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International Review of Economics & Finance
Volume 8, Issue 3, September 1999, Pages 281-292

Papers

Board structure, ownership, and financial distress in banking firms

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https://doi.org/10.1016/S1059-0560(99)00026-X
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Abstract

This investigation pursues a new direction in the analysis of financial distress in banking firms. The research was inspired by recent research on corporate governance and the need to understand the internal processes behind the financial decisions that result in bank failures. The analysis examined the relationship between the ownership and structure of the board of directors and the internal control mechanism that influences the survival of the firm. The following aspects of ownership and governance are investigated: ownership by directors and officers, ownership by the CEO, number of directors, percentage of inside directors, and CEO duality. The influence of board structure and ownership on the probability of financial distress was explored with a sample of approximately 300 banking firms. The empirical tests indicated a lower probability of financial distress when one person is both the CEO and chairman of the board, but the other factors did not have a significant effect.

Introduction

The emergence of the banking industry from the most serious financial crisis since the 1930s has resulted in a strengthened deposit insurance fund and a relaxation of regulatory concern for bank failures. The large amounts of risky credit card debt recently incurred by banks, however, underscore the point that financial distress in banking is always an issue (Federal Deposit Insurance Corporation, 1997).

Financial distress in banking remains a significant issue for owners, managers, and the public. The incentives for risk-shifting from equity owners to depositors exist in banking similar to the agency problems caused by the conflict between owners and debt-holders in other corporations. John, John, and Senbet (1991) argue that risk-shifting incentives in depository financial institutions arise from the existence of limited liability for owners and the associated convexity of the levered equity pay-off produced by the limited liability. The incentives for risk-shifting will exist in spite of risk-adjusted deposit insurance premiums according to John, John, and Senbet (1991). As a result, banks with managers closely aligned with the owners would seek risk that is shifted to depositors and the public insurance fund.

An analysis of bank failures prepared by the Office of the Comptroller of the Currency (OCC) identified the major immediate cause of many bank failures as poor asset quality that eventually impaired the bank's capital position (Office of the Comptroller of the Currency, 1988). The OCC investigation further concluded that the primary reason banks encounter asset quality and capital problems is the failure of the board of directors and management. According to the OCC, the ultimate causes of bank failures are an uninformed or inattentive board of directors and/or management, overly aggressive activity by the board and/or management, problems involving the chief executive officer, and other problems related to board oversight and management deficiencies. Failure of the board to monitor the activities of management and staff resulted in poorly followed loan policies, inadequate compliance with internal policies and banking laws, inadequate problem loan identification, and ineffective asset/liability management, according to the OCC.

Jensen (1993) argues that the board of directors is crucial to effective internal control systems: “The problems with corporate internal control systems start with the board of directors. The board, at the apex of the internal control system, has the final responsibility for the functioning of the firm. Most importantly, it sets the rules of the game for the CEO” (p. 862). The ultimate consequence of a dysfunctional corporate internal control system is the failure of the firm.

A rich and important body of research that addresses the prediction of financial distress in commercial banks and the classification of banks based on financial stability has evolved (Demirguc-Kunt, 1989). The present investigation pursues a new direction in the analysis of bank survival inspired by the research on corporate governance and the need to understand the processes behind the financial decisions that result in bank failures.1 The purpose of this analysis is to examine the relationship between the board structure and ownership of a commercial banking firm and the occurrence of financial distress in that firm. A set of testable hypotheses was developed from the model governance structure in Jensen (1993). The hypotheses were tested empirically by regressing measures of the board structure and ownership of a group of approximately 300 banking firms on an indicator of the probability of financial distress.

Section snippets

A model governance structure

Jensen (1993) contends that few boards in the recent past have functioned properly in the absence of external crises and he provided several proposals that should cause the board to become an effective control mechanism. First, board cultures must be changed to emphasize frankness and truth instead of politeness and courtesy so that CEOs do not have the influence to control the board and escape scrutiny. Second, board members must have free access to all relevant information and not just the…

Hypothesis I: Management and board member equity ownership

Jensen (1993) suggests that many problems occur because neither managers nor directors normally own a substantial proportion of the firm's equity, which decreases the incentives of directors and officers to pursue the shareholders' interests. Saunders, Strock, and Travlos (1990) provide evidence that banks controlled by stockholders have incentives to take higher risk than banks controlled by managers. If stockholders prefer more risk than non-owner managers and stock ownership aligns managers…

Sample design and data sources

The sample consisted of those banking firms listed in the *SNL Quarterly Bank Digest* (SNL Securities, 1993), which also had proxy statements available for 1989. The sample included only banking firms that were publicly traded because these were the only firms with publicly available ownership data. The *SNL Quarterly Bank Digest* provides data on most publicly traded banking firms and includes approximately 375 firms. Only firms that did not have complete financial data or a proxy statement were…

Tests of hypotheses

The maximum likelihood estimates of the ordered logistic regression parameters reported in Table 2 reveal that the null hypothesis was rejected for Hypothesis IV but could not be rejected in the other relationships. The parameter estimate indicates that CEO duality (i.e., when the same person is both the CEO and chairman of the board) has a significant effect on the future probability of financial distress in a banking firm. The regression coefficient β_0 for Hypothesis IV is positive which…

Conclusion

This investigation indicates that the combination of the CEO and chairman of the board into one position may influence the internal control system of a banking firm in such a way as to reduce the probability of financial distress in the firm. The result that a single powerful manager will reduce the probability of financial distress is consistent with theory and previous empirical evidence. A manager with significant control over both operations and the board would not be as susceptible to the…

Acknowledgements

We are grateful to Carl Chen, editor, and an anonymous referee for their patience and many helpful comments. The authors bear full responsibility for any remaining errors or omissions.…

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