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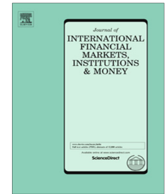

Does public–private status affect bank risk taking? Worldwide evidence ☆

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ABSTRACT

In this paper, we examine risk taking by publicly traded and privately owned banks in an institutionally diversified international sample of countries. Using the Z–score as our primary risk proxy, we find that publicly traded banks engage in less risky activities than their privately owned peers. We further investigate whether listing status (i.e., public or private) impacts bank risk taking before and after the recent financial crisis and across different institutional environments. We find that public banks are likely to exhibit less risk taking than their private counterparts in countries with weak institutions. Further, we find that publicly traded banks are engaging in less risk-taking activities compared to private banks in the pre-crisis and post-crisis alike, but more in the post-crisis, across all countries.
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1. Introduction

A sound banking system has always been considered a pillar of stability and sustainable economic growth. Deemed to lie at the heart of the recent financial crisis, bank failures and riskiness have drawn renewed and widespread attention that, more than ever before, put banks under the scrutiny of regulators and supervisors.[1] Examining ownership structure and bank risk taking, Barry et al. (2011, p. 1327) stress "*the inherently unstable nature of banking and the tendency of banks towards excessive risk taking*" during the recent financial crisis. The authors also note that for a bank, "*the choice to be publicly held or privately owned* ...*implies difference in terms of market discipline and access to capital markets: for publicly traded banks, market forces can influence risk taking*". The same argument is presented in Harris and Raviv (2014).

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[1] For instance, UK banks are forced to hold buffers that are eight times greater than before the financial crisis to guard against new threats. Source: *Financial Times*, October 21, 2012.

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In this paper, we analyze this issue and posit that the listing status of the bank (i.e., publicly traded versus private) can drive differences in risk taking behavior. Our main conjecture hinges on the rationale that being a publicly traded or a privately owned bank implies differences in terms of control and exposure to capital market forces, which potentially affect bank risk-taking incentives. We define public banks as banks whose stocks are publicly traded on the stock exchange, and private banks all other banks. Compared to a typical private bank, a publicly traded bank is characterized by a diffuse ownership and a greater separation of ownership and control (e.g., Nichols et al., 2009). This in turn implies a greater divergence in incentives for shareholders and managers to take more risk (Jensen and Meckling, 1976).

In the theoretical and empirical literature, the relationship between ownership structure (i.e., public or private) and risk-taking behavior is a still-debated open question (e.g., Gorton and Rosen, 1995; Chen et al., 1998, Anderson and Fraser, 2000). Considering that public equity is more liquid and cheaper to raise than private equity, one expects public banks that seek financing for their growth opportunities, to be more risk-takers than privately owned banks, all else being equal. In addition, shareholders whose portfolios are more diversified, in exchange for higher expected returns, are likely to push managers towards higher risk taking.[2] Bank managers on their part also have personal incentives to do so due to the composition of their pay packages that include bonuses and stock options (e.g., Mehran and Rosenberg, 2009; Chesney et al., 2012). Due to the misalignment between shareholders' interests and managers' interests, managers can take excessive risk even if it is not required by shareholders in case the latter are unable to discipline the former (e.g., Axelson and Bond, 2015). These arguments thus suggest that *public banks exhibit more risk taking than their private counterparts.*

Nevertheless, disciplining forces exerted by (1) capital markets and (2) managerial career concerns can counter these incentives. Indeed, capital markets encompass a large set of mechanisms that involve different players who help monitor and influence excessive risk-taking attitudes of banks (Kwan, 2004), namely the banking regulatory and supervision body, and market participants (e.g., financial analysts, the media, and shareholder activists). As for managerial career concerns, they are likely to differ in a public bank compared to a private bank. In a typical privately held bank, the ownership structure is concentrated in the hands of a limited number of shareholders, with managers very often appointed among large shareholders. Public banks instead are more likely to be run by professional managers who are deeply concerned about their careers and reputation, and are thus more inclined to adopt less risky behavior to protect their firm-specific investment and reduce their non-diversifiable employment risk (e.g., Amihud and Lev, 1981; Hirshleifer and Thakor, 1992). Based on these arguments, we expect *public banks to show less risk taking than their private peers.*

Despite the potential important policy implications, and to the best of our knowledge, only limited evidence exists on whether private (i.e., unlisted) and public (i.e., listed) banks differ in terms of risk taking, and no existing study examines whether and how the listing status affected banks around the recent financial crisis.

To test our main conjecture, we use an internationally diversified sample of 6816 commercial banks from 77 countries, of which 581 are publicly traded and 6235 are private. The study period extends from 2000 to 2015 to include the recent financial crisis. Using the Z–score as our primary measure for risk taking, since it is inversely related to the probability of bank solvency (e.g., Laeven and Levine, 2009; Houston et al., 2010), we find that publicly traded banks display less risk taking than their private counterparts, suggesting that the bank listing status acts as an effective disciplining mechanism. This result holds after controlling for several determinants shown in the literature to affect bank risk taking, including size, asset growth, and being too big to fail (e.g., Laeven and Levine, 2009; Houston et al., 2010), as well as country-level variables that encompass creditor rights, efficiency of the debt enforcement procedures, legal origin, deposit insurance, and gross domestic product (GDP) per capita. We also document that public banks exhibit less risk taking than their private peers in countries with weak institutions and less efficient debt enforcement procedures. This result suggests that listing status acts as an effective monitoring system in such environments.

Considering the period surrounding the recent financial crisis, we investigate whether listing status (i.e., public or private) impacts bank risk taking before and after the recent financial crisis. An exogenous liquidity shock such as that of 2008–2009 provides us with an opportune testing ground to examine whether the crisis has altered the incentives of banks to take more risk, depending on their listing status and on the quality of their home country institutions. We find that public banks exhibit less risk taking than their private counterparts during the whole sample period, but more in the post-crisis period compared to the pre-crisis one.

Our results survive a battery of robustness checks, including alternative measures of risk taking, alternative samples, and considering endogeneity issues and size effects. Our paper adds to this literature on at least three grounds: *First*, we do not limit our analysis to one specific country as in Kwan (2004), or region as in Barry et al. (2011), and consider an international sample of 77 countries. *Second*, we examine the public-private status on bank risk taking before and after the recent financial crisis. No previous study has focused on this issue despite the fact that bank risk taking is a conditioning factor of the sector's financial stability. *Last but not least*, we investigate the impact of the private-public status in different institutional environments (i.e., in terms of investor protection and the efficiency of the debt enforcement procedures) and extend this analysis to the periods before and after the recent financial crisis.

Our research question is of interest to academics as well as regulators, policymakers, credit rating agencies, shareholders, bondholders, and depositors. Indeed, policymakers and regulators have been seeking ways to limit excessive risk taking by

[2] According to Dallas (2012), the recent financial crisis was preceded by a pressure on financial institutions to boost their short-term performance regardless of long-term consequences.

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