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Board structures and performance in the banking industry: Evidence from Japan

Hideaki Sakawa *, Naoki Watanabel

Graduate School of Economics, Nagoya City University, 4678501, Nagoya, Japan

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ABSTRACT

This paper presents an examination of the relation between board size and composition and firm performance for the Japanese banking industry during 2006–2011. Our results for the banking industry show that the advisory and monitoring roles of larger boards and outside directors are ineffective. Results also show that banks which received taxpayer funds cannot reform their board structure and that taxpayer funds do not strengthen the advisory role of outside directors. We conclude that Japanese bank boards have not performed well during recent periods and that taxpayer funds have tended to rescue banks with weaker governance.

1. Introduction

Financial academics and practitioners recognize the importance of corporate governance mechanisms. In recent years, controversy in the field has specifically emphasized the functioning of boards of directors, which constitute important corporate internal control mechanisms (Jensen, 1993). To date, few analyses of the relation between board composition and firm performance in the banking industry have been reported. Earlier studies of the functioning of boards of directors have mainly addressed non-financial industries. From the viewpoint of revealing board functions under various corporate governance systems, it would be invaluable to analyze the relation between board composition and firm performance in Japan, where corporate governance mechanisms are expected to serve a "bank-centered system", different from Western "market-oriented systems" (Aoki, 1990). Regarding a board's role in a banking entity, no report in the relevant literature describes a study of the Japanese banking industry.

Studies of the role of boards of directors in non-financial industries present mixed evidence. Results of many early studies suggest that larger boards are not good monitors because of their higher coordination costs (Jensen, 1993; Lipton & Lorsch, 1992). Empirical studies such as those of Yermack (1996) and Eisenberg, Sundgren, and Wells (1998) find a negative relation between board size and firm performance. These findings support the view that smaller boards perform their roles better. However, some studies, such as those of Dalton, Daily, Johnson, and Ellstrand (1999), show that larger boards offer better advice to CEOs. Hermalin and Weisbach (1998) show through a theoretical study that the CEO might choose an outside director who will give good advice and counsel, who can bring valuable experience and expertise to the board.

A few analyses assess the relation between board composition and firm performance in the banking industry in several OECD countries. Their results show that the bank board composition and size are positively related to performance, meaning that the directors'

* Corresponding author. Nagoya City University, 1 Yamanohata, Mizuho-cho, Mizuho-ku, Nagoya, Nagoya, 467-8501, Japan.
E-mail addresses: sakawa@econ.nagoya-cu.ac.jp (H. Sakawa), naoki-watanabe@econ.nagoya-cu.ac.jp (N. Watanabel).

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salient capabilities are the monitoring and advising of managers, and that independent boards might help to monitor and advise management more efficiently, thereby creating more value. Andres and Vallelado (2008) analyze the relation between board composition and firm performance in the banking industry. Adams and Mehran (2012) also analyze the relation between board composition and firm performance in US bank holding companies (BHC), but found no negative relation between board size and firm performance.

Since the so-called *Lost Decade* of the 1990s in Japan, whether corporate governance mechanisms function well in the Japanese banking industry or not has remained an unresolved issue. A few earlier studies (Hoshi & Kashyap, 2010) describe the transition of Japanese banking, but most such studies (Dow & McGuire, 2008; Hiraki, Inoue, Ito, Kuroki, & Masuda, 2003; Morck & Nakamura, 1999; Morck, Nakamura, & Shivdasani, 2000) analyze the era preceding the lost decade up to the 2000s.[1] Especially after the late 1990s, the rescue of the Japanese financial system through government bail-outs and loans was funded with taxpayer-derived capital because Japanese bank operations were impaired by persistent deficits. Many commercial banks intended to recover through merger activities in the early 2000s, and attempted particularly to regain a good operating foundation on which to do business.

The Japanese banking industry changed dramatically after the lost decade. According to Hoshi and Kashyap (2010), the changing phases of the banking industry during three periods in 1990–2003 are classifiable: Phase one (1990–1997), the Actual phase (1997–1999), and Phase three (1999–2003). The first period, occurring before the late 1990s, included a few mergers and failures, which led to some changes in the corporate governance of Japanese banks (Anderson & Campbell, 2004). During the second period in later periods, the rescue of the Japanese financial systems through government bail-outs and loans was funded by taxpayers.[2] However, the Japanese government did not allow large banks to fail because of their central role in economy (Skinner, 2008). The rescue of Japanese financial systems through government bail-outs and loans was funded by taxpayers in later periods. During the third period after the early 2000s, the Japanese Financial Service Agency (FSA) asked banks that had received funds from taxpayers to change their corporate governance structures through reforms such as cutting executive compensation, altering the board size, and appointing outside directors to increase profitability. Under such circumstances, many banks suffered from bad deficit problems. They sought recovery through M&A activities.

After the third phase, many commercial banks reduced their "bad deficits." Through M&A activities from early 1990 through 2005, nine large city banks merged into three mega-banks: Mitsubishi–UFJ Financial Group, Sumitomo Mitsui Banking Corporation, and Mizuho Financial Group. Hoshi and Kashyap (2006) explain that Japanese commercial banks needed to propose a new strategy for the ensuing period. After 2006, the Japanese banking industry was completing its restructuring. During 2006–2011, Japanese banking industry merging activities were largely completed. Restructuring of their corporate governance systems had been established. This fourth period was probably ended by the Great East Japan Earthquake and the tsunami that struck Tohoku in 2011, causing severe damage throughout northeastern Japan.

Two empirical questions arise about the Japanese banking industry after 2006, when almost all merger activity had abated. The first is whether or not Japanese corporate governance mechanisms such as board structure in the banking industry are taking an effective monitoring role or advisory role in the recent period from the late 2000s. Since 2006, the Japanese banking industry has undergone complicated restructuring compared with that conducted during the lost decade of the 1990s. Hoshi and Kashyap (2006) describe that the total amount of "bad deficits" in the Japanese banking industry declined dramatically during 2002–2005 and that many commercial banks had managed to resolve "bad deficit" problems. Secondly, it remains unclear whether or not board members functioned effectively as management monitors or advisors at banks that were supported with taxpayer funds. Some Japanese banks were strongly impaired by deficit problems. Consequently, they were rescued using taxpayer funds through the Japanese financial system, which then imposed regulatory demands to safeguard taxpayer funds.

Our findings presented herein are related to the role of board of directors in the Japanese banking industry. They are summarized as the following points. We find that board size is negatively associated with bank performance. However, board independence is not related significantly to bank performance. Secondly, our sample includes banks with and without experience of taxpayer capital injection. Our analyses can reveal the role of board size or independence with taxpayer capital funds and can reveal how taxpayer funds affect the roles of bank boards. Results show that bank performance is positively related to board size in banks that received taxpayer funds. These results demonstrate that the negative association between performance and board size in Japanese banks is not stronger for banks that received taxpayer funds. Furthermore, our results show that board independence in banks receiving taxpayer funds does not contribute to enhancement of firm performance. We infer that banks with a weaker corporate governance structure were rescued and that they remained operational through later periods. This evidence also implies that Japanese bank boards have not performed well during the recovery period.

We contribute to the existing studies in several important ways. This paper is the first of a study examining whether Japanese bank boards function effectively under a bank-centered system, or not. Under bank-centered corporate governance, earlier studies specifically examine the role of main bank through the appointment of directors to the client firms (Hoshi & Kashyap, 2001). However, the effectiveness of bank-appointed directors itself presumes a sound corporate governance system of the main bank itself. This report reveals the relevance of the assumptions for Japanese corporate governance studies. Additionally, we compare banks with non-financial firms. An earlier study found that deregulation is expected to change corporate governance of regulated firms (Kole & Lehn, 1999). The

[1] After the 2000s, Sakawa, Moriyama, and Watanabel (2012) analyzed the relation between bank-appointed directors and executive compensation.

[2] During the second period, Big Bang deregulation was announced in late 1996 and implemented during fiscal year 1997. The objective of Big Bang deregulation was to remove barriers to competition within the financial industry both for domestic and foreign participants, thereby producing a US-style competitive system. After Big Bang deregulation, formal limits on "*mochiai*" or cross shareholding. Such cross shareholding was regarded as playing an important role in Japanese corporate governance and bank-centered systems (Aoki, 1990; Hoshi & Kashyap, 2001). After financial deregulation, bank ownership tend to be decreased. Main bank ownership ties might have been weakened (Sakawa, Ubukata, & Watanabel, 2014).

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