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Corporate governance and bank capitalization strategies☆

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ABSTRACT

This paper examines the relationship between banks' capitalization strategies and their corporate governance and executive compensation schemes for an international sample of banks over the 2003–2011 period. Shareholder-friendly corporate governance, in the form of a separation of the CEO and chairman of the board roles, intermediate board size, and an absence of anti-takeover provisions, is associated with lower bank capitalization, consistent with shareholder incentives to shift risk towards the financial safety net. Higher values of executive option and stock wealth invested in the bank are associated with higher capitalization as a potential reflection of executive risk aversion, but the risk-taking incentives embedded in executive compensation packages are associated with lower capitalization.

☆ This paper's findings, interpretations, and conclusions are entirely those of the authors and do not necessarily represent the views of the World Bank, its Executive Directors, or the countries they represent. We thank an anonymous referee for useful comments and suggestions.

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1. Introduction

A failing bank can be defined as one that has insufficient capital. Bank capitalization strategies thus are crucial in determining the probability of bank failure both at the individual bank level and at the systemic level. Two key aspects of bank capitalization strategies can be distinguished.

First, a bank has to determine its level of capitalization under normal business conditions. This normal level of bank capital corresponds to the bank's level of capital before it is hit by any major shock that can have an adverse impact on bank capital. A higher normal, pre-crisis level of capital should increase a bank's chances of withstanding major income shocks. Confirming this, Berger and Bouwman (2013) find that higher levels of pre-crisis capital increase a bank's probability of survival during a banking crisis. Along similar lines, Beltratti and Stulz (2012) and Demirguc-Kunt et al. (2013) find that banks that were better capitalized before the crisis had a better stock market performance during the crisis.

Second, a bank has to decide whether to cut its net payouts to bank stock investors in case of negative income shocks so as to preserve capital. A conservative bank would tend to reduce dividends and share repurchases and possibly increase share issuance after experiencing major losses. Acharya et al. (2009), however, show that many of the world's largest banks continued to pay significant dividends in the initial phase of the crisis in 2008 before the demise of Lehman, increasing their riskiness.

Banks are subject to regulatory requirements in the form of minimum capital ratios and – depending on individual circumstances – restrictions on payouts to bank stock investors to prevent capital shortfalls that may give rise to bank failure. In practice, however, banks continue to enjoy considerable discretion in their capitalization policies. Using data for an international sample of banks, we empirically examine various aspects of corporate governance structures and executive compensation schemes to see how they are related to bank capitalization strategies over the period 2003–2011.

Corporate governance is a set of rules that resolve potential conflicts between managers and shareholders. For banks especially, value-maximizing shareholders may favor risky capitalization strategies so as to increase the option value of potential public bailout guarantees as reflected in bank share prices. In our empirical work, we investigate whether banks with shareholder-friendly corporate governance adopt relatively risky bank capitalization strategies.

We consider three main aspects of banks' corporate governance: board independence, board size, and anti-takeover provisions. Aspects of corporate governance that are considered to favor shareholder interests are: boards that are independent (and particularly not chaired by the CEO), boards of intermediate size (large enough to be effective, but not so large that free rider problems become pressing), and an absence of anti-takeover provisions (which would restrict the operation of the market for corporate control).

Our results indicate that banks with shareholder-friendly corporate governance tend to have lower capitalization. These results are consistent with the hypothesis that banks with shareholder-friendly corporate governance adopt risky capitalization strategies in order to maximize shareholder value.[1] Some aspects of shareholder-friendly corporate governance (and in particular separation of the CEO and chairman roles, and intermediate board size) are associated with a tendency for banks to scale back payouts to shareholders after experiencing a negative income shock. This suggests that banks with already low capitalization rates prior to a negative income shock need to reduce payouts to shareholders after experiencing an income shock in order to remain in business, and perhaps are forced to scale back payouts by regulators.

Complementary to our analysis of corporate governance, we consider how banks' capitalization strategies vary with executive compensation. We distinguish between the overall compensation, as measured by total annual compensation and the value of options and shares that have been awarded, and the incentive to take risk as embedded in compensation packages.

[1] Convex pay-offs to shareholders resulting from limited liability provide firms with incentives to create risk (see Galai and Masulis, 1976, and Jensen and Meckling, 1976). Explicit and implicit state guarantees of bank liabilities contribute to incentives for banks to create risk. In particular, Merton (1977) shows that with a risk-insensitive deposit insurance premium, bank shareholders potentially enjoy a subsidy that increases in value with bank leverage and asset risk.