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Endogenously structured boards of directors in banks

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ABSTRACT

This paper examines the trends and endogenous determinants of boards of directors (board size, composition, and CEO duality) for a sample of 212 US bank holding companies, from 1997 to 2004. Overall, the results show that the costs and benefits of boards' monitoring and advising roles could explain bank board structures with caveats. For example, due to the regulatory nature and comparatively intensive scrutiny of bank officers and directors, it is argued that bank managers have less control over the directors' selection processes. Thus, bank board independence should not be the outcome of negotiation with CEOs. Consistent with this view, bank CEOs are found not to affect bank board independence. The trend analysis also provides some important results. In contrast to non-bank evidence, for instance, board size was discovered to decrease over the sample period for large and medium-sized banks, while board size remained relatively stable for small banks. These results are robust with respect to different estimation specifications. Furthermore, the study's findings have important policy implications for bank regulators and investors.

1. Introduction

A wide range of accounting, finance and management literature has determined that a certain type of board structure is preferred to monitor managers. For instance, a small number of board directors and more independent directors are considered to be important elements of an effective board (e.g., Yermack, 1996; Fama and Jensen, 1983). This issue was further emphasized by the introduction of the Sarbanes–Oxley Act of 2002 and the associated listing rules by NYSE, NASDAQ, and AMEX as they require a majority of independent board directors and a completely independent audit committee. Hence, these developments are in favor of a uniform board structure, irrespective of the industry in question. However, if we believe Alchian's (1950) economic theory of 'Darwinism,' it is important to understand why some firms still maintain large boards, while others have majorities of non-independent or executive directors. To answer this question, several studies attempt to explain this observation by relating the costs and benefits associated with boards' monitoring and advising functions (Hermalin and Weisbach, 1998; Raheja, 2005; Adams and Ferreira, 2007; Harris and Raviv, 2008). Based on these theoretical works, among others, Baker and Gompers (2003), Boone et al. (2007), Coles et al. (2008), Linck et al. (2008), and Lehn et al. (2009) empirically find evidence in support of the endogenous formation of boards of non-financial firms.

While the same theoretical underpinnings relating to board structure are valid to both banks and non-bank firms, the existing empirical studies exclude banks from their sample, and several factors (such as regulation, high leverage) could limit generalizing non-financial board structure findings to banks. This study aims to fill this knowledge gap by investigating whether the costs and benefits of the boards' monitoring and advising functions could also explain board structure (board size, composition, and CEO duality[1]) in a regulated industry, like banks.

The global financial crisis also highlights the importance of improving understanding of bank governance. Indeed, the study on bank board structure deserves special attention for several reasons. Perhaps the bank board of directors is even more important

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[1] 'CEO duality' refers to a situation in which the CEO is also the board chair.

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as a governance mechanism than its non-bank counterparts because banks have become larger, complex and more diversified, following the deregulation with the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994, as well as the Gramm–Leach–Bliley Act of 1999. In addition, the presence of regulation could have different implications for bank board structure determinants. For example, as discussed later in Section 2, bank directors and managers are subject to stringent regulatory scrutiny, compared to non-bank board directors. This regulation is commonly justified for three reasons. First, there are costly consequences in the case of bank failure (Flannery, 1998). Second, bank shareholders have distorted objective of excessive risk-taking in the presence of deposit insurance (Galai and Masulis, 1976). Finally, bank debtors do not have the incentive to monitor bank managers due to high information asymmetry (Demirgüç-Kunt and Detragiache, 2002). This constant regulatory monitoring could limit bank managers' self-serving behavior (such as perks). Hence, bank managers, including CEOs, cannot influence the director selection process. As a result, in contrast to non-bank studies, CEO power (i.e., CEO's ability to influence board decisions) should not be an important determinant of bank board independence. Thus, it is important to examine, even in the presence of such regulation, whether bank board structure can still be explained by the costs and benefits associated with boards' monitoring and advising functions, given bank characteristics and other governance mechanisms. It is also important to determine whether board structure has changed significantly for regulated banks due to the enactment of the Sarbanes–Oxley Act (SOX) of 2002 and associated listing rules changes. The study of the banking industry also provides a unique setting in which to enhance our understanding of board structure determinants.

Using a sample of 212 US bank holding companies monitored between 1997 and 2004, this study finds some evidence in favor of endogenously chosen boards of directors. This supports the argument that banks structure their boards consistently with the costs and benefits associated with boards' monitoring and advising functions. More specifically, the results show that: (i) larger and more diversified banks have larger and more independent boards, and also combine both CEO and board chair titles; (ii) bank board independence is not the outcome of negotiations with the CEO; (iii) banks in which managers' opportunities to consume private benefits are high have larger boards, while banks in which the cost of monitoring managers is low have more independent boards; (iv) banks in which managers have substantial influence and the constraints on managerial influence are weak combine both CEO and board chair roles; and (v) banks in which insiders' shareholding is high and the outsiders' shareholding is low have smaller boards.

The trends in bank board structure over the sample period also provide some significant insights. For example, bank board size declines over the sample period, particularly for large and medium size banks, which is in contrast with non-bank firm evidence. However, the percentage of independent directors increases substantially, especially during the post-SOX period.

This study contributes to the existing literature on board structure determinants in several important ways. This is the first study to demonstrate that even in a regulated industry like banking, the costs and benefits of monitoring and advising functions of boards could explain their structure. This paper complements and extends Adams and Mehran's (2009) study, which investigates bank board governance for a sample of 35 BHCs from 1959 to 1999. They illustrate that bank board size relates to M&A activity and organizational structure. However, they have not shown the determinants of other important board features, such as board composition and leadership structure. Likewise, they have not exclusively examined the determinants of bank board structure (such as negotiations with the CEO, ownership incentive structure), in view of existing non-bank evidence by Lehn et al. (2009), Linck et al. (2008), and Boone et al. (2007), among others. This study also broadens our knowledge by showing that bank CEOs do not influence the board selection process due to fear of regulatory action. This result challenges the existing non-bank evidence and thus has important policy implications, while designing appropriate governance system for banks. In terms of methodology, a broad set of diagnostic and statistical consistency tests were conducted to confirm the robustness of the results, including several approaches that account for unobserved heterogeneity and simultaneity. For example, a system generalized method of moments (GMM) estimation technique was used to directly control for any 'dynamic endogeneity' problem. Finally, this is perhaps the first study to provide some evidence that bank board structure has significantly changed, following SOX and the associated changes mandated by the stock exchanges. Such findings are vital to evaluating the possible impact of SOX on regulated banks' board structure.

The rest of the paper is structured as follows. Section 2 further drives the study of bank board structure determinants by discussing the regulatory oversight of boards of directors in banks. Section 3 reviews the literature on board structure determinants and formulates the relevant hypotheses for banks. Then, Section 4 describes the data and methodology. Section 5 provides the empirical results, while Section 6 demonstrates the robustness of the results, using different estimation techniques. Section 7 reports some results with regard to the impact of SOX and associated listing rules' changes on bank board structure determinants. Finally, Section 8 concludes the paper.

2. Regulatory oversight of boards of directors in banks

Banks' boards of directors historically have not been legally bound to solely serve the shareholders, as is typically the case for non-bank firms. The 'fiduciary'[2] responsibility (i.e., duty of loyalty and care) of the bank directors and managers extends beyond shareholders to depositors and bank regulators (for more details, see Macey and O'Hara, 2003; Fanto, 2006). Bank regulators set detailed standards of conduct for directors and managers and monitor individual conformity with these standards to ensure 'safe and sound' bank system. The regulators have considerable disciplinary powers available, if they discover bank directors and managers in any violation of the standards. The disciplinary actions include suspension and removal from the bank, and even a life-long ban from the industry; regulators can also refer the matter to federal prosecutors. With the passing of the Financial Institutions Reforms, Recovery and Enforcement Act (FIRREA) of 1989, and the FDIC Improvement Act of 1991, Congress further empowered bank regulators in taking 'prompt corrective actions' against bank directors and officers for their decisive roles (see Shepherd, 1992 for details). For example, Section 1821(k) of FIRREA 1989 stated that directors and officers of insured institutions would be held personally liable for any misconduct of bank business (Shepherd, 1992, p. 1122).

The available data indicate that bank regulators frequently use these disciplinary powers against bank directors and managers. For example, in 2005, of the 32 consensual removal orders by the Office of the Comptroller of the Currency (OCC), 12 involved senior bank officers, including CEO and directors.[3] Thus, bank directors and managers have a legal duty to recognize their obligation to the

[2] Macey and Miller (1993, pp. 401–407) define fiduciary duties as ". . . the mechanism invented by the legal system for filling in the unspecified terms of shareholders' contingent [contracts]." In addition, see Macey and O'Hara (2003, pp. 93–95) for a good discussions of bank directors' fiduciary duties, or 'duty of care' and 'duty of loyalty' to shareholders, depositors and regulators.

[3] Source: The OCC Web site http://apps.occ.gov/EnforcementActions/ (viewed on August 27, 2009) for a search engine for enforcement actions.