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Corporate governance and performance of financial institutions

Andrey Zagorchev[a,*], Lei Gao[b,1]

[a] Department of Commerce and Business, Rhodes College, Memphis, TN 38112, United States
[b] College of Business, Iowa State University, 3138 Gerdin Business Building, Ames, IA 50011-1350, United States

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ABSTRACT

We examine how corporate governance affects financial institutions in the U.S. between 2002 and 2009. First, we find that better governance is negatively related to excessive risk-taking and positively related to the performance of U.S. financial institutions. Specifically, sound overall and specific governance practices are associated with less total non-performing assets, less real estate non-performing assets, and higher Tobin's Q. Second, we show that better governance contributes to higher provisions and reserves for loan/asset losses of financial institutions, supporting the income smoothing hypothesis. Moreover, the results are similar without the financial crisis period, and different robustness checks confirm the analysis.

1. Introduction

This study evaluates the role of corporate governance on the degree of excessive risk-taking and performance of U.S. financial institutions from 2002 to 2009. Corporate governance deals with agency problems caused by the separation of ownership and control and represents a set of mechanisms for direction and control of firms (Cadbury Committee, 1992; Jensen & Meckling, 1976; Shleifer &

* Corresponding author. Tel.: +1 901843 3301; fax: +1 901843 3736.
E-mail addresses: zagorcheva@rhodes.edu (A. Zagorchev), lgao@iastate.edu (L. Gao).
[1] Tel.: +1 515294 7860.

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Vishny, 1997). We analyze how corporate governance by restricting managerial self-interest can affect corporate investment risk choices and the consequent effects on U.S. financial institutions.

Since many financial institutions are primarily focused on higher rates of return, they may employ obscure and sophisticated financial instruments and engage in risky lending activities without appropriate risk assessment, resulting in greater information asymmetries and a more unstable financial system (Morgan, 2002; Summit on Financial Markets and the World Economy, 2008). Collapses of financial institutions and misconducts within the financial sector illustrate that highly developed financial systems are exposed to systemic risks, weaknesses, and wrongdoings when good governance is lacking (Alexander, 2006). Some of the main instances of failure or misconduct in the U.S. financial industry include IndyMac Bank, Washington Mutual, Wachovia, and recently J.P. Morgan, among many others. Most of the recent corporate governance research focuses on large, systematically important financial firms across the globe. This study expands the scope of the analysis by including a variety of firms in the U.S. financial sector with broader range of market capitalization. By utilizing a governance index with a number of attributes as well as specific governance components for different U.S. financial institutions, this research fills a gap in the literature.

Recently banking regulators and central banks have stressed the need for effective corporate governance practices in the banking system because failures and weaknesses in bank governance contribute to the development of financial crises (Basel Committee on Banking Supervision, 2010; Board of Governors of the Federal Reserve System, 2010a, 2010b; Kirkpatrick, 2009).[2] How sound corporate governance in terms of stronger management oversight and better practices by the board of directors could affect excessive risk-taking and performance of financial institutions? This is an essential research question since the corporate governance of banks affects economic progress and has important implications for society.

On the one hand, prior studies about corporate governance in the financial industry show that weak governance has a detrimental impact on the performance, valuation, and opportunistic manipulation of earnings by financial companies (Andres & Vallelado, 2008; Caprio, Laeven, & Levine, 2007; Cornett, McNutt, & Tehranian, 2009; Rezaee, 2008). Firms with weaker corporate governance quality may not implement adequate incentives and controls that can increase shareholder value (Diamond & Rajan, 2009). Further, Akhigbe and Martin (2006, 2008) find that improvements in certain governance characteristics as a result of SOX in 2002 are associated with greater valuation of financial companies and reduced risk measures.

Alternatively, it is also conceivable that better corporate governance practices fail to improve the performance the financial firm because either the riskiness of the projects increases or the costs of implementing good governance exceed the market value benefits (Beltratti & Stulz, 2012; Fortin, Goldberg, & Roth, 2010; John, Litov, & Yeung, 2008; Pathan, 2009). As a result, financial firms will not find it advantageous to improve the quality of their governance if it does not help them to better identify project risk and potential return. A study by Erkens, Hung, and Matos (2012) during the 2007–2008 period documents that greater board independence and larger institutional ownership of financial firms is related with lower stock returns. Examining the relationship between chief executive officer (CEO) ownership stakes and U.S. bank profitability, Fahlenbrach and Stulz (2011) show that larger equity ownership stakes by bank managers were not correlated with higher profitability. In other words, CEOs driven by shareholder wealth maximization principles had incentives to take risks that enhanced their compensation and, as a result, their firms' experienced inferior stock returns.

In this paper, we postulate that better corporate governance practices minimize excessive risk-taking and enhance the profitability for financial firms during the sample period including the 2008 financial turmoil. An excessive risk-taking can occur when a firm undertakes projects without adequately considering the tradeoff between risk and return and the probability of actually suffering a loss. Poorly governed financial institutions can report big losses during a crisis if they have previously accepted projects with excessive risks. Conversely, a well-governed financial institution has a greater

[2] Given that there are mixed findings of the impact of corporate governance on bank risk-taking and performance, the significance of corporate governance is still unsettled. For example, see Beltratti and Stulz (2012), Erkens et al. (2012), Peni and Vähämaa (2012), Aebi et al. (2012), Fortin et al. (2010), and Cornett et al. (2009).