J. Finan. Intermediation xxx (2015) xxx–xxx

Contents lists available at ScienceDirect

J. Finan. Intermediation

journal homepage: www.elsevier.com/locate/jfi

CEO power, government monitoring, and bank dividends ☆

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ARTICLE INFO

Article history:
Received 17 April 2014
Available online xxxx

Keywords:
CEO power
Dividends
Entrenchment
Government monitoring
Banks

ABSTRACT

We investigate the role of CEO power and government monitoring on bank dividend policy for a sample of 109 European listed banks for the period 2005–2013. We employ three main proxies for CEO power: CEO ownership, CEO tenure, and unforced CEO turnover. We show that CEO power has a negative impact on dividend payout ratios and on performance, suggesting that entrenched CEOs do not have the incentive to increase payout ratios to discourage monitoring from minority shareholders. Stronger internal monitoring by board of directors, as proxied by larger ownership stakes of the board members, increases performance but decreases payout ratios. These findings are contrary to those from the entrenchment literature for non-financial firms. Government ownership and the presence of a government official on the board of directors of the bank, also reduces payout ratios, in line with the view that government is incentivized to favor the interest of bank creditors before the interest of minority shareholders. These results show that government regulators are mainly concerned about bank safety and this allows powerful CEOs to distribute low payouts at the expense of minority shareholders.

☆ We thank Charles Calomiris (the editor), Sanjai Bhagat (the referee), Afrasiab Mirza, all participants at the AIDEA Bicentenary conference and seminar participants at Xi'an Jiaotong Liverpool University and Nottingham University Business School China.

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http://dx.doi.org/10.1016/j.jfi.2015.08.001
1042-9573/© 2015 Published by Elsevier Inc.

1. Introduction

Powerful CEOs can invest in non-value maximizing projects to pursue managerial objectives including empire-building, expense preference behavior and the like.[1] As such, shareholders monitor CEOs in order to prevent such expropriation, but this can be costly if ownership is dispersed (Shleifer and Vishny, 1986). A partial solution to this problem is provided by dividend payouts. These can act as a monitoring device for shareholders because they reduce the amount of cash that CEOs can dissipate in non-value maximizing projects (Jensen, 1986) and also increase the frequency of CEO scrutiny from outside investors (Easterbrook, 1984).

The U.S. literature related to non-financial firms documents that CEO entrenchment leads to higher dividend payout ratios (Hu and Kumar, 2004; Elyasani and Zhang, 2013). This behavior is ascribed to the incentive of entrenched CEOs to discourage minority shareholder monitoring. Where corporate governance is weak dividends act as a pre-commitment device: a promise to regularly pay cash to shareholders reduces agency costs since it reduces the likelihood that these funds will be wasted on projects that increase the private benefits of CEOs without maximizing shareholder value (John and Knyazeva, 2006). However, the incentive to pay larger dividends also depends on whether entrenched CEOs can fend off take-over threats (Stulz, 1988), and on the degree to which monitoring from the board of directors is effective (Boumosleh and Cline, 2015). A possible reason for weak shareholder monitoring and low dividend payouts relates to the protection of the rights of minority shareholders. In their seminal paper, La Porta et al. (2000) provide evidence that in countries with stronger minority rights payout ratios are higher, suggesting that high payout ratios are an outcome, rather than a substitute, of strong minority rights. Consistent with this hypothesis, Adjaoud and Ben-Amar (2010) find a positive link between the quality of corporate governance and payout ratios.[2] There is evidence also that dividends dampen expropriation in group-affiliated firms (Faccio et al., 2001), as investors anticipate the risk of expropriation from the controlling shareholder and require higher payouts. Moreover, shareholders in countries with strong creditor rights tend to be more sensitive to possible expropriation from insiders, suggesting that firm insiders set dividend policies with the objective to minimize agency costs of both equity and debt (Shao et al., 2013). This is an important finding – in equilibrium, payout ratios should reflect the monitoring incentives of *all* stakeholders.

Building upon this literature, we aim to investigate the relationship between CEO power and dividend payouts in the banking sector. This is of interest because unlike non-bank firms, the objectives of managers and shareholders can conflict with those of other powerful stakeholders such as depositors and government regulators. Bank executives are subject to the scrutiny of different stakeholders. For instance, Schaeck et al. (2012) provide evidence of shareholder discipline for risky institutions, while there is no evidence of such discipline from debt holders and regulators. Monitoring by minority shareholders may well influence CEO behavior less than oversight from the government. In this case, the government may favor lower payouts since this could improve bank capital positions, resulting in safer institutions. Bank safety is a primary concern for the government, because bank failures result in long-lasting negative effects on economic growth (Kupiec and Ramirez, 2013).

Because of government monitoring, the relation between CEO power and dividend payouts in banking is not necessarily positive. Banks with entrenched CEOs may have relatively low payout ratios to deter greater government scrutiny. Dividend policy can shape the features of agent-principal issues in banking and as such is worthy of further investigation.

Characteristics of CEO power and dynamics are strongly intertwined with the role of bank corporate governance.[3] This topic has recently drawn attention from academics and policy makers alike

[1] Alternatively, bank CEOs can decide not to take projects with positive Net Present Value (NPV) (Vallascas and Hagendorff, 2013).

[2] Other recent literature, however, finds that dividends may act as a substitute for strong minority rights (De Cesari, 2012), and can mitigate the conflict between strong and weak stakeholders (Bøhren et al., 2012). This is in-line with the 'substitute model' for dividends. Dividends are paid by insiders to establish a good reputation and reduce conflicts with minority shareholders (La Porta et al., 2000). According to the 'outcome model', dividends are the 'outcome' of regulation that protects the rights of minority shareholders (La Porta et al., 2000).

[3] Corporate governance can be defined as 'the allocation of authority and responsibilities, i.e. the manner in which the business and affairs of a bank are governed by its board and senior management' (BIS, 2010, p. 5).

Please cite this article in press as: Onali, E., et al.. J. Finan. Intermediation (2015), http://dx.doi.org/10.1016/j.jfi.2015.08.001