

Chicago Fed Letter

Corporate governance at community banks: A Seventh District analysis

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Community banks can be vulnerable to the same economic tensions and conflicts of interest that have compromised corporate governance at more high-profile firms over the past few years. The authors discuss their preliminary findings from a project designed to construct a systematic database on the corporate governance practices at District community banks.

Corporate managers make daily business decisions that determine how most of the resources in our economy are used, and they almost always make these decisions without consulting their stockholders, the owners of the resources.

Corporate governance—one of the foundational concepts of a capitalist society—is the set of public laws and regulations, private rules, and informal practices designed to directly control or indirectly influence corporate managers to make decisions that benefit stockholders and society rather than themselves.

In the American corporate governance framework, the interests of stockholders in publicly traded firms are protected largely by three institutions. A board of directors, elected by stockholders,

hires and monitors the activities of the firm’s management. The Securities and Exchange Commission (SEC) requires the firm’s management to publish regular financial statements that are reviewed and certified by outside auditors. And the stock market, made up of various investors, offers daily opinions on the health of the firm by translating public information into a higher or lower stock price.

Until recently, what makes for “good” and “bad” corporate governance has chiefly been debated by financial theorists in professional journals and by financial practitioners and company directors in boardrooms. But with news of the fraudulent practices of some top managers at high-profile firms like Enron, Tyco, and WorldCom—as well as the revelations of questionable accounting practices and the appearance of excessive managerial compensation at other firms—corporate governance has become the focus of very public debate. In response to the scandals, Congress passed the Sarbanes–Oxley Act of 2002 aimed at improving the quality of audits, enhancing the financial expertise of directors, and increasing the accountability of managers at publicly traded firms. While the corporate governance environment at commercial banks can be quite different from that found in most other U.S. corporations, banks can be vulnerable to the same underlying economic tensions and conflicts of interest among managers, stockholders, and the public interest. Although very few commercial banks have failed in recent years, virtually all of these insolvencies were related to improper managerial behavior and ineffective controls (e.g., First National Bank of Keystone in 1999 and Oakwood Deposit Bank in 2002). This *Chicago Fed Letter* reports on a research project we are conducting at the Federal Reserve Bank of Chicago on

1. Community banks in the Seventh District

| Profitability | |
|---|-----------------|
| Average return on assets | 1.06 |
| Average return on equity | 10.89 |
| Other characteristics | |
| Average assets | \$251.4 million |
| Less than 10 years old | 12.0 |
| Subchapter S corporations | 31.3 |
| Non-lead affiliates in multibank holding companies | 12.8 |
| Located in a metropolitan statistical area (urban market) | 39.3 |
| Publicly traded | 10.4 |

NOTES: All numbers in percent unless stated otherwise. The year-end 2004 data used for this figure are from a sample comprising 115 commercial banks with state charters and Federal Reserve System membership. A Subchapter S corporation is a form of corporation, allowed by the Internal Revenue Service for most companies with 75 or fewer shareholders, which enables the company to enjoy the benefits of incorporation but taxes earnings only at the shareholder level, thus avoiding the corporate income tax.

2. Corporate governance for the average community bank

Bank ownership

| | |
|--|------|
| DMO ownership stake | 10.7 |
| DMO ownership as share of personal wealth | 39.6 |
| DMO family ownership stake | 24.6 |
| Board of director ownership stake | 40.4 |
| Large block (>5%) non-DMO family ownership stake | 14.0 |
| Banks with employee stock ownership plans | 14.8 |

DMO status and pay

| | |
|---|------------|
| Hired DMO (with less than 1% ownership stake) | 41.2 |
| DMO tenure | 11.4 years |
| Formal succession plan in place | 54.0 |
| DMO base pay | \$146,340 |
| DMO bonus pay | \$39,110 |
| DMO contract contains performance incentives | 43.2 |
| DMO received stock options | 22.1 |
| DMO received stock grants | 11.3 |

Director status and pay

| | |
|--|------------|
| Outside directors | 62.6 |
| Director age | 59.1 years |
| Director tenure | 14.5 years |
| Director pay (lump sum) | \$2,724 |
| Director pay (per meeting) | \$418 |
| Director attendance | 92.7 |
| Boards that sometimes meet without DMO | 25.4 |
| Mandatory director training | 21.4 |
| Limits on number of other boards | 2.9 |

NOTES: All numbers in percent unless stated otherwise. The data used for this figure were collected in late 2003 and early 2004 from a sample comprising 115 commercial banks with state charters and Federal Reserve System membership, and reflect corporate governance conditions present at these banks during 2003. DMO refers to daily managing officer.

soundness, internal controls, corporate governance practices, auditing policies, and compliance with numerous financial regulations. Indeed, aside from the expenses of compliance, the Sarbanes–Oxley Act has had less impact on corporate governance at U.S. commercial banks than at nonbank corporations because banks have been exposed to stricter regulatory scrutiny for quite some time. In their role as outside monitors, state and federal bank supervisors have long sought to foster strong corporate governance practices at community banks, with the recognition that best practices at these small privately held organizations may differ from best practices at large publicly traded banking companies.

Data collection

One key objective of our project at the Chicago Fed is the construction of a database that describes the corporate governance environment at community banks. The data we present and analyze here for banks in the Seventh District were collected as part of the regular examination process. These data were collected both off-site (from previous examination records and internal supervisory databases) and on-site (from interviews with bank managers and internal bank documents), and were then combined with financial statement information from standing regulatory databases (the Federal Deposit and Insurance Corporation’s *Reports of Income and Condition* or “call reports”).³

These data were collected during bank examinations conducted in late 2003 and early 2004, and they reflect the corporate governance environment that existed at each bank prior to 2004. Banks were included in the database only if they were headquartered in the Seventh District, were state chartered, were members of the Federal Reserve System, and could arguably be considered as community banks. We exclude from our analysis any bank that sustained a

material change in control or top management between 2001 and 2004, as well as any bank for which information was substantially incomplete. This left us with 115 banks in the database, out of a possible 185 community banks in the Seventh District in 2004.

Profile of the community banks

Figure 1 describes the size, financial performance, and organizational details of our sample banks based on financial data from 2004. The average bank had about \$250 million in assets, but size ranged widely from about \$10 million to as much as \$3 billion. Bank profits also varied substantially: return on assets (ROA) averaged 1.06% and ranged from –0.26% to 2.55%, while return on equity (ROE) averaged 10.89% and ranged from –2.69% to 25.68%. A substantial minority of the banks were located in urban markets (39.3%), and/or were organized as Subchapter S corporations (31.3%). Smaller percentages were affiliated with multibank holding companies (MBHCs), were newly chartered “de novo” banks less than ten years old, and/or were publicly traded corporations.

Figure 2 displays selected information on the corporate governance environment at the typical community bank in the Seventh District. The daily managing officer (DMO) is responsible for making the day-to-day operating decisions; this person is usually the president or chief executive officer (CEO) of the bank.⁴ The typical DMO owned 10.7% of the bank’s stock, and this ownership stake accounted for 39.6% of the DMO’s personal wealth. An additional 13.9% of the average bank was owned by the DMO’s immediate family members—a clear illustration of the closely held, owner-operator environment at most community banks—while large shareholders (holdings greater than 5%) who were unrelated to the DMO’s family held a 14% stake. Overall, members of the board of directors (including the DMO and his or her family) held a 40.4% stake at the average bank. In addition, 14.8% of the banks had employee stock ownership plans (ESOPs).

The typical DMO had been at the job for over 11 years and received a \$146,000 base salary with a \$39,000 cash bonus. About 43% of the DMOs had contractual incentives linking their pay to the financial performance of the bank,

the state of corporate governance practices at community banks in the Seventh Federal Reserve District and the relationships between those practices and bank performance.¹

Corporate governance at community banks

Over 90% of the commercial banks in the U.S. can be described as “community banks.” Community banking companies are small firms, most having less than \$1 billion in assets, and are typically closely held.² For community banks that are owner-operated (i.e., the top managers and their families hold the controlling interest in the bank), there may be less scope for conflicts of interest between management and stockholders because these two sets of people largely overlap. However, because these banks are not publicly traded, they do not receive potentially useful monitoring and feedback from investors in the stock and bond markets.

Owner-operated or not, all commercial banks have an additional outside monitor not present at most other corporations: federal and/or state bank supervisors. Bank supervisors regularly review banks for financial safety and

3. Corporate governance and profitability

| | | Return on assets | Return on equity |
|---|---|------------------------|------------------|
| 54% of the banks had a formal management succession plan in place. | Adopting a formal plan is associated with: | a 13% increase. | an 11% increase. |
| On average, top managers received \$39,100 of their pay as a cash bonus. | A 10% increase in this bonus is associated with: | a 0.4% increase. | a 0.5% increase. |
| On average, bank directors received \$2,724 in lump sum compensation. | A 10% increase in this amount is associated with: | a 0.5% decrease. | a 0.5% decrease. |
| On average, top managers had 39.6% of their personal wealth invested in bank stock. | A 10% increase in this percentage is associated with: | no significant change. | a 0.7% decrease. |

NOTE: Based on results of regression analysis as described in the article.

while 22.1% and 11.3% had received stock options and stock grants, respectively, during the past four years. The DMO was a “hired manager” at 41.2% of the banks, which we define as a DMO with less than a 1% ownership stake in the bank.

Outside directors (i.e., non-managers) made up about 63% of the boards of directors. The typical director was about 59 years old and sat on the board for over 14 years. On average, directors received \$2,724 in lump sum pay (i.e., regardless of their efforts) each year and \$418 per board meeting attended, and they attended 92.7% of the scheduled meetings. Only about one-quarter of these boards ever met without the DMO being present. Finally, only about 21% of the banks required mandatory training for their directors, and only about 3% of the banks limited the number of other boards upon which their directors could sit.

Preliminary analysis of the data

A second key objective of our project is to determine whether and how corporate governance practices influence the financial performance of our sample banks. The ultimate related objective is to identify a set of corporate governance “best practices” for community banks. The results we report here mark the beginning of this endeavor; although some of these findings are encouraging, at this point they are exploratory in nature.

Using multiple regression analysis, we tested whether any of the corporate governance characteristics measured as of 2003 for our sample banks are statistically related to the ROA or ROE earned by these banks in 2004. We began with

simple baseline models in which the banks’ ROA and ROE in 2004 were regressed on the six “other characteristics” listed in figure 1 for the same year.⁵ Together, these six characteristics explained about 32% of the variation in ROA across banks and about 40% of the variation in ROE. Bank profitability was positively and statistically significantly related to bank size, Subchapter S status, and MBHC affiliation, and negatively and statistically significantly related to de novo status, urban location, and publicly traded status.⁵

We then tested whether the corporate governance characteristics displayed in figure 2 for 2003 helped *further* explain the differences in ROA and ROE across community banks in 2004. When we added each of these characteristics individually to the regression equations, only six were statistically related to ROA or ROE. Moreover, when we added all six of these characteristics simultaneously to the regression equations, only four—DMO bonus pay, DMO ownership as a share of personal wealth, director lump sum pay, and formal succession plan in place—retained their statistical significance. Together, these four measures explain an additional 11% of the variation in ROA across banks and an additional 10% of the variation in ROE.

These findings are summarized in figure 3. Profitability is 13% higher in terms of ROA (i.e., 1.20% instead of 1.06%) and 11% higher in terms of ROE (i.e., 12.09% instead of 10.89%) at community banks with formal management succession plans in place. Succession planning is recognized as a good corporate governance practice in all industries, and bank supervisors strongly

advocate that banks have such plans in place. We do not argue that the mere existence of such a plan buoys profits; rather, this result likely indicates that forward-looking banks that are attentive to this one managerial best practice are likely to be attentive to other profit-enhancing controls and managerial best practices as well.

Our regressions suggest that banks perform better when their managers and directors face the proper monetary incentives. Paying managers bonuses—is opposed to straight salary—is associated with higher profitability. According to the regression estimates, a 10% increase in DMO bonus pay is associated with about a 0.4% improvement in bank ROA and a 0.5% improvement in bank ROE. (We found similar results when we expressed DMO bonus pay as a share of base pay or bank assets.) Our estimates also suggest that bank directors respond to monetary incentives, but unfavorably so in this case: a 10% increase in lump sum director compensation is associated with about a 0.5% reduction in both ROA and ROE, an indication that rewarding directors regardless of their efforts may result in less active monitoring of bank management. (We found similar results when we expressed lump sum director pay as a share of bank assets.) Again, we stress that these findings are merely statistical associations

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and by themselves do not constitute evidence of causation.⁷

Perhaps the most intriguing result is the relationship we find among the DMO's personal wealth, the DMO's ownership stake in the bank, and the bank's profitability ratios. A 10% increase in the share of the DMO's personal wealth that is invested in the bank is associated with a 0.7% decrease in a bank's ROE, but is unrelated to a bank's ROA. The most likely explanation for these results is managerial risk aversion: non-diversified DMOs invested heavily in bank stock operate their banks with larger-than-optimal equity capital cushions in order to hedge their own personal financial risk. This leaves ROA unchanged, but it not only reduces the return on investment earned by the other stockholders, it also constrains the bank's growth opportunities.

Conclusion

The findings presented here are part of a broader supervisory effort to evaluate best practices corporate governance at community banks. The findings are preliminary in nature and are based on the performance of a relatively small sample of community banks from a limited geographic area in a single year. Furthermore, while we do find a number of statistical associations between a handful of corporate governance characteristics at community banks in 2003 and the financial performance of these banks in 2004, we are not implying that these factors in any sense "caused" or "predicted" that financial performance. Establishing such a finding would require additional data and more sophisticated analysis than we employ here.

We see these findings as a first step toward the overall objectives of the research project: to construct a systematic database on the corporate governance practices at community banks, to determine whether and how these practices are related to banks' financial performance, and to use these findings to evaluate the efficacy of best practices management and governance procedures encouraged by bank supervisory agencies. Establishing good corporate governance practices at commercial banks is a natural complement to the ongoing safety and soundness objectives of bank supervision. These practices will benefit bank shareholders and bank depositors, as well as help strengthen the financial system in general.

¹ The Seventh Federal Reserve District comprises all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

² There is no strict definition for a "community bank," although it is not uncommon for analysts to use a crude upper bound at \$1 billion or \$5 billion in assets. For a discussion, see R. DeYoung, 2004, "Community banks at their best: Serving local financial needs," *2004 Annual Report*, Federal Reserve Bank of Chicago, available at www.chicagofed.org/about_the_fed/annual_report_new.cfm.

³ Anna Drozdzyński, Yumna Farooqi, and Syed Hussain were instrumental in the final aggregation and review of these data.

⁴ The DMO designation was assigned by examiners, following the convention used in R. DeYoung, K. Spong, and R. J. Sullivan, 2001, "Who's minding the store? Motivating and monitoring hired managers at small, closely held commercial banks," *Journal of Banking and Finance*, Vol. 25, No. 7, pp. 1209–1244.

⁵ To remove the influence of outlying values, we truncated the values of ROA, ROE, and the corporate governance characteristics

at the 5th and 95th percentiles of their sample distributions.

⁶ The last of these six results was not expected—publicly traded firms arguably face greater earning pressure—and may simply reflect idiosyncrasies among the small number (12) of publicly traded banks in our sample.

⁷ For example, although we measure manager bonuses in 2003 and bank earnings in 2004, our results may partially reflect causation running from high earnings to high bonuses because well-run banks tend to generate above-average profits every year.