 ISBN 978-80-87927-92-2, IISES

NOORA ALJALAHMA
University of Salford, United Kingdom

RASOL ESKANDARI
University of Salford, United Kingdom

HASAN YAZDIFAR
University of Salford, United Kingdom

CORPORATE GOVERNANCE AND RISK TAKING IN FINANCIAL INSTITUTIONS: A PRINCIPAL COMPONENT ANALYSIS APPROACH

Abstract:

In this study, we examine the effect of corporate governance characteristics on risk taking in financial institutions. The risk taking in financial institutions affects the financial and economic stability and failure of financial institutions eventually reaches other sectors and firms in the market.

Previous studies in this area have mainly used governance indices as a proxy for corporate governance. Their findings show that there is a relationship between corporate governance and risk taking in financial institutions for example they found that shareholder-friendly corporate governance leads to excessive risk taking in firms. However, the utilization of indices only gives an overal view. In order to be more specific, we examine the effect of various corporate governance characteristics on several risk measurements. We develop governance factors by using Principal Component Analysis as a replacement of a single governance index, and then use Structural Equation Modelling to integrate several models in a single model.

Our findings show that, while corporate governance as a whole positively affects risk, there are certain characteristics that have a negative effect. We find that characteristics related to the compensation structure and auditing practices drive the positive effect on risk. However, insider ownership, debt-based compensation and board characteristics including board independence and size have a negative effect. In previous studies, these characteristics were found to have a positive effect on risk when examine in the context of a governance index. We also conduct an additional analysis using governance scores developed by the Institutional Shareholder Services to replace the governance factors. The results confirm that corporate governance as a whole have a positive effect on risk, but other variables including board characteristics and shareholders rights have a negative effect.

The findings of our study highlight the importance of studying corporate governance in detail rather than in general. We show that the utilization of a single index can be misleading. The implications of our findings are of a regulatory nature which benefits managers, regulators, and shareholders, it is important for them to know that not all aspects of corporate governance behave similarly. Thus, corporate governance frameworks should be read and developed cautiously, and each part of corporate governance should be treated differently. For example, when developing a framework that addresses risk taking behaviour in financial institutions, not all parts of the framework should have the same directions; while the equity compensation requirement should be lessened (reflecting less shareholder-friendly principles), there should be more requirement for board independence (reflecting more shareholder-friendly principles). Despite the fact that both principles have different directions, they all aim to minimize risk taking. This implies that each part of corporate governance should be treated differently.

Keywords:

Corporate Governance, Financial Institutions, Risk Measurements, Risk Governance, Principal Component Analysis, Structural Equation Modelling.

JEL Classification: G34, O16, G23