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Affiliation and professionalism: Alternative perspectives on decomposing the board structures of financial institutions

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ABSTRACT

Most financial institutions around the world are under concentrated ownership. To protect rents and the private benefits of control, controlling owners prefer to include more affiliated members on their boards. This study empirically examines financial institutions in Taiwan—a country that harbors both firms with controlling shareholders and pyramidal groups—and its results verify the aforementioned postulation. We find that board affiliation is positively associated with control rights, cash flow rights and the control/cash flow deviation associated with controlling owners. In contrast, professionalism can disentangle controlling owners' motives, as it is positively associated with the controlling-owner cash flow/control rights ratio and negatively correlated with the control/cash flow deviation. The results support the incentive effect associated with controlling owners. Moreover, the information argument provides auxiliary explanations for how boards are structured. Family is a catalyst for the bias toward lower levels of board professionalism. Finally, whereas board professionalism is positively correlated with stock returns during a financial crisis, board affiliation has a negative correlation.

1. Introduction

Forming concentrated ownership allows controlling owners to obtain decision rights and protect rents from proprietary knowledge (Christie, Joye, & Watts, 2003; Jensen & Meckling, 1992). Fan and Wong (2002) indicate that concentrated ownership is a solution for preventing information leakage that may result in competition and social sanctions. Controlling owners proactively pursue private benefits of control through either the "psychic" value of simply being in control (e.g., Aghion & Bolton, 1992; Harris & Raviv, 1988) or the perquisites they enjoy exclusively (Jensen & Meckling, 1976).[1] This also results in concentrated ownership. Moreover, the degree of ownership concentration is affected by the size of the control benefits (Bebchuk, 1999; Dyck & Zingales, 2004). The literature has documented that ownership concentration is widely evidenced in regions where legal systems are weak or corporate governance mechanisms are ineffective (Dyck & Zingales, 2004; La Porta, Lopez-de-Silanes, & Shleifer, 1999; Shleifer & Vishny, 1997).

Industry factors such as high leverage and strict regulation are related to ownership concentration. Leverage amplifies the size of private benefits of control in the sense that controlling owners use other people's money to leverage personal influence or

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[1] Note that the existence of private benefits of control is not necessarily inefficient. Dyck and Zingales (2004) indicate that private benefits of control may be the most efficient way for a company to capture some of the value created. Furthermore, the existence of private benefits of control may be socially beneficial, as they make value-enhancing takeovers possible (Grossman & Hart, 1988).

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pursue social capital. According to Demsetz and Lehn (1985), regulation may lower control potential. Following this thread, ownership structures in a highly regulated financial industry are expected to be diffusive. However, when the legal protection of public investors is ineffectual, controlling owners may concentrate ownership in hand, allowing them to engage in political lobbying and rent-seeking activities. This is consistent with a study by Caprio, Laeven, and Levine (2003), who find that with a few exceptions due to strong shareholder protection laws, the financial institutions in most countries are not widely held but tend to be ultimately controlled by families or the state.

In this paper, we portray the important effect of ownership structures on boards, through which controlling owners may protect rents and seize control benefits. If the one-share-one-vote rule is adhered to, owners may only arrange affiliated members in proportion to their cash flow rights. However, devices such as pyramidal structures, cross-shareholdings and dual-class share arrangements that result in control/cash flow deviation could provide owners with the leeway to arrange more affiliated members in disproportion to their cash flow rights. Due to attractive rents and the private benefits of control, controlling owners in the financial industry opt to arrange more affiliated board members whenever possible.

Studies have attached much importance to board independence, indicating that independent board members counterbalance the potential entrenchment of controlling owners. However, the empirical findings of these studies have been mixed.[2] This may be a result of identification rather than the notion of independence. For example, *resume*-independent members who do not have familial, employment or financial relationships with a company and its directors may be closely connected to a controlling owner. Moreover, the practice of including independent directors in most Asian countries is still in its infancy. In most cases, companies include the minimum number of *resume*-independent board members when legally required to do so. Either way, the relationship between board independence and the governing mechanism can become blurry.

In this study, we use board affiliation to consider the core sense of control. To determine a board affiliation, we meticulously trace the ownership structure of each financial institution to locate the controlling owner who possesses the most voting rights. Affiliation is recognized when a controlling owner ultimately controls board members via family ties or as representatives of his/her controlled firms or institutions. The notion of affiliation is different from family ties not only because the ultimate/controlling owner could be a family or the state, but also because nonfamily representatives from controlled firms or institutes are included. Board affiliation is defined as the percentage of affiliated members on a board. Although board affiliation superficially resembles the flipside of board independence, they are not necessarily equivalent. For example, using the affiliation framework, we do not have to make judgments on the status of dubious board members who are representatives of legal persons and may or may not be linked to a controlling owner.

Because board control is the top priority of controlling owners, we hypothesize that board affiliation is positively correlated with controlling owners' control rights from either direct cash investment or indirect wedges such as pyramidal structures, cross-shareholdings and dual-class shareholdings.

To understand the roles that a board can play and how effectively it can play them, it is crucial to understand how directors are chosen (Hermalin & Weisbach, 1998). Other than affiliation, we investigate another factor that is useful in disentangling controlling owners' motives: board professionalism. Professional members potentially contribute to a firm's operations, and this is especially true for a financial industry that is highly sensitive to market movements. In this study, we consider board members to be professional if they are certified accountants or attorneys or have prior management experience from other financial institutions. Board professionalism refers to the proportion of professional members on a board.

The higher cash flow rights associated with a controlling owner motivate that owner to accommodate more professional board members who can provide more value-added opinions (i.e., the *incentive alignment* hypothesis). In contrast, a deviating voting/cash structure that results from cross-shareholdings, pyramidal structures or dual-class shareholdings decreases the positive incentive of a controlling owner and thus lowers the level of board professionalism. Therefore, a controlling owner's motives, manifested in the ownership structure, dictate the level of board professionalism.

The predicted relationship between ownership structures and board professionalism is also reconciled with the information hypothesis. Controlling owners who are entitled to higher cash flow rights appreciate a positive signal associated with a professional board that warrants the informativeness and creditability of a firm's financial reports. The flipside of the information argument is that controlling owners who operate according to a deviating control/cash flow structure prevent the possible leakage of proprietary information to competitors and avoid unwanted political or social scrutiny, resulting in a lower level of board professionalism.

In this study, we examine the financial industry in Taiwan from 2003 to 2006. Taiwan is an ideal setting for examination because it features relatively weak shareholder protection, a predominance of controlling shareholders and an extensive use of pyramidal groups and cross-shareholdings, characteristics that are commonly seen in many countries (Caprio et al., 2003; Claessens, Djankov, & Lang, 2000; Faccio & Lang, 2002; La Porta et al., 1999).[3] Our results basically verify the aforementioned postulations. A controlling owner's cash flow and control rights are both positively correlated with board affiliation, implying that the rents and private benefits of control embedded in a highly leveraged structure are attractive enough for controlling owners to

[2] For example, Rosenstein and Wyatt (1997) find a positive market reaction to the addition of outside directors, and Byrd, Fraser, Lee, and Williams (2002) find that the thrifts that survived the thrift crisis had more independent directors than those that failed. In contrast, Baysinger and Bulter (1985), Hermalin and Weisbach (1991), Mehran (1995), and Bhagat and Black (2002) find no significant correlation between the proportion of independent directors on a firm's board and either accounting or long-term stock performances.

[3] According to La Porta et al. (1999), only three out of six legal protections for investors are included in Taiwanese law. The number is comparatively smaller than five in the U.S. and four in common law countries. However, it is equivalent to the average of the full sample of La Porta et al.