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Corporate governance and the systemic risk of financial institutions[☆]

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ABSTRACT

This paper studies the relationship between corporate governance and the systemic risk of financial institutions. Specifically, using a sample of large U.S. financial institutions from 2005 to 2010, we examine whether the strength of corporate governance mechanisms can explain the cross-sectional variation in systemic risk around the recent financial crisis. Our empirical findings indicate that financial institutions with stronger and more shareholder-focused corporate governance structures and boards of directors are associated with higher levels of systemic risk. Thus, our results suggest that good corporate governance may encourage rather than constrain excessive risk-taking in the financial industry.

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1. Introduction

This paper focuses on the linkage between corporate governance and the systemic risk of financial institutions around the recent financial crisis. Systemic risk can be broadly defined as a measure of the relation of a particular financial institution's risk-taking to the overall risk-taking in the financial industry. As recently noted, for instance, by Anginer, Demirguc-Kunt, and Zhu (2014), the contribution of an individual financial institution to the system's deficiency may be more relevant than the standalone risk of that institution during periods of market stress. Despite the amplified interest toward the measurement of systemic risk over the past few years, surprisingly little is so far known about the institution specific attributes that may influence the level of systemic risk[1]. In this paper, we aim to extend the prior literature by empirically examining whether the systemic risk of U.S. financial institutions is affected by the strength of corporate governance mechanisms.

In the aftermath of the global financial crisis, it has been widely argued by politicians, banking supervisors, and other authorities that the crisis can be, at least to some extent, attributed to flaws in the corporate governance practices of financial institutions (see e.g., Kirkpatrick, 2009; Basel Committee on Banking Supervision, 2010; Board of Governors of the Federal Reserve System, 2010; Haldane, 2012). These allegations seem reasonable given that corporate governance can be broadly considered as the set of mechanisms for addressing agency problems and controlling risk within the firm. In general, strong corporate governance practices, and especially, effective board oversight are supposed to encourage the firm's top management to act in the best interest of shareholders and other stakeholders (Shleifer & Vishny, 1997). So was something actually wrong with the corporate governance of financial institutions at the onset of the global financial crisis? We show in this paper that "good" corporate governance practices may have encouraged rather than constrained excessive risk-taking in the financial industry. Specifically, our empirical findings demonstrate that financial institutions with stronger and more shareholder-focused corporate governance mechanisms and boards of directors are associated with higher levels of systemic risk[2].

At first glance, it may seem somewhat counterintuitive that financial institutions with stronger corporate governance mechanisms are associated with higher levels of systemic risk. However, consistent with traditional shareholder value maximization, well-governed financial institutions may have tried to improve their profitability to placate shareholders before the crisis by increasing the level of risk-taking. Empirical support for this view is provided, for instance, by Beltratti and Stulz (2012), who document that banks with more shareholder-friendly boards took more risk at the onset of the global financial crisis and performed significantly worse during the crisis. Investors may have neglected or became less sensitive to the surge in bank risk-taking because of the growing complexity and opaqueness of banking activities (e.g., Mehran, Morrison, & Shapiro, 2011). Furthermore, as noted by Mehran et al. (2011), there is a "dark side to expertise" on the board of directors; expert board members may be hired to justify and increase risk-taking for the sake of value maximization instead of aiding in monitoring the top management. Consistent with this view, Minton, Taillard, and Williamson (2014) document that independent directors with financial expertise encouraged increasing bank risk-taking prior to the global financial crisis, and moreover, that the board's expertise is strongly negatively associated with bank performance during the crisis.

Fahlenbrach, Prilmeier, and Stulz (2012) argue that institution specific characteristics are responsible for the high correlation they find between stock returns in the 1998 financial crisis and the recent crisis. They label this argument as the risk culture hypothesis. According to Fahlenbrach et al. (2012), the business model of a financial institution, especially if it is successful, can be hard to change and reinforces the culture of the company. Acharya and Volpin (2010), in turn, argue that firms can,

[1] Among the few exceptions are the recent studies by Acharya and Thakor (2011), Brunnermeier, Dong, and Palia (2012), Pais and Stork (2013), Anginer et al. (2014), Mayordomo, Rodriguez-Moreno, and Peña (2014), and Calluzzo and Dong (2015). We discuss the related systemic risk literature in Section 2.

[2] Corporate governance mechanisms and the board of directors are considered to be stronger and more shareholder-friendly when they provide effective monitoring and stronger protection of shareholder's interests, and more generally, better alignment of managers' interests with those of the shareholders. Adams (2012) and de Haan and Vlahu (2015) provide comprehensive discussions about the corporate governance of financial institutions and the elements of "good" governance.