

# CORPORATE GOVERNANCE AND RISK-TAKING OF US BANKS

Michael Skully, Department of Accounting and Finance, Monash University  
J. Wickramanayake; Department of Accounting and Finance, Monash University

## *1. Aims and significance of the project*

The project seeks to examine the relationship between US bank board structure and bank risk-taking behaviour given the ownership structure, charter value and capitalization.

The increased importance of board structure as means of management control can be easily understood from the introduction of Sarbanes-Oxley (SOX) Act of 2002, the new listing rules of NYSE (such as Section 202A), NASDAQ (such as Section 4200(a)(15)) and AMEX (such as Section 121A). All these new rules require certain governance measures such as requiring majority of independent directors and complete independent audit committee. However, for the US bank holding companies (BHCs), Adams and Mehran (2003) and Belkhir (2004) found a positive association between board size and bank performance but failed to trace any significant relationship between independent directors and bank performance.

Further, the international regulatory authorities, like Bank for Intl. Settlements (BIS), International Organization of Securities Commissions (IOSCO) and International Monetary Fund (IMF), have also started to campaign for good bank governance with particular emphasis on bank board of directors. For instance, BIS (2005) formulates the principles of sound corporate governance in the banking organization and highlights how bank boards might be more effective in overseeing their senior bank management. Given this ongoing development of rules and policies on potential effective bank governance, this project should help in providing evidence on their effectiveness.

The proposed study will address three key research questions. First, whether bank board size and independence relate to bank risk-taking behavior? Second, whether the CEO's position within the bank (board chairmanship, tenure and ownership) has any association with bank risk-taking behavior? Finally, whether increased board activities (proxied by board meeting frequency) have any impact on bank risk-taking behavior?

## *2. Methodology, research plan and timetable*

The data will include all the listed BHCs in the US (SIC 6021 and 6022) for which board and accounting information are available. So far no one has extensively studied bank governance and its impact on risk-taking behavior in such detail. The sample period of 1995 to 2005 is used as it is a key deregulation period for the US banking system. The study will be conducted in three stages. For stage 1, we will look into the bank board structure and risk-taking behavior for all the BHCs over 2002 to 2005; the data we will purchase from SNL Financial. In stage 2, using the same dataset in stage 1, we will be able to explore how risk-taking behavior differs between small and large BHCs by dividing the sample between small and large groups. Finally, in stage 3, we will evaluate the risk-taking behavior of the top 300 BHCs over a much longer sample period, 1995-2005. Additional data, in this instance, will be manually collected from different sources such as governance variables from proxy statements (DEF 14A) with SEC. This part of the study will help us to understand how governance and risk-taking behavior of the US BHCs evolves over time with reference to SOX.

Methodology: Given our objective and three research questions, we will use the following model to examine the relationship between board structure (BOARDVAR) and risk-taking (RISK) in a panel data

environment using OLS with either fixed or random effect as specified by the Hausman (1978) test to control for heterogeneity among banks.

$$RISK_{it} = \alpha_0 + \sum \beta_i BOARDVAR_{it} + \sum \delta_i OWNVAR_{it} + \lambda CHARTERV_{it} + \omega CAPITALIZATION_{it} + \varepsilon_{it}$$

In addition, as there is a concern of endogeneity in the governance variables, we will check the robustness of our findings with instrumental variable (IV) analysis such as the three-stage least squares (3SLS).

### ***3. Expected outcomes of the project***

First, the use of US data should enhance our chances of acceptance by the top ranked finance journal.

Second, the outcomes of our initial US study will provide strong justification for an ARC grant application (round 2007) to fund a much larger cross country study using much more extensive and expensive database, Capital IQ (USD 30, 000).

Third, the bank regulators, particularly APRA, may benefit from the outcomes in deciding its rules for banks.