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Guest Editor's Introduction

# Corporate governance in the banking and financial services industries

Few issues in financial economics have received as much attention in recent years as corporate governance. Among academics, however, the effect of governance on the conduct and performance of firms in the financial services industries has received less scrutiny than it has in other industries. A better understanding of sound corporate governance practices in financial institutions—most notably, banking firms—is of particular concern to regulators, taxpayers, and investors. Such concern is warranted because of the unique role played by banks in the US and global economies: banks are an important source of liquidity in times of crisis, they have access to the nation's payment systems, and they maintain deposits backed by government insurance.

Accordingly, this special volume of the *Journal of Financial Intermediation* is intended to foster a better understanding of governance issues, especially as they apply to banking firms, among researchers and other interested readers. The rest of this volume consists of papers covering three distinct areas:

- Anderson, Becher, and Campbell's investigation of CEO compensation following acquisitions and mergers,
- Hirtle's analysis of share repurchases by bank holding companies (BHCs), and
- Carletti's study of the practice of borrowing from multiple banks.

## 1. Executive compensation after acquisitions and mergers

The empirically-documented correlation between CEO compensation and firm size is often viewed with suspicion. One way for executives to increase firm size and perhaps enjoy greater size-related personal benefits, such as higher compensation, is to acquire other institutions. Indeed, after a merger between large banks, the chief executive's compensation increases materially, seemingly consistent with the notion that executive pay is naively benchmarked to the bank's enhanced size.

Offering an alternative view to this notion, Anderson, Becher, and Campbell develop and empirically test explanations derived from theories of executive compensation based on managerial productivity and optimal incentives. Specifically, they theorize that changes in CEO compensation should be related to the challenges and potential gains inherent

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in mergers, and thus the observed positive correlation between executive compensation and bank size may be driven by the bigger challenge in running a larger organization. This rationale is consistent with Demsetz (1995), who argues that more is demanded of managers in larger and more complex organizations. After a merger, executives must restructure assets, reconfigure the organization, reduce costs, and enhance revenues. Managerial compensation should increase commensurately with the expected value gains from these merger-related responsibilities.

Anderson, Becher, and Campbell's study sample consists of ninety-seven mergers between billion-dollar banks in the 1990s. Following a merger, the authors observe not only higher CEO pay but also greater performance incentives, consistent with the argument that a newly-merged bank requires, and rewards, greater managerial effort. They hypothesize that greater managerial effort will be directed at realizing expected merger gains, predicting a positive relationship between changes in compensation and the financial market's assessment of merger gains. Consistent with the notion of efficient restructuring of managerial incentives, Anderson, Becher, and Campbell find that the higher the anticipated gain from the merger, the greater the increase in CEO pay. In contrast, they find no support for the argument that compensation increases merely because of expanded firm size. Their conclusion is that general patterns in CEO compensation following bank mergers appear consistent with a market for corporate control that motivates efficient asset consolidation, and a labor market for bank CEOs that rewards managerial productivity.

## 2. Share repurchases by BHCs

Why do companies repurchase their shares? Three theories have been advanced in the literature to answer this often debated question. First, firms with high future prospects signal their opportunities to outside investors through share repurchases (see, for example, Vermaelen, 1984; and Ofer and Thakor, 1987). A second theory contends that firms want to disgorge free cash flows, as discussed in Jensen (1986). Finally, because the choice of payout policy—such as dividends versus share repurchases—may be affected by tax codes (see, for example, Rau and Vermaelen, 2002), it could influence firms' decisions.

Despite an abundance of general empirical research on this topic, very little work has focused on share repurchases in the banking industry. In addition to the aforementioned motives for repurchasing shares, repurchases—particularly in banking—are often a critical tool in shaping capital structure. In very highly leveraged industries, such as banking, a few years of high profits and strong cash flows can easily lead to substantial departures from targeted capitalization ratios. Historically, banks, like many companies, used dividends and/or special dividends to control this process. More recently, following adoption of SEC rule 10b-18 in late 1982, repurchases could be used to supplement dividends as a way to maintain capital structure.

In her contribution to the volume, Hirtle expands this relatively small body of research by examining repurchases made by closely-held as well as publicly-traded bank holding companies. Specifically, she analyzes the effect of share repurchases on BHC operating performance using a sample of repurchases by 1717 bank holding companies over 1987–1998. Hirtle documents that share repurchases in one period are associated with a higher operating performance in the following period, although the findings are stronger for publicly traded BHCs.

Her findings are consistent with both the free-cash-flow and private-information theories of repurchases. The fact that improvements in operating performance prevail only one year after repurchases may be because share repurchases, unlike permanent increases in dividends or leverage, do not commit the firm to pay out future free cash flows. It is also important to note that theories that suggest share repurchases convey insiders' private information do not suggest how long the improvement in performance should last. In particular, changes in firm performance should depend on the nature of the firm's investment opportunity set. Banking firms have significantly smaller growth opportunities, as proxied by Tobin's $Q$, relative to comparable firms in unregulated industries (Adams and Mehran, 2003). Therefore, increases in performance after repurchases in the banking industry may not be large relative to increases attained by firms in unregulated industries, or long lasting. This argument is consistent with the view that repurchases have no announcement effect in the banking industry (Billingsley et al., 1989).

## 3. Borrowing from multiple banks

Although considerable empirical work has focused on the number of bank relationships that firms choose to maintain, little theoretical research has been undertaken to model *how* firms make this choice. Exceptions are Rajan (1992) and Detragiache et al. (2000).[1] Yet, Rajan (1992) only models the choice between a single informed bank and a diffuse group of wholly uninformed "arm's-length" lenders. Moreover, his paper assumes that a single bank lender monitors at no cost, abstracting from the bank's monitoring decision. Detragiache et al. (2000) model how a firm chooses its number of bank relationships, but, like Rajan, they abstract from the bank's monitoring decision. Because borrower monitoring is a key function of banks, a model is needed to examine explicitly how the number of bank relationships affects monitoring.

The paper by Carletti addresses this gap in the literature. In the paper, a firm requires funds, but it is tempted to engage in moral hazard once the funds are loaned. Banks can prevent moral hazard through costly monitoring. Because banks care only about contractible cash flows—whereas borrowers also care about noncontractible benefits of control—a single bank may monitor excessively. In this case, two banks may be preferable: because each bank benefits from the other's monitoring, a free-rider effect ensues, reducing the total frequency of monitoring. As the cost of monitoring increases, the free-rider effect becomes more pronounced, and the borrower prefers two bank relationships rather than one. Similarly, if the benefits of control increase, the value of the free-rider effect is greater, and the borrower is more likely to prefer two bank relationships.

Carletti provides a theoretical explanation for the empirical observation that borrowing from multiple banks does not imply higher loan rates or firm quality, particularly in terms of small-business lending. Furthermore, she offers a new explanation for the optimality of

[1] See also Boot and Thakor (2000).

multiple-bank lending relationships—one that contrasts sharply with the hold-up literature. Her results are also consistent with Ongena and Smith's (2000) finding that multiple banking relationships are more common in countries with weaker judicial systems and weaker investor protections.[2]

## 4. Conclusion

The governance of banking and other financial firms is clearly an area worthy of further research. Future studies, for example, could add greatly to the literature by examining the size of changes in CEO compensation following a bank merger relative to the size of these changes in an unregulated environment. Closer examination of the relationship between share repurchases and regulatory capital would also prove beneficial. This volume takes an important step in this direction, and these papers will no doubt enrich the growing literature on the governance of financial institutions. This is a potentially rich area for research because of the interplay between corporate governance that is desirable for the bank's shareholders and corporate governance that is desirable for bank regulators.

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[2] A related paper is Thakor (1996) which finds that borrowing from multiple banks benefits firms, but that banks' incentives to screen decline as borrowers approach more banks, leading to the rationing of borrowers who approach a large number of banks. This leads to each borrower approaching a small number of banks.

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