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Do bank regulations affect board independence? A cross-country analysis

Li Li [a], Frank M. Song [b,c,*]

[a] School of International Trade and Economics, University of International Business and Economics, China
[b] School of Economics and Finance, University of Hong Kong, China
[c] School of Economics, Peking University, China

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ABSTRACT

Based on the hand-collected board structure data of 277 listed banks across 55 countries, and the bank regulation and supervision database compiled by the World Bank, this paper provides the first cross-country assessment of the impacts of bank regulations on board independence of banks. In line with Beck et al. (2006), we examine the effects of two types of regulation policies, the first involving the empowerment of supervisory agencies to monitor and discipline banks directly, and the second focusing on encouraging private monitoring of banks through requiring disclosure of more accurate and complete information. We find that empowering official supervisory agencies to discipline banks directly reduces board independence, but encouraging private sector monitoring of banks increases it. The findings suggest that the first type of regulations tends to crowd out the internal governance of banks, while the second crowds in it. We also find that the legal system with better investor rights protection and better contracts enforcement not only increases board independence but also enhances the crowding in effect of promoting private monitoring and decreases the crowding out effect of direct official supervision on board independence.

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1. Introduction

In almost all countries, banks are intensively regulated because they are vulnerable to systematic risks. Several cross-country studies have investigated the effects of the national regulation of banks (Barth et al., 2004, 2006; Beck et al., 2006; Laeven and Levine, 2009). These studies suggest that regulations which encourage private monitoring work best to promote bank development and economic growth; while those which empower direct official supervision have no positive effects on bank development, and sometimes even undermine financial stability.

In addition to regulations, corporate governance is also important for banks, but its role has nevertheless been ignored by most cross-country studies on bank regulations (e.g. Barth et al., 2004, 2006; Beck et al., 2006). The first paper that studies the effects of national regulation on bank performance while also considers the influence of banks' corporate governance structure is Laeven and Levine (2009), where it is shown that, depending on banks' ownership structure, the same regulation policy can have different effects on their risk-taking.

In contrast to Laeven and Levine (2009), who focus on the simultaneous effects of regulation and corporate governance on bank performance, we study how cross-country differences of bank regulation policies impact the internal governance arrangements of individual banks. Specifically, we investigate the impacts of two types of regulation polices on the board independence of banks. Consistent with Beck et al. (2006), the first type of regulation policy involves empowering supervisory agencies to monitor and discipline banks directly, while the second focuses on encouraging private sectors to monitor banks by requiring more accurate and timely information disclosure. These two types of regulation policies have different implications for the monitoring costs and monitoring benefits of shareholders, and should therefore affect the internal governance arrangements of banks differently – which may explain why the literature shows opposite effects from such two types of regulation policies on bank development and lending corruption (Barth et al., 2004; Beck et al., 2006).

We use board independence as proxy of the internal governance of banks for two reasons. First, the degree of board independence is critical for the internal governance of firms. Outside directors monitor top managers better and play critical roles in discrete tasks such as the hiring and firing of the CEO, adopting anti-takeover devices and negotiating takeover premiums (for a useful survey, see John and Senbet, 1998; Shleifer and Vishny, 1997). The cross-country

* Corresponding author.
E-mail address: fmsong@econ.hku.hk (F.M. Song).

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study by Dahya et al. (2008) demonstrates that higher board independence is related to higher firm value and lower levels of related party transactions. Second, the board of directors is an even more important governance mechanism for banks than for non-financial firms because of the special characteristics of banking. The existence of intensive official regulation, such as deposit insurance, restrictions on ownership structures, and restrictions on banks' entry and operations, reduces the effectiveness of other mechanisms in dealing with corporate governance problems (Billett et al., 1998; Levine, 2004). Moreover, unlike other industries, external governance mechanisms such as takeovers hardly exist in banking (Prowse, 1997; Levine, 2004); and the opaqueness of banking makes it more difficult to design incentive contracts for top managers. All these aspects emphasise the need for more effective monitoring by boards of directors in the banking area. Several cross-country studies have demonstrated the importance of board independence for banking (Andres and Vallelado, 2008; Li and Song, 2011).

The literature on non-financial firms suggests that regulatory environments and policies play important roles in shaping the internal governance of firms (Kole and Lehn, 1999; Booth et al., 2002). Banks are more widely and intensively regulated than non-financial firms, and such intensive regulations are more likely to affect the internal governance arrangements of banks. Crawford et al. (1995), Hubbard and Palia (1995) and Becher et al. (2005) explore the issue from the perspective of deregulation in US banks during the 1990s. They show that deregulation leads to increased managerial discretion, and that banks respond to deregulation by improving internal monitoring through aligning the incentives of managers, directors and shareholders.

In contrast to these studies, which investigate the dynamics of internal governance structure in respect of bank deregulation, we focus on the influence of cross-country differences in regulation policies on cross-country differences in banks' board independence. To the best of our knowledge, we provide the first cross-country evidence on how different bank regulation policies affect the internal governance structure of banks, specifically their board independence.

We develop our hypotheses by analysing the impacts of the two types of regulation policies on monitoring costs and monitoring benefits for bank shareholders. Direct supervision and intervention by official supervisory agencies decrease managerial discretion, which means lower monitoring benefits. The intervention of authorities also indicates higher monitoring costs for shareholders, and is therefore likely to reduce board independence. Regulation policies that focus on promoting private monitoring decrease the information asymmetry between managers and shareholders by forcing banks to disclose accurate and timely information, and thus reduce the monitoring costs of shareholders and increase board independence. However, promoting private monitoring could also reduce board independence, since increased transparency and market discipline monitor bank managers and thus reduce shareholders' monitoring benefits.

We employ hand-collected data on boards of directors in 2004–2010 and the World Bank surveys II and III published in 2003 and 2007 on bank regulation and supervision to examine our hypotheses. The type of bank regulation policies that empowers direct official supervision by supervisory agencies is measured by *official supervisory power*, and the type of regulation policies that encourages private monitoring of banks is measured by *private monitoring index*. The degree of board independence is measured by *the ratio of independent directors on the board*. In robustness check we also use *prompt corrective power* and *external ratings and credit monitoring* as alternative measures of the two types of regulations respectively, and use *an independent director as board chairman* and *the ratio of independent directors on the audit committee* as alternative measures of board independence. The empirical results show a negative relationship between *official supervisory power* and *the ratio of independent directors on the board*, while a positive relationship between the *private monitoring index* and *the ratio of independent directors on the board*. The results support our hypothesis on bank regulation policies empowering direct official supervision. As for the hypothesis on regulation policies encouraging private monitoring, the results suggest that the effects of reduced monitoring costs dominate those of reduced monitoring benefits. Beyond the two main results, we find that the legal system with better investor rights protection as well as better contracts enforcement not only increases board independence but also enhances the positive effect of promoting private monitoring on board independence and decreases the negative effect of direct official supervision on board independence. An array of robustness tests supports the main results.

We contribute to the literature on national regulation of banks. Most of the existing cross-country studies directly investigate the impacts of regulation policies on bank performance without exploring the channel concerned. We extend the existing studies by documenting one possible channel – internal governance and specifically the board of directors. Since board independence is critical not only for non-financial firms (Dahya et al., 2008) but also for banks (Andres and Vallelado, 2008; Li and Song, 2011), different regulation policies, which influence board independence differently, will affect bank performance in different ways. The board of directors acts as the link between regulation policies and bank performance. The results imply that the possible impacts of regulation on banks' internal governance arrangements cannot be ignored when formulating regulation policies.

We also contribute to policy considerations of bank regulation. The New Basel Accord (Basel II) sets up a bank regulation and supervision framework. The influential best-practice recommendations of Basel II are based on three pillars. Most countries around the world have implemented or plan to implement the Basel II guidelines. The debates on regulatory overhaul after the 2007 financial crisis have also emphasised all three of these pillars. However, not enough studies have provided evidence on whether these guidelines can improve bank development, facilitate capital allocation and reduce system risk (Barth et al., 2004, 2007; Beck et al., 2006). We add to the literature by supporting Pillar 3 and challenging Pillar 2, since the regulation practices emphasised by Pillar 2 substitute for the internal governance of banks, while those emphasised by Pillar 3 enhance it.

In addition, we contribute to the literature on the determinants of board structure. Studies on such determinants agree that corporate board structure is endogenous to specific business environments and specific company characteristics. However, there is no consensus on which factors shape board structure (e.g., Boone et al., 2007; Guest, 2008; Linck et al., 2008; Andres et al., 2012). Moreover, prior studies seldom consider regulatory policies as one of the factors shaping board independence (Guest, 2008; Kim et al., 2007). By focusing on banks, we provide cross-country evidence on the determinants of board structure in a specific industry. We show that the regulation policies unique to the banking industry help shape the board structure of banks. Since regulatory policies are mostly external to banks, our research to some extent avoids the endogeneity problem that prior studies have had to deal with.

The rest of this paper is organised as follows. In Section 2, we develop our testable hypotheses. Section 3 describes the data and variables. We test the hypotheses on how regulation practices affect board independence in Section 4, and perform robustness checks in section 5. Section 6 is given over to concluding remarks.

2. Bank regulations and board independence: hypotheses

Banks, like other non-financial corporations, face potential conflicts of interest between management and shareholders. Managers

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