Financial Expertise of the Board, Risk Taking, and Performance: Evidence from Bank Holding Companies

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Financial Expertise of the Board, Risk Taking, and Performance: Evidence from Bank Holding Companies[i]

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In the current debate on how to best reform the banking sector, one view is that more financial experts on boards would have limited the excessive risks that contributed to the financial crisis of 2007-2008. However, a study co-authored by Bernadette A. Minton at The Ohio State University Fisher College of Business refutes that argument. She and her fellow researchers found that more financially knowledgeable boards potentially encourage bank management to increase their risk taking.

In the study, "Financial Expertise of the Board, Risk Taking, and Performance: Evidence from Bank Holding Companies", researchers Minton, Jérôme Taillard of Babson College and Rohan Williamson of Georgetown University found that a potential reason for the increased risk taking could be because independent financial experts have a better understanding of complex investments. Another possible explanation is that independent financial experts, with a fiduciary duty to shareholders, understand the residual nature of the equity claims and will generally favor more risk taking.

Understanding the risk taking before and after the financial crisis is important when looking for ways to "fix" the industry going forward. Financial expertise of independent directors is one aspect of internal governance mechanisms that has to be examined.

The study's finding were based on an analysis of a large sample of U.S. commercial bank holding companies with more than $1 billion in assets both prior to and during the financial crisis. At year-end 2006, 25 percent of the bank holding companies did not have a financial expert among their independent directors, according to the study. The study defined independent directors as financial experts if they held an executive position at a banking institution, an executive position at a nonbank financial institution, a finance-related position at a nonfinancial firm or an academic position in a related field, or if they were professional investors.

Translation:

Excessive risk taking by banks and other financial institutions contributed to the financial crisis of 2007-2008. In the current debate on how to best reform the banking sector, one commonly-held view is that more financial experts on boards would have limited the excessive risks. However, a study co-authored by a researcher at The Ohio State University Fisher College of Business found that the presence of financial experts among independent directors was linked to more risk taking leading up to the crisis.

The study, "Financial Expertise of the Board, Risk Taking, and Performance: Evidence from Bank Holding Companies", found that more financially knowledgeable boards potentially encourage bank management to increase their risk taking. Researchers Bernadette A. Minton of Ohio State, Jérôme Taillard of Babson College and Rohan Williamson of Georgetown University found that financial expertise on independent boards resulted in more risk taking that benefited investors before the financial crisis but was detrimental during the financial crisis.

This team of researchers analyzed a large sample of U.S. commercial bank holding companies with more than $1 billion in assets both prior to and during the financial crisis. The study defined independent directors as financial experts if they held an executive position at a banking institution, an executive position at a nonbank financial institution, a finance-related position at a nonfinancial firm or an academic position in a related field, or if they were professional investors.

At year-end 2006, financial expertise was not very common among independent board members. For example, JP Morgan Chase only had two directors with financial expertise on its 12-member board. Among all publicly traded U.S. commercial bank holding companies, 25 percent of them did not have a financial expert among their independent directors, according to the study. Some people argue that having more financial experts would have limited the risk taking and mitigated their fall during the financial crisis.

However, according to the study, the number of financial experts among independent directors did not determine how much risk banks were willing to take. In general, having financial experts increased the level of risk taking. One reason put forward by the authors is that independent financial experts generally favor more risk taking because they have a better understanding of complex investments. Another explanation offered by the authors relates to the fact that independent financial experts, with a fiduciary duty to shareholders, understand the residual nature of the equity claims and will generally favor more risk taking.

Understanding the risk taking before and after the financial crisis is important when looking for ways to "fix" the industry going forward.

Financial expertise of independent directors is one aspect of internal governance mechanisms that has to be examined. However, the study refutes the argument that the lack of financial expertise of board members played a major role in the crisis.

In stable times, the presence of financial experts among independent directors is associated with higher risk taking and slightly above-average performance. Since financial expertise on the board is related to more risk taking, it is not surprising that stock performance was worse during the crisis for large banks with more independent financial expertise. These results are still consistent with the board acting to maximize shareholder value ex ante.

[i]Original article

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