Journal of Banking & Finance 64 (2016) 36–51

Contents lists available at ScienceDirect

Journal of Banking & Finance

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

Do outside directors influence the financial performance of risk-trading firms? Evidence from the United Kingdom (UK) insurance industry

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ARTICLE INFO

Article history:
Received 8 April 2015
Accepted 29 November 2015
Available online 8 December 2015

JEL classification:
G3
G22

Keywords:
Outside directors
Financial performance
Insurance
United Kingdom

ABSTRACT

We examine the relation between outside board directors and six measures of financial performance using panel data for 1999–2012 drawn from the UK's property-casualty insurance industry. We find that the proportion of outsiders on the board is unrelated to performance; rather it is outsiders' financial expertise that has the most significant financial performance impact. In addition, superior performance can also be related to the financial expertise of inside directors, thereby reinforcing the importance of board-level financial expertise in the insurance industry. Our results have potential commercial and/or policy implications.

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1. Introduction

Over the last two decades or so, academic research (e.g., see Pi and Timme, 1993; Lin et al., 2003; Adams et al., 2010) and corporate governance guidelines issued in countries such as the United Kingdom (UK) (e.g., the Cadbury Report, 1992; the Combined Corporate Governance Code, 2012; the Financial Reporting Council (FRC) Report, 2012) and United States (US) (e.g., the Sarbanes-Oxley (SOX) Act, 2002) have highlighted the important role of independent outside (non-executive) directors in monitoring, controlling and advising executive board-level directors, including the Chief Executive Officer (CEO). This is because in theory, independent directors are usually in the best position to supervise the business behavior of executive directors (Masulis and Mobbs, 2014). Many prior studies and policy pronouncements are predicated on the agency theory-based notion that board independence will tend to have a positive impact on firms' performance in that, amongst other things, outside directors will help realign contracting incentive conflicts between shareholders, managers, and other constituents (e.g., creditors), bring new ideas and business contacts, and moderate the excesses of an entrenched and self-utility maximizing CEO (e.g., see Masulis and Mobbs, 2011, 2014; Veprauskaite and Adams, 2013; Baldenius et al., 2014). However, several researchers (e.g., Adams and Ferreira, 2007; Kumar and Sivaramakrishnan, 2008; Faleye et al., 2011) suggest that outside directors could have a negative impact on corporate performance because they are at an informational disadvantage relative to insiders on the board. Indeed, much empirical evidence supports the conjecture that board independence is unrelated to firm performance (e.g., see Adams et al. (2010) for a comprehensive survey of the relevant literature). Therefore, a key question that emerges from recent studies is what functional attributes (e.g., skill sets) of board outsiders are associated with superior results (Larcker, Richardson and Tuna, 2007; Dahya and McConnell, 2007; Dey, 2008). In this paper, we address this question in the context of the UK's property-casualty insurance industry – an important and integral part of the national and global social and economic system (see Section 2).[2]

Effective governance systems are especially apt in the case of the insurance industry as insurance is a risk-taking and risk-bearing activity which involves policyholders making regular premiums to insurance risk carriers in exchange for a promissory commitment to meet future claims on a schedule of risk events. In accounting terms this means that the trading and bearing of risks creates

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[2] Insurance is widely acknowledged to be one of the three main pillars of modern capitalist economies – the other two being the banking sector and financial markets (e.g., see the Geneva Association, 2012).

http://dx.doi.org/10.1016/j.jbankfin.2015.11.018
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contingent liabilities for insurance carriers at the point-of-sale. This necessitates that insurance firms are actively managed as financial 'going concerns' for the mutual benefit of all contracting constituents including investors, managers, and policyholders (Mayers et al., 1997; Boubakri et al., 2008; Boubakri, 2011). This aspect of the governance-performance relation in insurance markets is underpinned by the technical (actuarial) complexity and opaqueness of insurance transactions, and the statutory accounting and reporting requirements within which insurers have to operate (e.g., with respect to capital maintenance) (Serafeim, 2011). The importance of the governance-performance relation in insurance firms is further heightened by the failures of financial institutions during the 2007/8 global economic crisis. The most notable example being the US$182 billion US federal government bailout of the insurance conglomerate – the American International Group (AIG)) (Boubakri, 2011). Doubts about the contribution of board outsiders to corporate governance and the financial performance of UK insurers have also been highlighted in both prior research (e.g., O'Brien, 2006; Hardwick et al., 2011; Atkins et al., 2011) and official investigative reports (e.g., the Penrose Report, 2004; Walker Report, 2009).

In this study, we use 14 years of longitudinal data (1999–2012) drawn from the UK's property-casualty insurance industry to test the effects of six main occupational attributes of board outsiders namely: their representation on the board, independence, financial expertise, insurance experience, firm-based knowledge, and multiple appointments – on ratio-based measures of financial performance, namely, the net profit margin, return on assets, return on equity, solvency, loss ratio, and combined operating ratio, that are commonly used in the insurance industry (e.g., see KPMG, 2014). To deal with possible endogeneity, we follow recent research (e.g., Dass et al., 2014), and estimate two-stage least squares (2SLS) regressions in which board independence is instrumented by the location of insurers. Dass et al. (2014)[3] consider that this procedure produces more efficient and consistent parameter estimates than pooled ordinary least squares (OLS) and standard fixed or random-effects models.

We find that the proportion of board outsiders is unrelated to our performance indicators; rather it is outsiders' financial expertise that has the most significant financial outcomes. In addition, superior performance can also be related to the financial expertise of inside directors. This observation reinforces the functional importance of board-level financial expertise in the technically complex and risk information-sensitive insurance industry.

Three principal contributions emerge from our research. In one of the first studies of its kind, Anderson et al. (2011) examine the impact of board heterogeneity on a single measure of performance – industry-adjusted Tobin's Q – using cross-sectional data from the US corporate sector[4]. In contrast, our approach here focuses on the effects of different outside director traits on multi-dimensional measures of financial performance. Given the predicted importance of independent outside directors in optimizing the governance-performance relation in insurance firms (Boubakri et al., 2008), our dynamic single country/single industry focus enables us to conduct direct tests of our hypotheses. The functional and interactive role of inside and outside board members can also vary between industries as well as across countries that have different corporate governance systems, regulations, and business traditions (e.g., see Defond et al., 2005; Dey, 2008; Bebchuk and Weisbach, 2010). Therefore, the present study avoids the potentially confounding effects that could exist in cross-country/cross-sectional research.

Second, in comprising a range of insurance firms of different size, structure, product-mix, and age, our panel data set addresses a concern highlighted in some previous studies (e.g., Boone et al., 2007; Adams et al., 2011; Cornelli et al., 2013) that most prior research of the governance-performance relation has focused overwhelmingly on large publicly listed US-based companies. The greater variation in our sample of insurance firms (e.g., in terms of size and ownership structure) mitigates sample selection bias and so allows robust tests to be carried out.

Third, as Anderson et al. (2011) make clear in their paper, board heterogeneity and its link with corporate performance is a salient commercial and public policy issue in countries such as the UK and US. Like others before us (e.g., Masulis and Mobbs, 2011), we argue that the effectiveness of corporate boards in meeting financial targets is heavily reliant on how outside directors relate to, and cooperate with, inside directors. Indeed, the question of whether or not shared professional status promotes cooperation between inside and outside board members and improves financial outcomes is largely unexplored. This is also an issue of some theoretical as well as empirical importance in that the control obligations of being a member of a professional body (e.g., in protecting the interests of key stakeholders such as shareholders, policyholders and regulators) is an issue that resonates closely with the supervisory function of boards articulated in agency theory. The performance-effects of board members' characteristics are also likely to be of decision-making interest to the various stakeholders of insurance firms (e.g., shareholders, policyholders, and regulators) (e.g., see Dass et al. 2014). Our results could also be extended to other insurance markets and parts of the economically important financial services sector that have similar organizational, fiduciary, and structural (e.g., regulatory) features to the insurance sector (e.g., banking and pensions fund industries). Moreover, as the interface between inside and outside directors can be important for mitigating information asymmetries, controlling agency costs, and promoting the interests of the owners of firms in other business contexts (e.g., venture capital-supported enterprises – see Lerner, 1995) our results could have even broader cross-industry appeal.

Our paper is organized as follows. Section 2 provides information on the UK's property-casualty insurance. A review of the literature and articulation of our hypotheses follows in Section 3. Section 4 then outlines the research design, including the description of the data, model specification, and definition of the variables used. We then present and discuss the empirical results in Section 5, while conclusions are made in the final section of the paper.

2. Institutional background

The UK's property-casualty insurance industry is the third largest in the world (after the US and Japan) and comprises approximately 300 or so active domestically-owned and foreign-owned companies, subsidiaries and branches of varying size, ownership structure, and product-mix, which currently generates approximately £50 billion (US$84 billion) in gross annual premiums (International Underwriting Association, 2013).[5] In addition, 91 active syndicates

[3] Superior performance is captured by larger values for profit margin, return on assets, and return on equity, and smaller values for solvency, loss ratio and the combined operating ratio.

[4] Tobin's Q is measured as the ratio of the sum of the market value of equity and book value of debt and preference shares over the book value of total assets. Given the preponderance of non-publicly listed firms in our sample, Tobin's Q is inappropriate here. In any case, Anderson et al. (2011, p. 9) acknowledge that computing Tobin's Q for public utilities and financial firms can be problematical (e.g., due to different balance sheet structures) and accordingly, such entities are excluded from their analysis despite the importance of governance in such firms since the 2007/8 global economic crisis. Moreover, Tobin's Q can be mis-specified as it also proxies for other factors such as product-market share and growth opportunities (e.g., see Zou, 2010).

[5] In 2012/13 there were 976 property-casualty insurance entities licensed to operate in the UK but only about a third of these entities actively underwrite insurance business. Non-active insurance operatives include a miscellany of structures such as closed funds in run-off, 'brass plate' branches of overseas firms, and protection and indemnity pools that do not underwrite third party risks.

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