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The Risk-Taking Attitude of Global Banks- A Study

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ABSTRACT

The relationship between corporate governance, risk-taking, and financial performance at bank holding companies (BHCs) during the financial crisis is examined in this research. The paper finds that BHCs with lower risk performed better than BHCs with higher risk during the crisis, even if it does not discover a significant association between level of risk taking and corporate governance. The findings imply that taking risks exacerbated the financial crisis. Future research should investigate corporate governance practises and how they relate to risk-taking and financial performance, as this work has shown to be necessary. The results help to improve risk management and bank rules.

Keywords: Corporate Governance, Financial Crisis, Financial Performance, Risk Taking

INTRODUCTION

Previous studies have looked into the connection between risk-taking by financial firms and corporate governance. Essentially, corporate governance is a method for addressing agency issues and reining in the firm's risk-taking. Therefore, it is not unexpected that in reaction to the recent financial crisis, banking regulatory bodies and central banks have taken numerous actions and made numerous comments emphasising the significance of good corporate governance in the banking industry (Peni & Vahamaa, 2011). Assessing the potential effects of improved corporate governance on bank performance during times of market stress is crucial.

The recent financial crisis' severity makes it crucial for future public policy that the causes of the United States' subpar financial performance be identified. Be aware of HBCs and how they ultimately contributed to the disaster. It is crucial to empirically evaluate these variables in order to confirm their correlations and the causative processes at play. Last but not least, it's critical to comprehend which facets of corporate governance had the most effects on risk-taking and, as a result, on financial success for effective future public policy.

First, it adds to the ongoing discussion on corporate governance and risk-taking by conducting a thorough analysis of the corporate governance, risk-taking, and financial performance of BHCs during the financial crisis of 2007–2008. Second, this study uses a comprehensive corporate governance index based on 51 different governance attributes to examine the effects of corporate governance on BHCs' risk-taking levels, whereas the existing literature only looks at a few aspects of corporate governance, such as board structure and executive compensation. Third, this study investigates whether corporate governance practises within organisations may have contributed to the risk-taking behaviour that led to the financial crisis. Finally, this study builds on earlier research that looks at banks' risk-taking.

The study's conclusions have significant ramifications for shareholders and managers as well. The data support the idea that BHCs with solid corporate governance had better risk management during the crisis than other organisations, which led to higher performance. The findings also give shareholders the knowledge they require regarding the connection between taking financial risks and performance, allowing them to urge bank management to steer clear of future crises of a similar nature.

LITERATURE REVIEW

In recent literature, risk management has gotten a lot of attention. It is clear that financial institutions overextended themselves in an effort to drive up stock values, which significantly contributed to the crisis that began in 2007. (Bruner, 2011). According to Burner (2011), the expansion of credit resulted from investors' ferocious search for yield, which was "met by a wave of financial innovation, focused on the origination, packaging, trading, and distribution of securitized credit instruments, such as residential mortgage backed securities" (p.313). Financial institutions expanded their lending to less creditworthy customers in order to meet the rising demand for mortgages and to satisfy their owners (Bruner, 2011)

When banks' risk management strategies failed, it is claimed that corporate governance failed (Rose, 2010). As a result, several academics investigated whether a risk management failure ultimately led to a corporate governance failure. The Organization for Economic Co-operation and Development (OECD) identified flaws in corporate governance as being more responsible for these failures in risk management than inadequate risk assessment or risk model inadequacies as the primary causes of the financial crisis. When corporate governance frameworks were tested in a number of financial services organisations, Kirkpatrick (2009) came to the conclusion that they did not accomplish their intended goal of protecting against excessive risk taking. Kirkpatrick cited significant risk management failures at large financial institutions as a result of poor corporate governance practises. As an illustration, numerous boards neglected to ensure that approved risk management protocols were followed, while others were never made aware of exposure hazards (Kirkpatrick, 2009).

Population, Sample and Data Collection

All publicly traded BHCs in the US would need to have their structures and results examined in order to conduct a completely systematic examination of the corporate governance role played by BHCs during the financial crisis. It is not possible to do such a study. Because they are noticeably more significant than smaller BHCs from an economic and investment standpoint, this study concentrates on the largest BHCs.

All Top-tier BHCs (excluding atypical BHCs) that were designated as Peer 1 group and Peer 2 group as of December 31, 2006 were included in the study sample, yielding 156 BHCs. All BHCs with consolidated assets of $10 billion or more are included in the Peer 1 group. All BHCs with consolidated assets between. The sample was reduced to 94 BHCs after eliminating BHCs without Gov-scores. 20 of these 94 BHCs lacked full financial records for the years 2006 to 2009 due to closure, acquisition by another bank, shift from BHC to another entity, or being foreign entities.

Data Analysis

Hypothesis testing and descriptive statistical analysis made up the data analysis process. Descriptive statistics and inferential statistics are two categories of statistical tools used in quantitative analysis of data. In this study, descriptive statistics were produced using the arithmetic mean, median, standard deviation, minimum, maximum, and range for all constructs. Inferential statistical tests, such as basic linear regression and ANOVA tests, were used to examine the three hypotheses in this study. We used a Type I error of 5% to assess the statistical significance of each hypothesis.

Hypotheses Testing Results

Hypothesis 1 (H1): Corporate governance of U.S. BHCs had an impact on their level of risk taking during the recent crisis. Table 2 (Appendix) presents the regression analysis of z- score on Gov-score. The regression analysis tested the relationship between BHCs' corporate governance and their level of risk taking to determine if corporate governance affects risk taking. The results show that corporate governance is not a significant predictor of risk taking (Adjusted R Square = 0.004, $t = -1.08$, $P = 0.282$). The P-value is greater than the critical value of 0.05, meaning that the results are not statistically significant. Thus, the alternative hypothesis (H1) cannot be accepted.

DISCUSSION

Impact of Corporate Governance on Risk Taking

Findings that suggest risk taking is not affected by corporate governance contradict the fundamental theory of corporate governance because boards are called upon to determine a firm's strategy and tolerance of risk. Ultimately, it is the responsibility of management and the board of directors to ensure that appropriate risk-management systems are in place. Many scholars therefore concluded that the governance structures at most major financial institutions failed from a risk management perspective.

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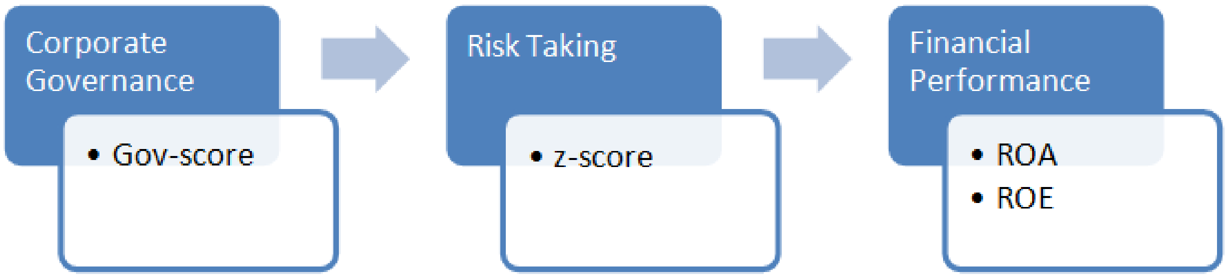

Figure 1: Conceptual Framework

Conceptual Model of the Study: The conceptual framework consists of three primary constructs: 1) BHC corporate governance as measured by Gov-score, and 2) BHC risk-takinglevel as measured by z-score, and financial performance as measured by ROA and ROE.

Implications for Banking Practitioners

Important ramifications of this study also apply to shareholders and managers. The study's findings support the idea that while banking governance had no influence on risk taking, banks that did follow sound risk-management practises nonetheless outperformed those that did not during the financial crisis. As a result, it would seem that bank management and board of director initiatives should focus on developing effective risk management processes rather than relying on governance policies that may not be efficient.

New interpretations of current corporate governance regulations that deal with boards' risk oversight duties may be one of these initiatives. The board must understand the firm's risk strategy, recognise the extent to which management has developed risk-aware strategies, and evaluate the firm's risk tolerance in relation to potential issues.

Implications for Future Research

Scholars concur that the recent global economic crisis was brought on by a housing bubble in the United States. There is, however, little consensus over the contribution corporate governance made to the financial crisis, the flaws in the governance framework, and the necessary reforms.

While corporate governance is a topic of much research today, just a few papers specifically address corporate governance in banks. The reality that governance frameworks are in fact industry-specific is highlighted by the systematic distinctions between banking and other enterprises' governance. Therefore, in order for banking governance reforms to be successful, industry-specific factors must be taken into account. Future studies that look at the corporate governance of banks may be able to establish this.

Future research should concentrate on deeper examinations of bank financial statements as well as additional financial metrics such write-downs, loan loss reserves, subprime losses, impairment charges, and credit losses as alternative risk and performance indicators.

These metrics may provide clear indicators of subpar performance as well as possible indicators of bank corporate governance standards.

CONCLUSION

Current conceptions of efficient corporate governance are called into question by the world economic crisis that broke out in 2008. Many financial businesses' boards were powerless to stop their leaders from making dangerous choices and shield the company from the financial crisis. Corporate governance is maybe one of the many intricate and interconnected factors that contributed to the economic crisis. This research helps explain how risk-taking, corporate governance, and financial performance interact in the context of financial institutions. By examining the connections between prominent U.S. BHCs' corporate governance, risk-taking, and financial performance during that time, it investigates the potential roles that risk-taking and corporate governance may have had in the financial crisis of 2007–2008.

In order to achieve this, this study offers a framework for thinking about the governance of financial institutions from the perspectives of both reform and research. It establishes the groundwork for subsequent research on financial performance, risk taking, and corporate governance in financial institutions. Additional investigation into the corporate governance practises of banks may reveal novel information regarding particular corporate governance clauses that influence risk taking and financial performance.

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