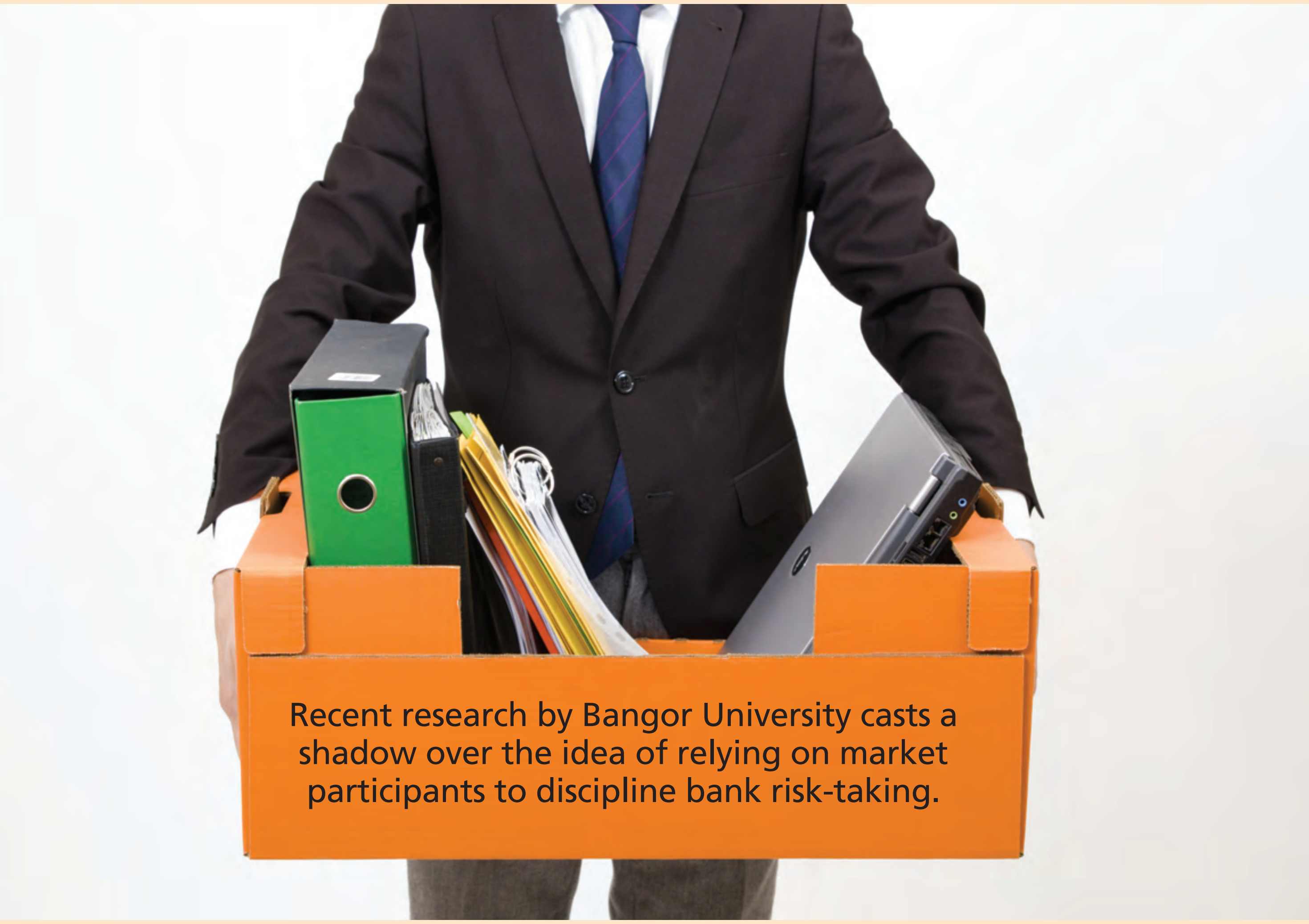

Recent research by Bangor University casts a shadow over the idea of relying on market participants to discipline bank risk-taking.

Behind the departures

Klaus Schaeck

Recent years, marked by one of the most severe financial crises in history, have seen a substantial increase in the number of banks incurring losses. One implication of such underperformance is the dismissal of bank executives. It may come as no surprise that we witnessed numerous forced departures of managers in large, systemically important institutions, such as Merrill Lynch and Citigroup in the US, and Northern Rock and HSBC in the UK.

In recent research*, Bangor University's Professor Klaus Schaeck, along with with his co-authors from the International Monetary Fund, the World Bank and the European Central Bank, investigated these forced departures to examine the driving forces behind these executive turnovers.

A well-functioning corporate governance system suggests that dismissals could be a manifestation of market discipline. Beyond the regulators, who can demand the dismissal of executives who are considered to be responsible for poor performance? Shareholders, and also debtholders, closely monitor bank performance and these two parties also have the ability to affect bank risk-taking and executive turnovers.

Large shareholders can directly influence executive dismissals through their representation on the bank's board. On the other hand, debtholders can indirectly contribute to managers' dismissals by raising funding costs of the institutions via the demand for higher-risk premiums and the withdrawal of funds if they consider the bank to be risky.

These considerations suggest bank executives, threatened with the loss of their jobs, will act in the interest of shareholders, debtholders and regulators and avoid taking on excessive risks. However, the objectives of these three different parties differ greatly and so banks and their

> **"BEYOND THE REGULATORS,** WHO CAN DEMAND THE DISMISSAL OF EXECUTIVES WHO ARE CONSIDERED TO BE RESPONSIBLE FOR POOR PERFORMANCE?"

managers will be subject to different meanings of what constitutes inadequate bank performance.

For example, shareholders' main interests lie in investment returns, debtholders focus on the repayment of their deposits, while regulators are mainly concerned with safety and soundness. Therefore, in order to avoid being fired, executives will have to achieve high profits, while at the same time keeping losses low and avoiding excessive risk-taking.

> **"IN ORDER TO** AVOID FIRING, EXECUTIVES WILL HAVE TO ACHIEVE HIGH PROFITS, AT THE SAME TIME KEEPING LOW LOSSES, AND AVOIDING EXCESSIVE RISK-TAKING."

The research by Schaeck and his co-authors evaluates the reliability of market discipline in shaping safe and sound banks. Their results suggest that the reality strays away from the theoretical view. In practice, only discipline imposed by the banks' shareholders leads to dismissal of managers. There is no compelling evidence that debtholders and regulators are the driving force behind executive dismissals when risk increases.

In an extension of their study, the researchers also assessed the effects of forced turnovers on future bank performance by tracking bank losses, performance and risk-taking in the three years following a dismissal.

Replacing executives should result in performance improvements in those banks that fired their executives on the grounds of poor performance. However, the research reveals that dismissals do not necessarily yield the desired performance improvements.

Several explanations have been put forward as to why bank performance might not improve considerably once replacement executives have arrived. Firstly, reduced earnings may be the result of restructuring unsound practices undertaken by previous management, depressing earnings in the first few years after the new executives come on board.

Secondly, new managers start by decreasing earnings so that they can take credit for subsequent improvements. Thirdly, dismissal of a bank's executives carries high costs, in the form of severance packages and commission paid to recruitment agencies.

Regardless of what causes such negative outcomes, the research results indicate that market discipline is insufficient to guarantee safe and sound banks, and firing an executive does not necessarily improve bank performance in the short term. CB

Bangor Business School, Bangor University is home to the Chartered Banker MBA. For more information about this MBA visit www.charteredbankermba.co.uk

*Schaeck, K. Cihak, M. Maechler, A. and Stolz, S. (2012) "*Who disciplines bank managers*", Review of Finance, Vol. 16, pp.197-243.