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Review

Role of Shareholder control on financial performance of commercial banks

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This study constitutes a theoretical review of existing literature relevant to the subject. The purpose of this paper is to examine the effect of shareholder control on financial performance of commercial banks. The emerging literature on corporate governance indicate that Shareholder rights reflect the ability of voting stockholders to exercise control over firm assets, remove ineffective or opportunistic management, or effect ownership changes to increase shareholder value. The purpose of this paper is to clarify role of shareholder control on performance of commercial banks.

Key Words: Board structure, bank performance, board size

INTRODUCTION

Interest in corporate governance has increased in numerous advanced as well as emerging economies during the past few decades, especially in the aftermath of the economic collapse and financial crises undergone by a number of countries in South East Asia, Latin America and Russia in the 1990s, as well as the consequences of the bankruptcies of a number of leading US global corporations. Therefore, corporate governance now receives considerable attention by numerous academics, international organizations, states, etc. seeking to find mechanisms which ensure good investment climate and financial stability in the face of growing crises witnessed by the global economy, especially in the banking sector. A lot of studies continue to call for further attention to this sector due to its vital importance in the economy with a view to exploring the status of governance in the banking sector and throwing light on the mechanisms which may be more important for ensuring a better performance by banks.

Overview of banking sector in Kenya

Financial sector witnessed a sudden nose-dive in rates beginning Q3 2009 when prime rates, and specifically the 91-day Treasury Bill hovered at a record sub-2% levels. This was entirely occasioned by the 'expansionist' policies adopted by the Central Bank of Kenya "CBK" at that time; the Bank's benchmark rate "CBR" hovered at

7.96% and 6.42% on annual average terms in 2009 and 2010 respectively. The period under review was also characterized by high liquidity levels in the market with the interbank rate circling at 1.48% on average terms in 2010. This phenomenon led to a significant growth in overall money supply and consequently stagnated the credit money creation momentum. With financial institutions, led by banks, sitting on cash positions above the 'threshold' 15%, they opted to park their cash in risk free instruments and specifically Government securities (CBK, 2011). A global balance sheet analysis from the Central Bank of Kenya data shows that placements and Government securities recorded robust growths in 2010; the former grew 16.10%/y/y to Kshs.73.60bn while the latter grew 40.80%/y/y to Kshs.443.1bn. The beginning of 2011 saw substantial weakening of macro and financial fundamentals with inflation breaching the CBK's target of 5%. The eruption of the 'Arab Spring' saw global crude prices soar to post-2008 record levels with WTI and Brent Crude surging to highs of USD 114 and USD 122 respectively. High food prices remained a global phenomenon: world food inflation accelerated to 34% in February 2011 from 25% in December 2010 due to rising prices of oil and cereals. Domestic dry weather conditions, both in Q1 and Q2 2011, worsened the food price increases that would have otherwise been recorded due to increases in international food prices. In a bid to

protect economic activity by controlling inflation and stabilizing the exchange rate, CBK began a series of rate hikes in March 2011 (RoK, 2011).

Shareholder Control and performance of commercial banks

Shareholder rights reflect the ability of voting stockholders to exercise control over firm assets, remove ineffective or opportunistic management, or effect ownership changes to increase shareholder value. Traditional theory is of the view that lower shareholder rights (weak external governance) generate information asymmetry between shareholders and managers that leads to greater managerial incentives to reduce transparency and manage earnings to increase their bonuses. Greater shareholder rights, on the other hand, enables shareholders to implement corporate governance mechanisms to monitor managers more meticulously. Much research has been done on the implications of greater shareholder rights to companies. The main finding is that greater shareholder rights are associated with reduced agency risks (Diamond and Verrecchia, 1991; Shleifer and Vishny, 1997a) and improved firm performance (Gompers *et al.*, 2003). However, these studies do not directly address the association between shareholder rights regimes and the quality of reported earnings. As the first objective of this study, we build on the existing literature on shareholder rights to investigate whether vigilant and effective shareholder oversight reduces the incentives and constrains the ability of managers to engage in opportunistic management of earnings.

A closely related issue to shareholder rights is the role of institutional ownership and its influence on earnings quality as the participation of institutional investors become increasingly important in the US financial markets. Sias and Starks (1998) noted that large institutional ownership in equities increased from 24 per cent in 1980 to nearly 50 per cent by the end of 1994. As their influence grew, institutional investors abandoned their traditional passive shareholder roles and became more active participants in the governance of their corporate holdings. Although, it is widely recognized that institutional participation has evolved into an integral part of shareholder rights mechanisms, the role of institutional investors in influencing corporate performance and earnings quality is still unclear. While there are arguments suggesting that the presence of substantial shareholdings is associated with superior corporate performance and less opportunistic self-serving behaviour (Shleifer and Vishny, 1997b; McConnell and Servaes, 1990; Gadhoun, 2000), there are also studies suggesting institutional investors are fixated on short-term performance even to the detriment of the long-term prosperity of the firm (Porter, 1992; Demirag, 1998; Lang and McNichols, 1999). Therefore, as the second

objective of this study, we seek to examine the influence of different types of institutional investors on the effectiveness of shareholder rights in constraining earnings management. We categorize institutional investors as “transient” (short-term investment horizon) and “nontransient” (long-term investment horizon) and examine whether their varying investment horizon moderates the association between shareholder rights and earnings quality.

Using the corporate governance index developed by Gompers *et al.*, (2003) as a proxy for the strength of shareholder rights, we find that strong shareholder rights improves the reliability of financial information by reducing the ability of management to intentionally manipulate accruals. However, we also find that when firms' stocks are held predominantly by institutions with short investment horizons, the role of shareholder rights mechanisms in constraining aggressive and opportunistic management of earnings is actually diminished or rendered essentially ineffective. Our results are consistent with the view that institutional investors' focusing on short-term earnings performance could pressure management into boosting reported earnings through aggressive accounting.

Some literature argues that strong shareholder rights could mitigate the agency costs by reducing the managerial entrenchment, thus reducing the cost of equity capital. Consistent with this theory, Cheng *et al.*, (2006) and Huang *et al.*, (2009) show that stronger shareholder rights as indicated by G-score are associated with lower cost of equity capital. However, prior studies (Stein, 1988; Harris, 1990; Bebchuk and Stole, 1993) also suggest that weaker shareholder rights provide managers with job securities and incentives to engage in long-term project; thus, some provisions that limit shareholder rights might reduce the cost of equity capital. Accordingly, results based on an aggregated shareholder rights index (e.g. G-score) would be misleading if individual provisions of shareholder rights have opposite associations with the cost of equity capital. In addition, some provisions of shareholder rights may play more important roles than others in affecting the cost of equity capital, creating a non-linear association between the overall shareholder rights and the cost of equity capital. Past studies on shareholder rights are generally conducted at the aggregated index levels (e.g. Gompers *et al.*, 2003; Cheng *et al.*, 2006; Bebchuk *et al.*, 2009), warranting an examination of the differing impacts of shareholder rights provisions on the cost of equity capital. Identifying these important provisions would also help to focus attention and resources on these crucial aspects of shareholder rights.

Shareholder rights reflect the balance of power between shareholders and managers. Voting shareholders have a motivation to make changes in management to increase firm value. Managers, on the

other hand, desire to "protect their turf" by restricting shareholder rights. Managers use various measures to restrict shareholder rights, including setting up defenses against takeover, requiring staggered terms for directors, and requiring "super majority" voting requirements for approval of mergers and ownership changes. These defensive measures along with other statutory and corporate charter provisions are designed to limit shareholders' participation in the governance process and hence their ability to intervene and take disciplinary actions against them, which in turn increases managers' ability to protect and conceal their private control benefits from outsiders through earnings management (Shleifer and Vishny, 1997a).

Prior studies have examined the implications of shareholder rights for various aspects of firm performance. Gompers *et al.*, (2003) showed that firms with greater shareholder empowerment are valued more highly by the market. More specifically, higher levels of shareholder rights are associated with positive abnormal returns, higher firm values, higher profits, higher sales growth and fewer acquisitions. Using a sample of firms from 31 wealthy economies, La Porta *et al.*, (2002) find evidence of higher valuation for firms in countries with better protection of minority shareholders. These empirical findings suggest that there are positive shareholder wealth implications for firms with stronger shareholder rights. Prior research also suggests that weak corporate governance mechanisms will lead to increased perceived risks of the firm, and thus higher cost of capital (Jensen and Meckling, 1976; Diamond and Verrecchia, 1991). Ashbaugh *et al.*, (2004) provided empirical evidence that lower levels of corporate governance as measured by the Gompers's index were associated with higher cost of capital. Cheng *et al.*, (2006) also found that firms with stronger shareholder rights and higher levels of disclosure had significantly lower levels of cost of capital relative to firms with weaker shareholder rights and lower levels of disclosure.

We add to the shareholder rights literature by examining the association between shareholder activism and the quality of reported earnings. Leuz *et al.*, (2003) examined this issue in an international setting and found that earnings management decreases in investor protection. Baber *et al.*, (2007) presented evidence that strong external governance (fewer restrictions on shareholder rights) is associated with relatively low probabilities of accounting restatement. We conjecture that vigilant and effective shareholder oversight increases the investors' ability to monitor and discipline managerial actions, and thus reduced incentives for managers to engage in opportunistic financial reporting.

CONCLUSION

This study examines whether stronger shareholder rights induce higher earnings quality and how institutional

ownership influences the effectiveness of shareholder rights in constraining opportunistic management of accruals. Our research adds to the extant literature by examining whether greater shareholder empowerment increases investors' ability to monitor and discipline managers, thus reducing earnings management. In addition, we investigate the role of institutional ownership in influencing corporate managers' earnings management behaviour in the broader setting of shareholder rights regimes. After controlling for the firm-specific factors, we find that greater shareholder empowerment (as measured by the Gompers's index) is associated with higher earnings quality.

However, this positive effect is attenuated or neutralized when institutional investors are predominantly transient with short investment horizons. Our results are consistent with the view that institutional investors' focus on short-term earnings performance could pressure management into boosting reported earnings through aggressive accounting. It appears that institutional investors may be using their increased empowerment and their ability to affect managerial behaviour for the purpose of increasing the value of their shares in the short-term. The results from this study enhance our understanding of the relation between shareholders rights and different types of institutional ownership, and how they interact in affecting the quality of corporate earnings. In view of the current effort by the SEC to increase shareholder rights, the results of this study provide evidence to the SEC that type of ownership should also be factored into the discussion when considering steps to increase shareholder rights.

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