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Bank risk and national governance in Asia ☆

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ABSTRACT

The role of national governance upon bank-level risk in the Asian region is analysed. Improvements in national governance are risk reducing at the bank level in developed nations in the Asian region, and over the longer run for those nations affected by the Asian Financial Crisis. A U-shaped relationship between bank risk and bank capital is found, and it is argued that the risk reducing impact of increased capital holdings is close to satiation for developed nations in particular. Evidence of risk seeking due to 'too big to fail' effects is observed; with improved national governance able to partially offset some of the moral hazard due to size in developed nations, but not in developing nations. In developing nations increased size interacts with improved national governance to result in increased bank risk.

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1. Introduction

Bank risk is an issue that has had its importance re-emphasised by the banking crisis of 2008 and the following moves to re-formulate the nature of global banking regulations in response to the perceived lessons of this crisis. This paper extends the current stream of literature addressing the issue of bank risk by considering the role national regulatory governance plays when modelling bank risk. It would be expected that improved national governance quality will result in lower bank-level risk, *ceteris paribus*. By considering national regulator quality this paper will test an important result of the model of Besanko and Kanatas (1996); that bank capital effectiveness in reducing bank risk is reinforced by regulatory quality. In contrast to previous studies in this area, this paper will offer the benefit of considering the impact of regulatory quality on bank risk. Previous studies such as Laeven and Levine (2009) and Klomp and de Haan (2011) considered the relationship between the existence of various banking regulations and bank risk.

A distinctive feature of this study is to consider measures of regulatory quality rather than regulatory existence. In this manner the paper is within the tradition of the law and finance approach to national governance La Porta et al., 1998, but with the distinctive feature of considering quality rather than existence of regulatory governance. Further, bank revenue volatility will be modelled using an approach drawn from the market microstructure literature, which will provide a different dimension to the issue of bank risk estimation. Finally, by considering banks from the Asian region, which were less directly affected by the banking crisis of 2008, but in the front line of the Asian financial crisis of 1997, a longer run (post recovery) perspective on bank risk can be adopted which has the potential to inform policy reforms following the 2008 banking crisis.[1] As argued by Tarr (2010), the banking crisis

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[1] The Asian region nations also provides a valuable region for this study due to a number of commentators citing shortfalls in national governance as a reason for the Asian financial crisis of 1997–98 (see Lee (2012) as an example).

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of 2008 had a number of causal factors and governance failures at both the political and regulatory levels were important amongst those factors. Thus, considering the role governance has to play in bank risk in a region which has previously experienced a financial crisis, has the potential to inform the current policy reform process.

This study will also offer the advantage of considering the roles of bank capital, franchise value and loan growth in explaining bank risk, thus considering the role of conventional variables employed in a bank risk model within the context of the impact of national regulatory governance variables. Measurement of bank risk can encompass a variety of dimensions; this paper considers revenue volatility, loan quality and proximity to default (z score). Employing a panel of Asian region nations across the period of 1998 to 2012, the models are estimated using unbalanced panel instrumental variables estimators to control for potential endogeneity, using a fixed effects approach to control for firm heterogeneity. Of considerable interest is the finding that a higher level of national regulatory quality is associated with lower bank risk in developed but not developing nations. However, contrary to the propositions of Besanko and Kanatas (1996), only limited evidence was found that national regulatory quality reinforces the risk reducing features of bank capital holdings. In the case of the nations impacted by the Asian financial crisis the short run relationship between bank capital and bank risk is at best mixed. Some evidence is found suggesting that banks in developing nations in Asia view improvements in national governance as improving the put option value they have with the national regulators in a too big to fail framework and accordingly increase the risk of their portfolios, consistent with Merton (1977).

Bank capital holdings are found to have a U-shaped relationship with bank risk. Thus continuously increasing required bank capital will not continuously reduce bank risk. Further, analysis of the marginal impact of increased capital upon bank risk indicates that increased bank capital holdings are associated with (for the average bank) relatively small reductions in bank risk, with the exception of asset risk which is found to increase as capital holdings increase in some cases. It is argued that the risk reduction benefits of increased bank capital are close to satiation and that requiring large increases in bank capital holdings are likely to result in increased bank risk.

The rest of this paper is structured as follows; the next section will provide a review of the relevant bank risk literature and develop the propositions to be tested. The third section will detail the nature of the sample that will be employed as well as the empirical method that will be employed. The fourth section will present the results of the empirical tests. The final section will provide conclusions as well as some suggestions for policy formulation that are based on these results.

2. Literature review

2.1. Bank capital

Proposition 1. *There is a U-shaped relationship between bank risk and bank capital.*

The role of bank capital in modifying the behaviour of bank management, and in particular, modifying the risk of banks, has an academic and regulatory tradition over five decades long (VanHoose, 2007). Over this time a voluminous literature has developed arguing that requiring banks to hold specified amounts of capital acts to both increase and decrease bank risk.[2] This stream of research has considered the impact of imperfect information and moral hazard upon the risk preferences of bank management in the presence of capital regulation.[3] Studies such as Koehn and Santomero (1980) and Blum (1999) have demonstrated that increased capital requirements can result in increased bank risk. In the case of Asia, Lee and Hsieh (2013) find increased bank capital is associated with lower bank risk, but their model does not control for potential non-linearities in this relationship. Williams (2013) demonstrated a U-shaped relationship between bank capital and risk in Indonesia. For the purposes of this study, the stream of research that relates the impact of regulatory quality and intensity to bank risk and capital holdings is of most relevance. Shrieves and Dahl (1992) demonstrate that the presence of bank capital regulations will result in increased bank risk unless accompanied by increased regulatory intensity. Both Brimmer and Dahl (1975) and Calem and Rob (1999) argue that lack of regulatory intensity will result in bank risk seeking activity, thus offsetting the risk mitigation impact of bank capital. It is argued that bank capital holding will have a U-shaped relationship with bank risk as both poorly and well-capitalised banks have (differing) incentives to increase bank risk (Calem and Rob, 1999; Jonghe et al., 2007).

2.2. Franchise value

Proposition 2. *Banks with higher franchise values will have lower risk.*

Franchise or charter value is simply the value that accrues to a bank from its ownership of a banking licence. This value is often considered within the context of the value a bank obtains via its coverage by actual or implied deposit insurance (Craine, 1995). Generally this value is considered to be the present value of economic profits if the bank continues to operate as a going concern. It is conventionally argued that the franchise value of a bank acts to reduce the incentives for morally hazardous risk seeking by bank management (Marcus, 1984). Further, it has been argued that the quasi-monopoly rents generated by increased market power will also act to increase bank franchise value (Keeley, 1990; Besanko and Thakor, 1993).[4] Banks will act to protect this franchise value by electing to invest in a lower risk portfolio of assets.

2.3. Bank size

Proposition 3. *Larger banks are riskier due to the negative externalities associated with too big to fail.*

The relationship between bank size and bank risk has also resulted in a considerable literature. The failure and government rescue of Continental Illinois bank in 1984 resulted in the term 'too big to fail' becoming part of banking language. Under the concept of too big to fail there is a group of large and important banks who are so central to the national (and global) banking system[5] that the regulatory authorities will seek to intervene to prevent their insolvency. In a recent study of Asian banks, Fu et al., 2014 find that

[2] Relevant surveys of the bank capital literature include VanHoose (2007), Behr et al. (2010), Barrios and Blanco (2003) and Santos (2001).

[3] Important seminal papers considering bank capital holdings in the context of deposit insurance include Merton (1977), Diamond and Dybvig (1983) and Diamond (1984). These papers conclude that bank capital holdings reduce the value of the put option granted to banks with deposit insurance and so reduce risk seeking by bank management.

[4] Repullo and Suarez (2004) argue that risk reducing regulations are more likely to be effective when banks have higher franchise value.

[5] Note that the Bank for International Settlements has introduced guidelines that suggest national regulators should require globally systemically important institutions hold additional capital. See http://www.bis.org/speeches/sp120120.htm and http://www.bis.org/publ/bcbs207.htm.

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