risk in the form of extremely large negative stock returns. *ES* is, therefore, a particularly appropriate signal that a bank is overly exposed to extreme risks that are detrimental to bank value. Furthermore, following studies that investigate the role of volatility in CEO dismissal in non-financial corporations (Bushman et al., 2010), we build our analysis on the distinction between idiosyncratic and systematic tail risk, with the former being seen as more directly linked to managerial choices.

By focusing on tail risk, our work is related to the stream of research that emphasizes the importance of going beyond the investigations of (average) stock returns and profitability in order to explain forced CEO turnovers in corporations (see, for instance, Brickley, 2003). This type of investigation is the focus of earlier studies on CEO turnovers in the banking industry (see Hubbard and Palia, 1995). Furthermore, our paper extends and complements the analysis conducted on small US community banks by Schaeck et al. (2011) where the authors show that an increase in bank default risk (measured by the accounting Z-score) raises the likelihood of a forced CEO turnover due to the disciplinary role played by shareholders.

Differently from the existing studies, we show the importance of accounting for tail risk in examining the decision to remove a CEO by the boards of large banks. We find a positive relationship between idiosyncratic tail risk and forced (but not voluntary) CEO turnover, and we document that the firing decision is not, in general, related to an exposure to systematic tail risk. Furthermore, we show that our result is not related to idiosyncratic tail risk capturing a poor performance effect or simply an idiosyncratic volatility effect, as in the model proposed by Bushman et al. (2010), and holds under different empirical settings, including changes in the way we compute bank tail risk.

A key consequence of the above results is that the importance of idiosyncratic tail risk for the firing decision should depend on the banking market structure as the evaluation of CEO choices is argued to be more difficult in more concentrated (less competitive) industries (DeFond and Park, 1999; Fee et al., 2013; Yonker 2017). This is because CEOs operating in more concentrated industries are less likely to be subject to similar uncertainties (DeFond and Park, 1999), have less peers (Brickley, 2003; Fee et al., 2013; Yonker, 2017), and their outputs are more likely to be influenced by the actions of other CEOs in the same industry (Holmstrom, 1982). Consistent with the view that the market structure influences the ability of the boards to identify unfit CEOs, we find that the sensitivity of forced CEO turnovers to idiosyncratic tail risk is lower in more concentrated banking markets.

We next evaluate which stakeholders amplify the importance of tail risk for forced CEO turnovers. In doing so, we contribute to the literature on how different bank stakeholders react to downside risks in banks (Gandhi and Lustig, 2015). We show that the sensitivity of CEO dismissals to idiosyncratic tail risk increases with a larger presence of subordinated debtholders (namely debtholders that are liable to incur potentially larger losses in the case of a bank distress) or shareholders with lower diversification opportunities. In other words, there is a stronger relationship between idiosyncratic tail risk and CEO dismissal in the presence of stakeholders that have more to lose in the case of distress.

The final part of our analysis looks more closely at a bank's exposure to systematic tail risk. In the case of large banks, there are specific factors that go against the argument that any exposure to systematic tail risk is completely unrelated to managerial choices. In particular, recent banking studies suggest that bank CEOs have incentives to manufacture non-firm-specific tail risks and to engage in systematic risk-taking (modelled as an endogenous choice) to extract value from the financial safety net (Acharya et al., 2017; Acharya and Yorumazer, 2007; Adrian and Brunnermeier, 2016; Bushman and Williams, 2015; Farhi and Tirole, 2012; Pennacchi, 2006).

To understand how boards perceive systematic tail risk in large banks, we test for the presence of variation in the sensitivity of forced CEO turnover to systematic tail risk when there are changes in the consequences a bank can suffer from being exposed to this risk. By using several alternative empirical settings, we consistently find that there is a stronger

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