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Does board structure in banks really affect their performance?

Shams Pathan*, Robert Faff

The University of Queensland, UQ Business School, Queensland 4072, Australia

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ABSTRACT

We study whether board structure (board size, independence and gender diversity) in banks relates to performance. Using a broad panel of large US bank holding companies over the period 1997–2011, we find that both board size and independent directors decrease bank performance. Although gender diversity improves bank performance in the pre-Sarbanes-Oxley Act (SOX) period (1997–2002), the positive effect of gender diminishes in both the post-SOX (2003–2006) and the crisis periods (2007–2011). Finally, we show that board structure is particularly relevant for banks with low market power, if they are immune to the threat of external takeover and/or they are small. Our two-step system generalised method of moments estimation accounts for endogeneity concerns (simultaneity, reverse causality and unobserved heterogeneity). The findings are robust to a wide range of other sensitivity checks including alternative proxies for bank performance.

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1. Introduction

The increased scrutiny of board governance in banks following the global financial crisis, motivates us to investigate whether and to what extent their board structure (size, composition and gender diversity) affects performance. Moreover, we explore whether the introduction of the Sarbanes-Oxley Act of 2002 (SOX hereafter) or the financial market crisis have influenced the board structure–bank performance linkage. Failure in bank governance can create significant costs. Such costs occur because banks are ‘special’ economic units relating to their distinctive roles in financial intermediation, the payments system, liquidity, information, and maturity and denomination transformation (Fama, 1985). In addition, banks are more intensely regulated to avoid negative externalities from ‘systemic risk’ (Flannery, 1998), as well as to protect the interests of ‘dispersed’ and ‘unsophisticated’ bank depositors. Furthermore, it is often argued that banks help facilitate better firm governance either in their role as creditors or alternatively as shareholders (Caprio and Levine, 2002). Therefore, well-governed banks cannot only contribute to, but in fact be critical

agents for the proper functioning of many non-financial sector firms and, thus, collectively promote a more efficient allocation of resources across the economy.

A bank’s board plays a vital role in achieving effective governance. Caprio and Levine (2002) insist that bank governance via its board is imperative because neither dispersed shareholders/debtholders nor the market for corporate control can impose effective governance in banks. Indeed, the board is likely even more important as a governance mechanism in banks than it is in non-banks, since banking fiduciary responsibilities extend well beyond shareholders to depositors and regulators (Macey and O’Hara, 2003). Hence, bank regulators and policymakers also emphasise the importance of bank board governance. For example, the Basel Committee on Banking Supervision (BCBS) (2006) in its consultative document titled “Enhancing Corporate Governance in the Banking Industry” identifies the board as an essential part of a bank’s regulatory reforms. Moreover, the second pillar (supervisory review process) of Basel II identifies the role of the board as an integral aspect of risk management (BCBS, 2005, pp. 163–164). This view is also echoed in the Dodd–Frank Reforms and the Consumer Protection Act of 2010, which include provisions related to compensation committee independence.

Our chosen research focus is also important because the existing literature on the board structure–performance relation is

* Corresponding author. Tel.: +61 7 3346 8075; fax: +61 7 3346 8166.

E-mail addresses: s.pathan@business.uq.edu.au (S. Pathan), r.faff@business.uq.edu.au (R. Faff).

inconclusive. For example, using a three-stage least squares estimation method to control for simultaneity, Sierra et al. (2006) suggest that ‘strong’ boards improve bank performance. In contrast, using a fixed-effects (FEs) panel model to control for unobserved heterogeneity, while Adams and Mehran (2012) support a positive relation between bank board size and performance, they fail to identify any association between independent directors and bank performance. However, they conjecture that the results could change if they control for organisation structure, M&A and other sources of endogeneity. Similarly, for a sample of 69 commercial banks from six OECD countries including the US, Andres and Vellido (2008) show a positive but concave effect of both bank board size and non-executive directors on bank performance. Nevertheless, their two-step system generalised method of moments (GMMs) estimates contradict their pooled ordinary least squares (OLSs) and FE estimates.

Our study is in line with Wintoki et al. (2012) in examining the causal effect of board structure on firm performance. Wintoki et al. (2012) illustrate in detail the importance of using Arellano and Bover (1995) and Blundell and Bond's (1998) dynamic panel GMM estimation technique in corporate finance studies. This research method is suitable for estimating a dynamic model, particularly when it is difficult if not impossible to find ‘orthogonal’ instruments to reduce the endogeneity problem in governance variables such as board size and independence. The approach centres on a system of two equations, the original equation of variables in levels and a counterpart equation based on differenced variables (‘system GMM’). Using a system GMM estimation technique to control for all the important sources of endogeneity, such as dynamic, fixed effects and simultaneity in governance and other firm characteristics, Wintoki et al. (2012) report no relation between board size or board independence and firm performance. Their findings are consistent with the evolving board structure determinants literature that suggests the make-up of boards depends on their unique information and contract environment (e.g., Adams and Ferreira, 2007; Linck et al., 2008; Coles et al., 2008).

Although the characteristics of banks are also relevant to their boards’ formation (Pathan and Skully, 2010; Adams and Mehran, 2012), such non-bank findings cannot be reliably generalised to banks for two key reasons. First, regulatory constraints might not allow a bank’s board to be either fittest or optimal (Hermalin and Weisbach, 2003). For example, the board of a national bank (regulated and supervised by the OCC) must consist of 5 to 25 directors. Similarly, New York State requires its member banks to maintain boards of seven to 30 directors (when their capital stock, surpluses and divided profits are in excess of \$50 million), while two-thirds of these directors should be non-executives, i.e., outsiders. Indeed, in unreported descriptive statistics for our sample, we find that the board size of national (state) commercial banks, i.e., ticker 6021 (6022) ranges from 5 to 26 (31).¹

Second, Wintoki et al. (2012) consider ‘dynamic endogeneity’ to be an important source of endogeneity that needs to be controlled for in governance and performance relation studies to obtain unbiased estimates. The term ‘dynamic endogeneity’ refers to the manner in which a firm’s current performance affects both its future performance and its governance. However, for banks, dynamic endogeneity is less problematic because a bank’s past performance, a proxy for management capability, does not affect either its board size or its composition (see Pathan and Skully, 2010; Adams and Mehran, 2012).² Therefore, *a priori* the first-order effect of board

structure on performance should be more discernible in banks even using a system GMM estimation.

The introduction of SOX, following the high profile corporate scandals at Enron and WorldCom and the associated listing rule changes of the NYSE, NASDAQ and AMEX, now requires more independent boards. Based on samples of non-financial firms, several studies suggest that board governance has improved in the post-SOX period as measured by firm value (e.g., Chhaochharia and Grinstein, 2007; Linck et al., 2009). Therefore, these changes might have implications for studying how a bank’s board affects performance. Similarly, the recent financial crisis provides an opportunity to explore how better-governed banks performed during the crisis. Such a study on banks is also important, in light of the findings of Francis et al. (2012) who show that better-governed firms performed well during the crisis. Since the crisis was an exogenous shock to the firm’s investment choices, a study on the relation between board structure and performance around the crisis period would be robust to any endogeneity concern related to board structure variables.

Based on a sample of 212 large US BHCs over the period 1997–2011, using the system GMM estimation technique, we document a strong negative relation between bank board size and performance, i.e. other things equal banks with smaller boards perform better. We also find evidence that banks in which boards have more independent directors perform worse. While our results show that gender diversity in the boardroom improves bank performance in the pre-SOX period (1997–2002), the positive effect of gender weakens in the post-SOX (2003–2006) and crisis periods (2007–2011). This result is particularly important because it indicates that the inclusion of more female directors does not necessarily improve bank performance. One plausible interpretation could be that more female board members beyond a “desirable” limit reduce the possibility of the inclusion of more capable male directors. Finally, we present evidence that the impact of board structure on performance is prevalent particularly for banks (i) with low market power, (ii) exposed to external takeovers and/or (iii) of smaller size.

Our study is similar to those of Sierra et al. (2006), Andres and Vellido (2008) and Adams and Mehran (2012) in investigating how board structure influences bank performance. However, our tests and resulting evidence complement and extend the above studies in several important ways. First, to the best of our knowledge, the sample in this study is considerably larger than the samples in previous studies. As such, we afforded the flexibility to use and reliably interpret the results from different panel data estimation techniques including system GMM. Our relatively long sample period also enables us to investigate for the first time the impact of SOX and the financial crisis on the relation between the board structure of banks and their performance. Such analysis is important to evaluate the effectiveness of enforcing independent director criteria in SOX, the Dodd–Frank Act and the major exchanges’ listing rules.

This is also the first study to examine the effect of gender diversity in bank boards on their performance. The outstanding evidence on the value relevance of women on boards is inconclusive (e.g., Adams and Ferreira, 2009; Farrell and Hersch, 2005; Carter et al., 2003). However, the differences in empirical findings could be due to divergent samples, time periods and industry coverage, as well as endogeneity problems. Of particular note, the mean percentage of female directors on bank boards (7.94% in our study) is substantially lower than that of non-bank boards (e.g., 15.2%; see Catalyst, 2010). Thus, the marginal effect of female directors on bank boards might have a more detectable impact on bank performance.

In addition, ours is the first study to present evidence that banking regulation could have shifted the need for board governance.

¹ However, the Federal Reserve System, the ‘umbrella supervisor’ for BHCs, does not impose any such specific restrictions or requirements on BHCs’ boards. Therefore, the regulatory environment alone cannot fully explain a BHC’s board structure.

² In an unreported test, we find the same for our sample banks that the lagged performance of banks does not relate to their board size or composition.

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