

Tilburg University

Bank governance and regulation

Laeven, L.

Published in:
The Future of Banking

Publication date:
2011

[Link to publication in Tilburg University Research Portal](#)

Citation for published version (APA):
Laeven, L. (2011). Bank governance and regulation. In T. H. L. Beck (Ed.), *The Future of Banking* (pp. 49-56).
Centre for Economic Policy Research (CEPR).

General rights

Copyright and moral rights for the publications made accessible in the public portal are retained by the authors and/or other copyright owners and it is a condition of accessing publications that users recognise and abide by the legal requirements associated with these rights.

- Users may download and print one copy of any publication from the public portal for the purpose of private study or research.
- You may not further distribute the material or use it for any profit-making activity or commercial gain
- You may freely distribute the URL identifying the publication in the public portal

Take down policy

If you believe that this document breaches copyright please contact us providing details, and we will remove access to the work immediately and investigate your claim.

VOX

Research-based policy analysis and commentary from leading economists

Bank governance and regulation

Luc Laeven

25 October 2011

Recent financial regulatory reforms target banks' risk-taking behaviours without considering their ownership and governance. This chapter argues that bank governance influences how regulations alter bank's incentives. Banks with more powerful owners tend to take more risks, and greater capital requirements actually increase risk-taking in banks with powerful shareholders. Bank regulation should condition on bank governance.

Regulations for banks are being rewritten in response to the global financial crisis. The Basel III framework is being adopted, capital requirements are being increased, and safety nets have expanded in scope and size, all with the aim of making banks safer. These financial reforms and re-regulations, however, ignore bank governance – the ownership of banks and the incentives and conflicts that arise between bank owners and managers. But what if the governance structure of banks is intrinsically linked to bank risk? And what if bank governance interacts with regulation to shape bank stability?

This emphasis on using official regulations to induce sound banking while ignoring the role of bank governance is surprising because standard agency theories suggest that ownership structure influences corporate risk-taking (Jensen and Meckling 1976). This gap is also potentially serious from a policy perspective. The same regulations could have different effects on bank risk-taking depending on the comparative power of shareholders within the ownership structure of each bank. Changes in policies toward bank ownership, such as allowing private equity groups to invest in banks or changing limits on ownership concentration, could have very different effects on bank stability depending on other bank regulations.

Yet research on bank risk-taking typically does not incorporate information on each bank's ownership structure. In an exception, Saunders *et al* (1990) find that owner-controlled banks exhibit higher risk-taking behaviour than banks controlled by managers with small

shareholdings. They do not, however, analyse whether ownership structure and regulations jointly shape bank risk-taking, or whether their results generalise beyond the United States to countries with distinct laws and regulations.

Banks naturally take more risk than is optimal for society because their shareholders are subject to limited liability. As in any limited liability firm, diversified owners have incentives to increase bank risk after collecting funds from bondholders and depositors (Galai and Masulis 1976). However, the ability of bank shareholders to maximise their equity value by increasing risk depends in part on the preferences of the bank's managers and on the constraints imposed on bank risk-taking by bank regulation and the regulators that enforce such regulation (Buser *et al* 1981).

The risk-taking incentives of bank managers will depend on the degree to which their interests are linked to those of value-maximising stockholders. Managers with bank-specific human capital skills and private benefits of control tend to advocate less risk-taking than stockholders without those skills and benefits (Jensen and Meckling 1976, Demsetz and Lehn 1985, John *et al* 2008). From this perspective, banks with an ownership structure that empowers diversified owners take on more risk than banks with owners who play a more subdued governance role. Of course, to the extent that the manager has a large equity stake in the bank or holds stock options, this would enhance his or her risk-taking incentives by enticing them with potentially large rewards for high-return investments. In practice, however, bank managers often do not hold much bank stock, placing them at odds with diversified bank owners in their views on risk-taking.

To complicate matters further, the effectiveness of bank regulation to curtail bank risk-taking will also depend on the incentives of the bank regulators that enforce such regulations. With self-interested bank regulators that have private benefits or concerns (such as reputational concerns from intervening in banks) or can be captured by industry, regulation to constrain bank risk-taking may be muted.

Theory also predicts that regulations influence the risk-taking incentives of diversified owners differently from those of debt holders and non-shareholder managers. For example, deposit insurance intensifies the ability and incentives of stockholders to increase risk (Merton 1977, Keeley 1990). The impetus for greater risk-taking generated by deposit insurance operates on owners, not necessarily on non-shareholder

managers. As a second example, consider capital regulations. One goal of capital regulations is to reduce the risk-taking incentives of owners by forcing owners to place more of their personal wealth at risk in the bank (Kim and Santomero 1994). Capital regulations need not reduce the risk-taking incentives of influential owners, however. Specifically, although capital regulations might induce the bank to raise capital, they might not force influential owners to invest more of their wealth in the bank. Furthermore, capital regulations might increase risk-taking. Owners might compensate for the loss of utility from more stringent capital requirements by selecting a riskier investment portfolio (Gale 2010), intensifying conflicts between owners and managers over bank risk-taking. As a final example, many countries attempt to reduce bank risk by restricting banks from engaging in non-lending activities, such as securities and insurance underwriting. As with capital requirements, however, these activity restrictions could reduce the utility of owning a bank, intensifying the risk-taking incentives of owners relative to managers. Thus, the impact of regulations on risk depends on the comparative influence of owners within the governance structure of each bank.

While banking theory suggests that bank regulations affect the risk-taking incentives of owners differently from those of managers, corporate governance theory suggests that ownership structure affects the ability of owners to influence risk. As argued by Shleifer and Vishny (1986), shareholders with larger voting and cash-flow rights have correspondingly greater power and incentives to shape corporate behaviour than smaller owners. From this perspective, ownership structure influences the ability of owners to alter bank risk in response both to standard risk-shifting incentives and to incentives created by official regulations.

Taken together, these theories predict that diversified owners have stronger incentives to increase risk than non-shareholder managers, so banks with powerful, diversified owners tend to be riskier than widely held banks, holding other factors constant. They also predict that bank regulations affect the risk-taking incentives of owners differently from managers, so the actual impact of regulations on risk-taking depends on the comparative power of shareholders relative to managers within each bank's corporate governance structure.

In a recent paper (Laeven and Levine 2009), we make a first attempt to test how national regulations interact with a bank's private governance

structure to determine its risk-taking behaviour. We find that banks with more powerful owners (as measured by the size of their shareholdings) tend to take greater risks. This supports arguments predicting that equity holders have stronger incentives to increase risk than non-shareholding managers and debt holders, and that owners with substantial cash flows have the power and incentives to induce the bank's managers to increase risk-taking.

Furthermore, the impact of bank regulations on bank risk depends critically on each bank's ownership structure such that the relation between regulation and bank risk can change sign depending on ownership structure. For example, the results suggest that deposit insurance is only associated with an increase in risk when the bank has a large equity holder with sufficient power to act on the additional risk-taking incentives created by deposit insurance. The data also suggest that owners seek to compensate for the loss in value of owning a bank from capital regulations by increasing bank risk. Stricter capital regulations are associated with greater risk when the bank has a sufficiently powerful owner, but stricter capital regulations have the opposite effect in widely held banks. Ignoring bank governance leads to incomplete and sometimes erroneous conclusions about the impact of bank regulations on bank risk-taking.

These findings have important policy implications. They question the current approach to bank supervision and regulation that relies on internationally established capital regulations and supervisory practices. Instead, private governance mechanisms exert a powerful influence over bank risking and the same official regulation has different effects on bank risk-taking depending on the bank's governance structure. Since governance structures differ systematically across countries, bank regulations must be custom-designed and adapted as financial governance systems evolve. Regulations should be geared toward creating sound incentives for owners, managers, and debt holders, not toward harmonising national regulations across economies with very different governance structures.

Naturally, regulations will shape the future of banking. It is not too late for bank regulation to condition on bank governance, and for supervision with limited resources to make the enforcement of regulation a function of a bank's governance structure. For example, supervisors could allocate a disproportionate amount of their resources to supervising those banks that corporate governance theory would

indicate are intrinsically more inclined to take risk, such as owner-controlled banks and/or banks with concentrated ownership. More generally, the risk-taking of banks will depend on the underlying incentives and preferences of the banks managers and owners, including their ownership and wealth concentration in the bank.

Finally, it is important to recognise that the risk-shifting incentives of banks arising from limited liability would be significantly reduced if bank owners would be subject to extended liability – for example, through double liability which holds each shareholder liable to the amount of the par value of the shares held by him, in addition to the amount invested in such shares (Esty 1998). While holding shareholders liable for a portion of the bank's debts after insolvency would significantly increase the cost of capital and therefore reduce the lending capacity of banks with potentially negative ramifications for growth, it would create safer banks and therefore should not easily be discarded as a policy option to enhance financial stability.

Disclaimer: While the author of this chapter is a staff member of the International Monetary Fund, the views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management.

References

Buser, S, A Chen, and E Kane (1981) "Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital," *Journal of Finance* 36, 51-60.

Demsetz, H and K Lehn (1985) "The Structure of Corporate Ownership: Causes and Consequences," *Journal of Political Economy* 93, 1155-1177.

Esty, B (1998) "The Impact of Contingent Liability on Commercial Bank Risk-taking," *Journal of Financial Economics* 47, 189-218.

Galai, D and R Masulis (1976) "The Option Pricing Model and the Risk Factor of Stock," *Journal of Financial Economics* 3, 53-81.

Gale, D (2010) "Capital Regulation and Risk Sharing," *International Journal of Central Banking* 23, 187-204.

Jensen, M and W Meckling (1976) "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure," *Journal of Financial Economics* 3, 305-360.

John, K, L Litov and B Yeung (2008) "Corporate Governance and

Managerial Risk-taking: Theory and Evidence," *Journal of Finance* 63, 1679-1728.

Keeley, M (1990) "Deposit Insurance, Risk, and Market Power in Banking," *American Economic Review* 80, 1183-1200.

Kim, D and A Santomero (1994) "Risk in Banking and Capital Regulation," *Journal of Finance* 43, 1219-1233.

Laeven, L and R Levine (2009) "Bank Governance, Regulation, and Risk-Taking," *Journal of Financial Economics* 93, 259-275.

Merton, R (1977) "An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees: An Application of Modern Option Pricing Theory," *Journal of Banking and Finance* 1, 3-11.

Saunders, A, E Strock, and NG Travlos (1990) "Ownership Structure, Deregulation, and Bank Risk-taking," *Journal of Finance* 45, 643-654.

Shleifer, A and R Vishny (1986) "Large Shareholders and Corporate Control," *Journal of Political Economy* 94, 461-488.

This article may be reproduced with appropriate attribution. See Copyright (below).

Topics: [Financial markets](#), [International finance](#)

Tags:

Comments