



Concentrated control, institutions, and banking sector: An international study

In-Mu Haw^a, Simon S.M. Ho^b, Bingbing Hu^{c,*}, Donghui Wu^d

^a Neeley School of Business, Texas Christian University, Fort Worth, TX 76129, USA

^b University of Macau, Taipa, Macau

^c Department of Accountancy and Law, Hong Kong Baptist University, Kowloon Tong, Hong Kong

^d School of Accounting and Finance, The Hong Kong Polytechnic University, Hung Hom, Kowloon, Hong Kong

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ABSTRACT

Using a broad sample of listed commercial banks in East Asia and Western Europe, this paper investigates the relations among concentrated control, a set of bank operating characteristics, and legal and regulatory regimes. We find that banks with concentrated control exhibit poorer performance, lower cost efficiency, greater return volatility, and higher insolvency risk, relative to widely held ones. We also document that legal institutions and private monitoring effectively reduce the detrimental effects of concentrated control and that official disciplinary power plays a weak governance role, whereas government intervention exacerbates the adverse effects. Further evidence shows that the relations between control concentration and bank operating characteristics are curvilinear and vary according to the types of controlling owners. Overall, our findings support the contention that country-level institutions play important roles in constraining insider expropriation, and that private monitoring mechanisms are more effective than are public rules and supervision in governing banks.

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1. Introduction

The health of the banking sector is crucial to economic growth and stability. The structural weakness in the banking systems of Asian countries has been identified as one of the major causes triggering the Asian financial crisis in 1997 (Alba et al., 1999). In the aftermath of the crisis, large-scale banking reforms have been undertaken across regions to restructure the banking sector, including privatizing state-owned banks, lifting the entry barriers to foreign banks, tightening loan and credit policies, adopting international standards in bank supervision and regulation, and enforcing stringent corporate governance practices. Although it may still be too early to assess the long-term success of these reform measures, an in-depth understanding of the determinants of the health of bank operations can offer directions for furthering the reforms. Using a sample of listed commercial banks from 22 economies over the period 1990–1996, this study investigates the impacts of concentrated control on bank performance, cost efficiency, and risk under various legal and regulatory regimes.

As is the case in non-financial industries, a high degree of control concentration, the presence of controlling owners with sig-

nificant control rights in excess of cash flow rights, and close ties between managers and controlling owners are the defining features of the ownership structures of banking firms in East Asia and Western Europe (Claessens et al., 2000; Faccio and Lang, 2002; Djankov et al., 2005; Williams and Nguyen, 2005). Such an ownership structure is susceptible to agency conflicts between controlling owners and minority shareholders, because concentrated control rights empower controlling owners to exercise full control over firms, while the disproportion in cash flow rights fails to align their interests with those of minority shareholders (Shleifer and Vishny, 1997; La Porta et al., 2002b). The extant literature documents the adverse impacts of such ownership structures for industrial firms, including lower firm value and stock returns, weaker profitability, and poorer earnings quality (Claessens et al., 2002; Fan and Wong, 2002; Lins, 2003; Haw et al., 2004). Nonetheless, a long-standing view suggests that the presence of large shareholders mitigates the classic owner–manager agency problems through their strong incentives to monitor and substantial power to influence management (Shleifer and Vishny, 1986, 1997). Consistent with this view, a few studies show that large shareholdings by controlling shareholders are associated with better performance and higher valuation (La Porta et al., 2002b; Anderson and Reeb, 2003; Villalonga and Amit, 2006).

* Corresponding author. Tel.: +852 3411 5273; fax: +852 3411 5581.

E-mail address: bingbing@hkbu.edu.hk (B. Hu).

Most studies on the relationship between ownership structure and bank operations focus on different types of ownership, such as private, state, managerial, domestic, or foreign ownership, and report mixed results (e.g., Saunders et al., 1990; Anderson and Fraser, 2000; Williams and Nguyen, 2005; Iannotta et al., 2007; Sullivan and Spong, 2007; Lensink et al., 2008; Boubakri et al. 2009).¹

There is little evidence, however, on the effects of concentrated control on bank operations. Theoretically, the agency problems arising from concentrated ownership structure could be severer in the banking sector than in other industries for several reasons. First, banks with concentrated ownership structure are typically affiliated with a business group through pyramids or cross-shareholdings, and become the capital supplier of the related firms (Laeven, 1999; Unite and Sullivan, 2003; Williams and Nguyen, 2005).² In such a setting, connected lending and relationship banking rather than merit-based considerations shape bank lending practices. Second, because of strict regulations, market discipline plays a limited role in the banking sector (Hassan et al., 2004). Thus, bank governance relies largely on internal governance together with legal and regulatory institutions. Third, the inherent opacity of bank assets makes insider expropriation easier for banks than for other firms.

Based on a wide range of listed commercial banks, we find that banks with concentrated control underperform their widely held counterparts in terms of accounting profitability and stock returns. In addition, they exhibit significantly lower cost efficiency, greater returns volatility, and higher insolvency risk. Further evidence indicates that these detrimental effects are largely mitigated by strong legal and private/market monitoring institutions. In contrast, public regulation plays a less effective governance role, and a high level of government intervention even intensifies the detrimental effects. These results imply that, in the banking sector, legal protection and private/market monitoring are more effective in mitigating agency conflicts than public regulation or government intervention. This is in line with Barth et al. (2004), which finds that private monitoring works better to promote bank development, performance, and stability, relative to government restriction and official oversight.

In addition, we find that the relations between control concentration and some of the bank operating characteristics are nonlinear, and that controlling owners are entrenched over an intermediate to high range of control. We also document differential effects of distinct owner types on bank operations, and that family and state control is subject to greater agency conflicts in countries with weak legal and regulatory institutions.

This study adds to the literature in several ways. First, a large body of studies examines the impacts of concentrated ownership structure on industrial firms. This study extends the research scope to the homogenous banking industry, which is under heavier regulations and inherently more opaque than non-financial industries. Second, our cross-country sample allows us to assess the relative effectiveness of various legal and regulatory institutions in constraining agency problems and offers important insights to regulators and practitioners for developing good governance model for banks. Finally, our findings from the pre-crisis period provide policy implications to regulators worldwide to improve bank ownership structure and enhance soundness of the banking sector.

The rest of this paper is organized as follows. Section 2 discusses the theoretical framework and proposes the hypotheses. Section 3 describes the data sources, sample, and variables. Section

4 presents the descriptive statistics and multivariate analyses. We also perform a set of robustness checks in Section 4. Section 5 concludes the paper.

2. Hypothesis development

2.1. Concentration of control and bank performance, cost efficiency, and risk

Conceptually, concentrated control can affect bank operations in contrasting ways. On the positive side, the presence of controlling owners helps alleviate the traditional agency problems between owners and managers. If controlling owners also hold substantial cash flow stakes, then they have both strong incentives to monitor management and enough control to influence or replace inefficient management (Shleifer and Vishny, 1986). The active monitoring role played by controlling shareholders is beneficial to minority shareholders, especially when external governance institutions are weak (La Porta et al., 2002b). In the banking sector, controlling shareholders have strong incentives to monitor bank management through tight oversight of lending practices, operational efficiency, and risk management (Unite and Sullivan, 2003). In addition, relationship banking, which is built on the strong ties between banks and their corporate borrowers, facilitates private communication between the two parties and thus lowers transaction costs (Williams and Nguyen, 2005). Consistent with the theoretical grounds, Anderson and Reeb (2003) and Villalonga and Amit (2006) find that concentrated ownership in the hands of a family is positively associated with firm performance and value. However, it is crucial to note that the alignment effect is related to the ownership stakes held by the controlling owners and is conditional on the extent of the legal protection of investors (Claessens et al., 2002; La Porta et al., 2002b).

On the other hand, concentrated control is considered to be detrimental to minority shareholders as it induces insider expropriation and distorts management decision making (Shleifer and Vishny, 1997; Bebchuk et al., 2000). The agency costs associated with control concentration may be greater in the banking sector because of its unique features. First, banks with concentrated control are typically connected to business conglomerates comprising many member firms. Banks are more likely to serve as “house banks” and become an easy tool for tunneling. For example, controlling owners may lend credits with more favorable terms to connected firms, prop up distressed group firms with unsecured loans, or adopt liberal lending policies for related parties. In support of this argument, Laeven (1999) finds that family-controlled and corporate-controlled banks in five East Asian countries experienced extremely high loan growth during the period from 1992 to 1996. Second, unlike other industries, the banking sector is subject to heavy regulation. Market discipline, such as takeover, market competition, and other private monitoring, has limited scope in monitoring banks. Regulators that aim to ensure the safety and stability of banking systems may not serve the best interests of minority shareholders. Third, Morgan (2002) argues and empirically shows that the financial nature of bank assets and their high leverage make them inherently more opaque and riskier than other firms. The great information asymmetry arising from the opacity of banking assets and proprietary information makes it more difficult to monitor insiders and detect insider expropriation.

The presence of controlling owners has particular implications for bank risk-taking. It is well recognized that bank shareholders have incentives to increase their risk-taking because of the moral hazard engendered by the deposit insurance system (e.g., Saunders et al., 1990; Pathan, 2009). In the absence of controlling owners, the preference of shareholders for higher risk-taking is moderated

¹ In a related study, Saunders et al. (1990) examine how the agency conflicts between managers and shareholders affect the risk-taking behavior of banks. Our study measures ownership structure by the control stake held by the ultimate controlling owners, who may not necessarily be managers, and focuses on the agency conflicts between the controlling owners and minority shareholders.

² For example, Unite and Sullivan (2003) find that virtually all large commercial banks in the Philippines are affiliated with business groups.

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