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What's in an education? Implications of CEO education for bank performance

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ABSTRACT

Exploiting a unique hand-built dataset, this paper finds that CEO educational attainment, both level and quality, matters for bank performance. We offer robust evidence that banks led by CEOs with MBAs outperform their peers. Such CEOs improve performance when compensation structures are geared towards greater risk-taking incentives, and when banks follow riskier or more innovative business models. Our findings suggest that management education delivers skills enabling CEOs to manage increasingly larger and complex banking firms and achieve successful performance outcomes.

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1. Introduction

If heterogeneous CEO characteristics matter for firm performance, which characteristics define a good CEO? The corporate governance literature has established that the personal characteristics of CEOs hold explanatory power in explaining firm performance differentials (Bertrand and Schoar, 2003; Malmendier and Tate, 2005, 2008; Frank and Goyal, 2007; Malmendier et al., 2011; Kaplan et al., 2012; Fee et al., 2013; Graham et al., 2013). Our paper contributes to literature by disentangling the dynamic relationships between CEO education and the incentives for risk-taking that are implicit in the structure of executive compensation contracts, in order to determine the effects on firm performance outcomes. We investigate possible channels through which CEO education and the choice of business policies interact and influence performance outcomes. Our findings shed light on an important yet unresolved issue. Graham et al. (2012) and Benmelech and Frydman (2015) cite a paucity of substantive evidence on the effects of unobservable personal characteristics like the innate ability of CEOs that conditions educational attainment, and which shapes CEO fixed-effects and firm performance.

This paper offers a rigorous treatment on whether and how CEO educational attainment affects firm performance. Educational attainment influences career outcomes in terms of pay and career trajectory. Literature shows that education background conditions firm investments and general decision-making (Laderman, 1994; Donkers et al., 2001; Frank and Goyal, 2007). Educational attainment contains expectations on the latent ability of CEOs. Bhagat et al. (2010) report stock market reaction to announcements of appointments

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of CEOs with stronger educational credentials is positive and creates significant abnormal returns. Falato et al. (2015) find firms pay a premium to newly appointed CEOs with superior educational credentials. Yet, not all forms of CEO education produce a homogenous effect on firm performance because of selection effects. Academic qualifications vary by levels and quality of awarding institutions. This leads to differences in CEO skill-sets and results in performance differentials (Miller et al., 2015).

We investigate if a particular type of CEO education has greater causal effect on firm performance. Literature on the demand for human capital piques our interest. Frydman (2007) and Murphy and Zbojnik (2007) describe the recent growth in business education as reaction to increasing demand for general managerial skills over technical skills. This shift in preference stems from the fact that firms have become considerably larger and more complex because of technological advances and innovations in business practices.¹ In support, Chevalier and Ellison (1999) report that fund managers who graduated from universities with tougher entry requirements, and managers with MBA awards, generated higher returns. Evidence shows CEOs with MBA choose more aggressive corporate strategies (Bertrand and Schoar, 2003), and such CEOs speculate more in the forex market (Beber and Fabbri, 2012).

For our analysis, we carefully construct a unique hand-collected dataset that captures CEO educational qualifications for 149 large US banks for the period 1992 to 2011. A relatively recent process of financial deregulation and financial innovation has increased the scale and scope of what have become increasingly complex operations. The opaque nature of a bank's assets and liabilities, and the fact that large banks operate across financial markets and jurisdictions including cross-border, suggests that the banking industry is an ideal laboratory on which to test the proposition that the observed increase in business education and preference for general managerial skills has resulted in superior firm performance outcomes. We collect data on the types of degrees held by CEOs (undergraduate, MBA, or PhD) and identify if the awarding university is amongst the top-20 U.S. institutions according to U.S. World and News Report, following Bhagat et al. (2010) and Cohen et al. (2010). Just under 40% of our sample CEOs hold MBA awards.

We exploit the properties of the dataset to determine the sensitivity of bank performance to the level and quality of CEO educational attainment. To do this, we develop a CEO Education Index comprising three factors: UG Education (constituting a basic undergraduate level of training that aids development of transferable skills), MBA Education (representing the level of management training and knowledge acquired through an MBA programme), and PhD Education (showing the level of technical expertise obtained through an advanced degree or doctorate). We arrive at this measure by following prior work (Tetlock, 2007; Kaplan et al., 2012; Ellul and Yerramilli, 2013) and employing factor analysis to extract these factors. Using factor analysis to construct an index, which acts as a barometer of educational attainment, potentially mitigates issues arising from subjective researcher judgement. For instance, the choice of variables that should be included and how each factor should be scored relative to other factors (Tetlock, 2007), as well as mitigating other measurement issues (Custódio et al., 2013).

Our paper provides several contributions to existing literature. First, our work extends and complements earlier analysis conducted on CEO education and firm performance (Chevalier and Ellison, 1999; Bhagat et al., 2010; Beber and Fabbri, 2012) by investigating the banking industry. We find that bank CEOs with higher MBA Education factors (i.e. level and quality of management education) typically exhibit better firm performance, but UG Education and PhD Education appear not to matter. This effect is also economically meaningful, with one standard deviation in MBA Education resulting in improving performance by 11.4% relative to the mean. Our main results reconcile an apparent contradiction between strong theoretical priors and the mixed empirical evidence on the impact of education on firm performance. Our result substantiates the duration of the effect of MBA Education, which counters arguments in Bhagat et al. (2010) that the impact of education is short-lived, and supports the actions of external and internal stakeholders in considering CEO education a measure of innate talent (Kaplan et al., 2012; Elsaid et al., 2015). Our results are consistent with the emerging consensus in literature that the education of CEOs is a factor in explaining performance differentials (Chevalier and Ellison, 1999; Beber and Fabbri, 2012; Miller et al., 2015). Furthermore, we find that the 'quality' of education matters, since our results highlight that CEOs who graduate from top-20 US universities are able to realise superior firm performance.

Our original contribution speaks to the compensation literature, where prior research has largely focused on the relationship between equity incentives and bank performance (Crawford et al., 1995; Mehran, 1995; Fahlenbrach and Stulz, 2011; Minnick et al., 2011). Our findings provide new insight into this relationship. We show that education moderates the responsiveness of CEOs to incentives embedded in their compensation contracts. CEOs with higher Management Education scores are more likely to improve bank performance in response to higher risk-taking incentives (notably, Vega incentives to increase the volatility of stock price returns) and receiving a higher fraction of equity compensation in their compensation structure. Our findings preclude any form of generalisation across either CEO education or types of incentives. Instead, we show that specific types of incentives and education matter for performance. In this regard, we further extend Bandiera et al.'s finding (2015) that managers with high-powered incentives are more likely to be university-educated and hold a business education award. Taken together, we argue that CEO-specific attributes may play a key role in explaining cross-sectional heterogeneity in how CEOs respond to equity incentives embedded in their compensation contracts.

Another contribution of our paper is to demonstrate channels through which CEOs with specific education credentials improve bank performance. We provide micro-level evidence by focusing on bank business models and implicit strategic choices to better identify CEO actions and decisions. Custódio and Metzger (2014) point out that very little is known about how CEOs improve performance and create value for shareholders, and the channels through which such performance gains accrue. We provide new insights on this issue. We show that CEOs with higher MBA Education factor scores who follow riskier or more innovative business models achieve significantly higher levels of bank profitability.

¹ Murphy and Zbojnik (2007) report a 15 percentage point increase in the number of CEO hires with MBA from the 1970s to the 1990s (14 to 29%). The statistics infer that approximately one-in-three U.S. CEOs held an MBA qualification in the 1990s.

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