Shareholder Empowerment and Bank Bailouts

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The Question

Did shareholder empowerment affect bank performance during the crisis?

The Context of the Mainstream View

- Inactive shareholders as part of the problem: absentee landlords

- More active shareholders as part of the solution
  - Crisis response: empower / encourage shareholders to be engaged
    - In the UK (Stewardship code)
    - In the US (say on pay)

→ How to measure governance?

→ How to assess crisis performance?

Measuring governance

- What do we need?
  - Governance variation
  - A means of measuring that variation

- How do we do it?
  - Traditional governance measures
  - A contingent ‘managerial insulation’ index
  - Hand-collected constitutional documents of the firm, and on state corporate law

The Management Insulation Index

- It attempts to measure the extent to which shareholders can use their legal rights to oust management, or credibly threaten to do so

- It focuses on the question of how core corporate law rules make it more or less difficult and time-consuming to challenge incumbent management

The Management Insulation Index

Scores 1 and 2: Shareholders can replace the board (almost) immediately

Scores 3 and 4: Shareholders can replace the board in the next shareholder meeting

Score 5 and 6: Shareholders can replace the board after two shareholder meetings

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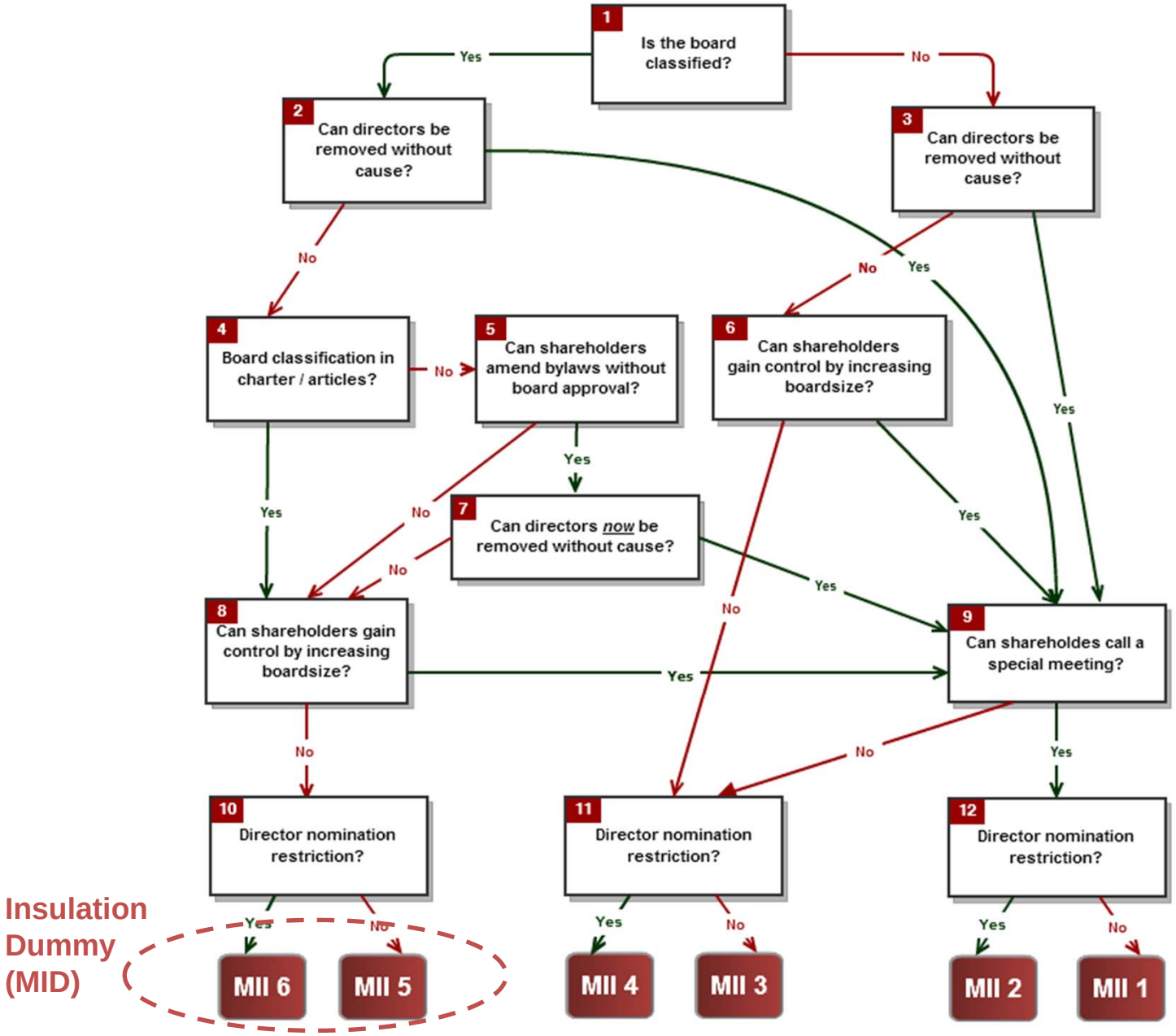
<u>Differences between 1 / 2 (and 3/4 & 5/6):</u> No restrictions on director appointments versus some restrictions on director appointments

Restrictions on director appointments are of little relevance in 5/6

Manager Insulation Index

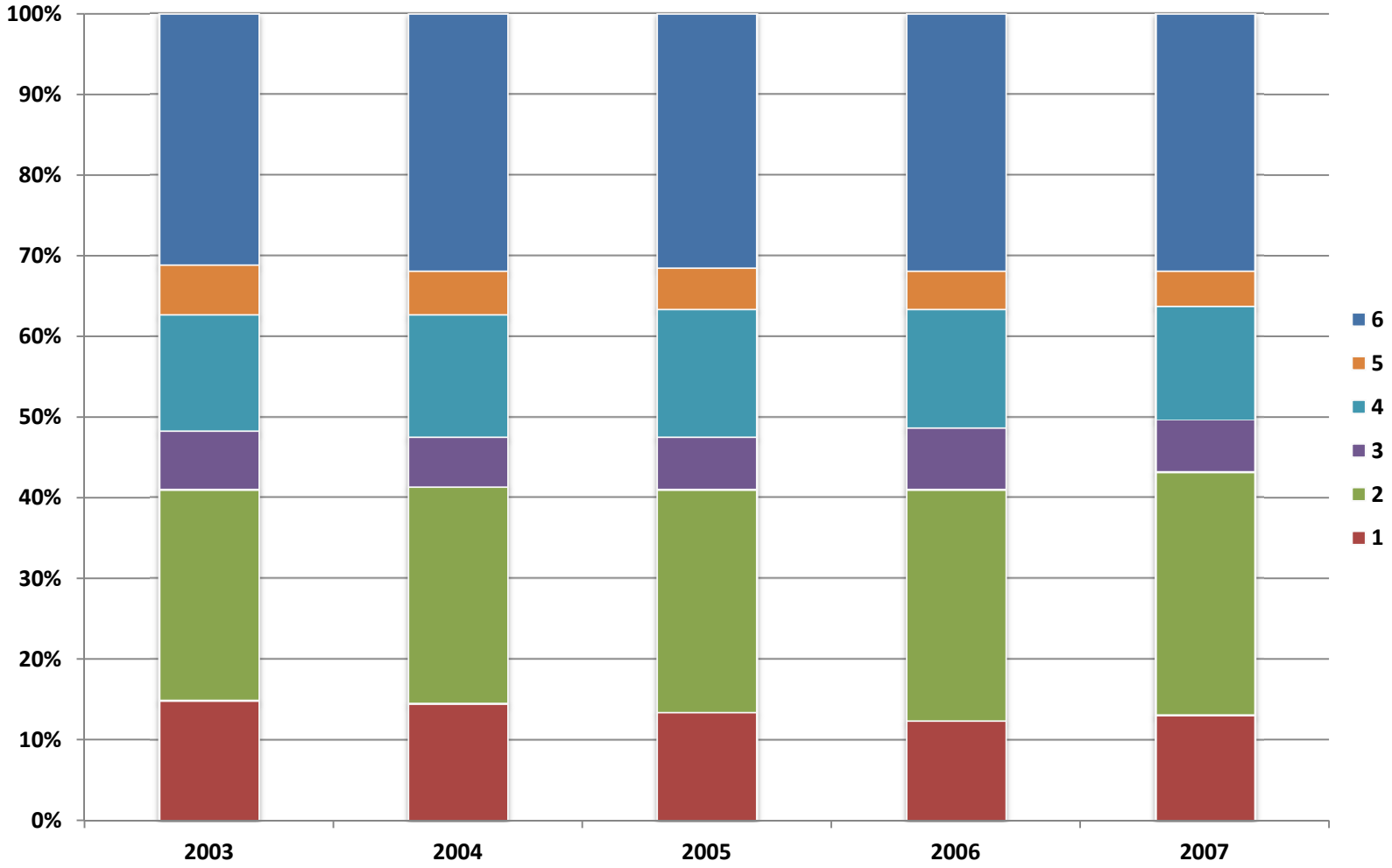


Data

- 276 US commercial banks
- Full sets of all constitutional documents for the 2003-2007 timeframe
- Banks have to be publicly listed, and have data available on BoardEx. Additional data are collected from Worldscope, Bankscope, CapitalIQ, Thomson One Banker and FDIC.

Management Insulation Index

Index Frequencies per Year, 2003-2007



Management Insulation Variables and Board Classification

Year	Variable		
	Management Insulation Index [MII]	Management Insulation Dummy [MID]	Board Classification Dummy [BCD]
2003	**3.64**	**0.38**	**0.77**
2004	**3.66**	**0.38**	**0.77**
2005	**3.66**	**0.37**	**0.76**
2006	**3.67**	**0.37**	**0.75**
2007	**3.62**	**0.37**	**0.73**

MID = 1 if MII = 5 or 6
MID = 0 otherwise

Measuring crisis performance

- We use bank bailouts as a proxy for crisis performance
  - This has been done in other papers (e.g. Adams 2009)
- Easily definable event (banks that received CPP(TARP) funds)
- However, bailouts may also be a noisy proxy for performance (we try to address this issue in a positive way)

Bailouts

- Bank participated in the Capital Purchase Program (CPP) 2008-09
  - CPP was the main bank-recapitalisation program under the US Troubled Assets Relief Program (TARP)
- Funds came in form of preferred equity injections
- 56% of the banks in the sample received funds

Selected Bank Variables (2003)

	Average Values Conditional on MID	
	MID = 0	*MID = 1*
Bailout dummy	**0.62**	**0.43**
Size (assets - median)	1,554	1,038
Size (assets - mean)	23,534	26,034
Leverage (assets/equity)	11.05	11.14
Return on Equity (ROE)	11.08	9.97
Number of acquisitions 2003-2006	1.58	1.84
Board independence	0.76	0.72
Board directors' banking experience	0.17	0.19
Block ownership dummy (20%)	0.09	0.10
N	172	104

Marginal effects of management insulation on probability of bailouts (2008/09)

Independent Variable	Dependent Variable: Bailout Dummy		
	(a)	(b)	(c)
Management Insulation Dummy MID (2003)	-0.191***	-0.201**	-0.221**
	[-3.085]	[-2.036]	[-2.004]
Controls (2006)	--	Size, leverage, state dummies	Size, leverage, ownership, board independence, acquisitions, board experience, incentives, state dummies
Observations	276	266	248

Marginal effects of management insulation on probability of bailouts (2008/09)

Independent Variable	Dependent Variable: Bailout Dummy	
	(a)	(b)
Management Insulation Dummy MID (2003)	-0.221**	-0.265**
	[-2.004]	[-2.573]
Change in Management Insulation (2003-06)		-0.130**
		[-2.103]
Controls (2006)	Size, leverage, ownership, board independence, acquisitions, board experience, incentives, state dummies	Size, leverage, ownership, board independence, acquisitions, board experience, incentives, state dummies

The issue with ‘Bailout’

- Banks with serious liquidity needs had no option but to apply for CPP funds.
- However, some banks did not qualify for CPP capital injections or had their applications rejected because they were too **weak**.
- There are 14 banks in this category.
- We also identify 8 banks that did not receive funds and subsequently **failed** (as of 2010).

Adjusting bailouts for performance

We create two new indicator variables:

1. “Bailout + weak bank dummy”

2. “Bailout + weak + failed banks”

Bailouts and Bank Strength

Independent Variable	Dependent Variable	
	Bailed out + weak banks	Bailed out + weak banks + failed banks
Management Insulation Dummy MID (2003)	-0.353***	-0.329***
	[-3.611]	[-3.438]
Change in Management Insulation (2003-06)	-0.102**	-0.093**
	[-2.113]	[-1.982]

Note: full set of controls

Ex-ante Risk Measures and Bailout

Non-interest to Net-interest Income (Brunnermeier 2012)

Independent Variable	Dependent Variable: Change in non-interest to net-interest income	
	(a)	(b)
Management Insulation Dummy - MID (2003)	-0.210***	-0.163***
	[-3.687]	[-3.153]
Change in Management Insulation (2003-06)	-0.041	-0.033
	[-1.590]	[-1.009]
Controls (2003)	Assets, leverage, independence, experience, ownership	As before, + compensation
Observations	184	179

Level 3 Assets

Independent Variable	Dependent Variable	
	Proportion Level 3 Assets	Proportion Level 3 Assets (log)
Management Insulation Dummy MID (2003)	-0.512**	-0.771*
	[-2.640]	[-1.764]
Change in Management Insulation (2003-06)	0.119	0.193
	[1.017]	[0.928]
N	240	124

Note: full set of controls

The Findings

- Our measure of management insulation is a good predictor of bank bailouts:
  - Insulated banks 19% to 26% less likely to be bailed out,
  - … 35% if we include failed banks.
  - Change in management insulation affects (negatively) the likelihood to be bailed out.
  - Findings appear to be robust to alternative explanations.
- In our sample, 56% of banks received TARP funds.

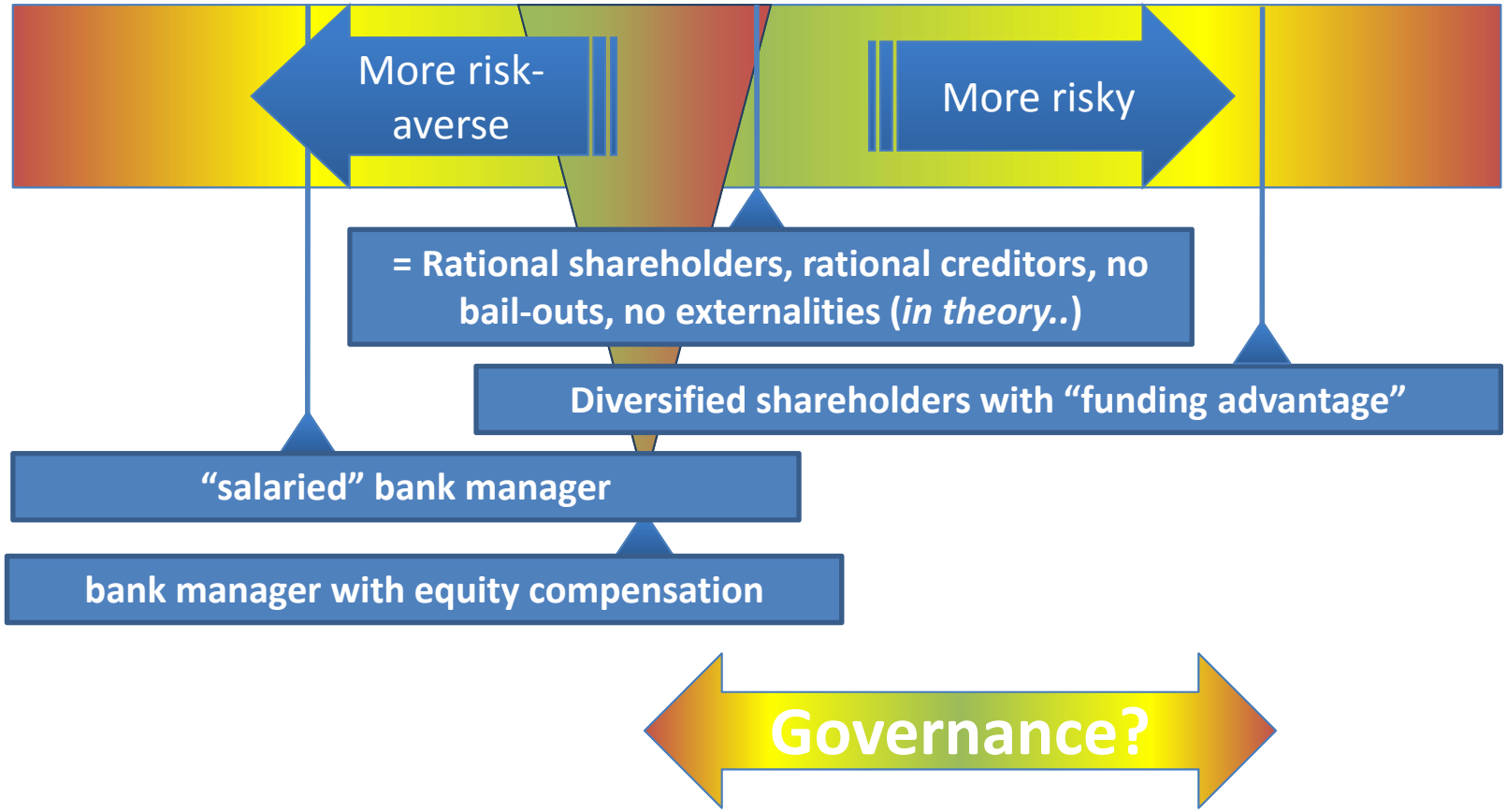
Main possible interpretations

1. If shareholders' privately optimal risk levels exceed those of managers, governance can affect the result of "bargaining about risk"

Possible interpretation: risk-aversion

- Banks are different
- Shareholders benefit from limited liability
  - Unlimited upside, limited downside
    - Strong incentive to increase risk taking
- Bank creditors do not discipline shareholders' risk taking incentives
  - Explicit and implicit state guarantees
  - Funding advantage
- Shareholders' privately optimal risk level > socially optimal risk level..

Privately optimal risk levels: Who wants what?



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2. Possible Tweaks on the Risk Taking Story
    - The "market for managerial talent" as a transmission mechanism
    - Incompetence, innovation and "conservative" behaviour.

1. Bad governance 1: Less accountable managers did not want to apply for CPP, although doing so would have been optimal.

Conclusions

- Management insulation predicts bank bailouts.
- Effects are economically strong; other governance variables fail to produce significant results.
- Evidence consistent with shareholder empowerment being associated with weaker banks during the crisis.
- Absentee and disempowered landlords maybe a good thing in financial institutions