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# CEO power, ownership structure and pay performance in Chinese banking



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### ABSTRACT

This paper examines the determinants of executive compensation in Chinese banking during 2005–2012. Using the fixed effects panel, 2SLS and dynamic GMM regressions, I find that there is no significant positive pay performance relation, and CEO power does not necessarily exhibit higher levels of executive compensation. However, I show that ownership structure (measured by ownership concentration and ownership identification) and compensation committee are significant in determining executive compensation in Chinese banking. It suggests that government may ensure efficient monitoring functions when the pay incentive is ineffective. The results have important implication on bank regulation and corporate governance in emerging markets.

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## 1. Introduction

This paper attempts to examine the determinants of executive compensation in Chinese banking. Particularly, it investigates whether powerful chief executive officers (CEOs) have privileges over the board to obtain higher remunerations. In general, agency theory states that CEO stock options and equity incentive should be utilized to align the incentives of top managers with the interests of

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shareholders (Jensen & Meckling, 1976; Fama & Jensen, 1983); while in countries where corporate governance is weak, the pay practice may follow a relation-based rather than a market-based contract (Luo & Jackson, 2012b), and management is inclined to “undertake activities to increase their own welfare by consuming more resources at the expense of minority shareholders” (Shleifer & Vishny, 1997). Moreover, “Decisions with extreme consequences are more likely to be taken when the CEO is more powerful” (Adams, Almeida, & Ferreira, 2005). Nonetheless, an optimal compensation contract is important because the degree of CEO power affects not only the minority shareholders, but also national economic stability. For example, in the 2008 financial crisis, poor bank CEO incentives are criticized to be “one of the most fundamental causes” of the financial crisis (Blinder, 2009; Fahlenbrach & Stulz, 2011)<sup>1</sup>. Therefore, regulators need to continually improve their understanding of corporate governance in the banking system and enhance their ability to monitor the risks that banks have taken (Hagendorff, Collins, & Keasey, 2007).

This study focuses on Chinese banking because the Chinese financial market has a unique governance structure. Academics argue that the effectiveness of commonly used agency-based corporate governance mechanisms may not work in emerging economies (Ball, Robin, & Wu, 2000). Particularly, Palvia (2011) documents that most U.S. commercial banks are private and over 90% of them have assets less than US \$1 billion; while the Chinese banks are dominated by state owned banks and have huge market capitalization. Generally speaking, the U.S. banking is a mix of both privately-owned and publicly-traded institutions. They are overseen by several regulatory agencies, such as the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), or the Office of the Comptroller of Currency (OCC). Peek, Rosengren, and Tootell (2003) find that the Federal Reserve has an informational advantage over the public; if incorporating the Federal Reserve’s confidential bank supervisory data, it will significantly improve forecasts of variables relevant for the conduct of monetary policy. In contrast, the China Banking Regulatory Commission (CBRC) is the primary regulator governing the overall banking system, while the People’s Bank of China (PBC) also has regulatory authority monitoring individual banks’ operations. Because the issues of CEO entrenchment and weak corporate governance might lead to the presence of inefficient compensation contract (Luo & Jackson, 2012a), and the “complexity of the banking business increases the asymmetry of information and diminishes the stakeholders’ capacity to monitor bank managers’ decisions” (Andres & Valledado, 2008), regulatory monitoring of financial firms may be especially beneficial to provide the board of directors in the banks, as well as shareholders valuable information which leads to enhanced managerial discipline (Palvia, 2011).

This is the first study to examine the pay practice in Chinese banking during 2005–2012. The literature in this field is scant (Conyon & He, 2012; Firth et al., 2006, 2007; Kato & Long, 2006). Previous studies typically exclude the financial firms because the banking industry is considered to be regulated and opaque in assets (Morgan, 2002). The exclusion of financial firms helps focus more closely on the tangible side of the economy; however, regulatory monitoring of banks yields valuable information for investors and regulators (DeYoung et al., 2001). Such information is also valuable for economic forecasting or in predicting bank failure (Wheelock & Wilson, 2005). For instance, Gunther and Moore (2003) show that accounting data provided by banks enable supervisors to detect risky banks and to decide whether an early on-site exam must be conducted; therefore, banks would report their financial statements in a more comprehensive manner if regulatory actions are involved.

To empirically test the pay performance sensitivity (PPS), I use both Ordinary Least Square (OLS) and the fixed effects (FE) panel regressions. In addition, this study investigates whether powerful CEOs have privileges over the board to obtain abnormal pay. To proxy managerial power, following Finkelstein (1992), I identify four sources of CEO power: structural power, ownership power, expert power, and prestige power. To control for endogeneity problems in model specification, I also employ Two-Stage Least Square (2SLS) and dynamic Generalized Method of the Moments (GMM) methods. In general, I find that both agency theory and managerial power theory do not hold; however, ownership structure (measured by both ownership concentration and ownership identification) is significant in determining executive compensation in Chinese banking. It suggests that government may ensure efficient

<sup>1</sup> For example, Stan O’Neal, the former CEO of Merrill Lynch, received an annual compensation package up to US\$ 161.5 million, but the company suffered huge losses up to US\$ 8.4 billion in sub-prime crisis (Farrell, 2007).

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