Do Shareholders Penalize Bank Boards & Management for the Financial Crisis?

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Abstract

The 2007-2008 Financial Crisis was a pervasive shock that profoundly impacted the financial services industry. Often described as the worst financial crisis since the Great Depression, this event provides a unique opportunity to examine the consequences experienced by members of boards of directors and top management at bank holding companies for failures in oversight and excessive risk taking. This study examines whether shareholders penalize directors and top management at banks and provides some new evidence of the crisis's impact on the careers of bank directors and management.

Introduction

The 2007-2008 Financial Crisis is often attributed to failures of oversight and excessive risk-taking on the part of bank holding companies in the United States and around the world. Politicians, the media, and members of social movements like Occupy Wall Street, for example, accuse the leadership of major domestic banks of not being held sufficiently responsible or penalized for their perceived role in precipitating the crisis. According to Yeoh (2009), many financial services executives whose companies received controversial bail-out funding or other special assistance from the US federal government were simultaneously awarded large severance packages in exchange for resigning from their respective firms. U.S. President Barack Obama, in a news conference on Thursday, October 6, 2011, said of this potential inequity, "you're still seeing some of the same folks [bankers] who acted irresponsibly trying to fight efforts to crack down on abusive practices that got us into this problem in the first place" [7].

However, there is typically little discussion about the crisis's implications for members of banks' boards of directors – the group of powerful bank leaders who, practically speaking, are ultimately responsible for the performance of the firm. A thorough investigation of the consequences actually experienced by these leaders of the American financial services sector following the crisis will therefore inform continuing conversations about the event and yield important policy implications.

Research Problem, Objectives, and Plan

This study examines whether shareholders – the owners of public bank holding companies – penalized board members at American banks during and after the Financial Crisis. Our aim is to determine whether such penalization existed, and if so, whether certain individual firm, board, and even director characteristics may have contributed to the degree of penalization. In order to measure shareholder dissatisfaction of bank directors, we consider the vote statistics

of those directors' elections (which in the American financial services industry are invariably uncontested). Shareholders of bank holding companies signal their dissatisfaction of their boards of directors by reelecting director nominees with statistically lower percentages than those same directors had obtained prior to the crisis. This approach allows us to further observe what may have prompted and even followed such shareholder disapproval. Several studies about the nature of director elections and their implications for management and firm performance [e.g. 3, 4, 5] will inform such an effort.

Kirkpatrick (2009) establishes that failures in governance on the part of boards of directors of bank holding companies may have triggered, if not caused, the Financial Crisis. In theory, these directors' actions ought to have been guided by the will and the best interests of shareholders; by definition, directors are agents to the shareholders' principals [5]. Determining whether shareholders blame or penalize bank directors and management for the Financial Crisis may therefore determine the extent to which this agency problem existed during the event, and, further, may motivate new policies that could prevent another crisis from occurring in the future. Despite the potential benefits to such an endeavor, there has yet to be a comprehensive event study of shareholder sentiment towards the leadership of bank holding companies during the Financial Crisis.

Literature Review

The existing literature on the topic of governance of large corporations suggests that the issues examined in this study are timely. Preston (1990), for instance, observes a positive relationship between the size of an organization and societal perceptions of social responsibility [6]. The top 35 publicly traded American bank holding companies examined in this study own more than $13 trillion in assets, and are becoming increasingly controversial [9]. Nonetheless, large firms such as these typically have more complex operations, and so are more challenging to oversee, manage, and control from a governance perspective [11].

Regulation in the United States therefore requires shareholders of publicly traded companies to elect boards of directors. The board, on behalf of shareholders, oversees firm management by providing incentives for executives to act in certain ways [3]. By law, boards must consist of a minimum number of individuals, meet regularly, form committees, and comply with various rules regarding group composition [4]. Thus, boards exist both to optimize organizational design and to comply with regulations. Such regulations exist, in theory, to protect shareholders. If shareholders believed that this mechanism of protection should have prevented or did not sufficiently blunt the effects of the financial crisis, it is likely that their sentiment would be communicated through their director election votes. Presently, director elections are virtually the only mechanism that American shareholders to formally evaluate their directors.

The role of bank boards of directors in management oversight

Typically, boards fulfill several roles in the governance of firms. First, they provide advice and counsel to top management [1]. In this sense, directors are appointed because they possess a particular level of expertise or perspective that would add value to the firm. Directors are therefore charged with determining the strategic direction, mission, vision, and corporate policies of the firm, and provide leadership during crisis situations [1]. Finally, boards of directors serve a disciplinary role for the firm in that top management, along with all firm employees, is answerable to the board [1].

One of the most important roles of the board of directors is to change the firm's Chief Executive Officer (CEO) if necessary. Boards are tasked with monitoring the abilities and actions of top management, continually assessing the value and quality of each [1].

Selection of members of bank boards of directors

The directors of each bank in this study are nominated for shareholder election by a committee of the board, typically called the Nominating (or Governance) Committee. Such committees are often strongly influenced by each firm's respective CEO [3]. The nominating committee also routinely nominates incumbent directors for vacant management positions, including the position of CEO. Most firms effectively prevent or make it very challenging for shareholders themselves to nominate directors [4].

The frequency with which board members are subject to shareholder reelection depends on whether a board is classified or declassified. Classified boards are those with staggered director elections. On such boards, only a portion of the directors – typically one-third – are up for election each year [3]. By contrast, all members of declassified boards of directors must be reelected by shareholders each year. Declassified boards are, by definition, more accountable to shareholders, as their directors must secure reelection every year [3].

Nominees to the board are submitted to shareholders for a vote once per year. Because nominating committees and CEOs have no incentive to nominate multiple individuals for the same director position, essentially all director nominations are uncontested [3]. Votes may be cast for a director, against a director, withheld from a director, or not voted at all. Sixteen of the banks in this study require a majority vote in order to elect directors; the remaining twenty-nine require only a plurality. Thus, it is either very difficult or practically impossible for shareholders to prevent a director nominee from assuming office [3]. Thus, the director voting system inherently weakens the strength of shareholders, as not voting for a nominee essentially does nothing in terms of influencing the outcome; in a majority of cases in the financial services industry, a nominee in an uncontested director election needs only one vote to win.

Interpreting director election outcomes and subsequent board actions

Therefore, securing the nomination to the board almost inevitably ensures victory in the shareholder election. In practice, shareholders have very limited ability to remove directors from the board, or to deny nominees from assuming office. Because of the nomination and voting systems, incumbent directors "do not currently face any meaningful risk of being replaced" by shareholder vote [2]. Cai, Garner & Walkling (2009) also observe that incumbent directors generally always win reelection when re-nominated. Across all firms, a 90% margin of victory in the reelection vote is the norm for even poorly-performing directors. This presents a significant corp-orate governance problem: even though directors are the agents of the shareholders, the shareholders are generally not empowered to remove directors or veto director nominees [3].

Nonetheless, shareholders may communicate their disapproval of poorly performing directors and firms by refusing to vote in favor of director nominees. As per the rules of plurality, nominees are still seated on the board even though they may receive lower percentages of shareholder votes year over year. However, lower margins of victory are still undesirable for directors, as such outcomes may result in negative publicity or embarrassment to individual directors or to their firms [3]. Director turnover is desirable for shareholders, especially when firms perform poorly. A study conducted by Schnake, Fredenberge & Williams (2005) found a negative correlation between board member tenure and firm misconduct as a product of poor

corporate governance. Long-tenured board members may, with time, become too comfortable with the organizational status quo, thereby losing their ability or inclination to recognize and respond to problems within the firm [8].

Developing the research model and Hypotheses

H_1: Shareholder dissatisfaction signaled in director election outcomes

The hypotheses tested in this study are informed by the aforementioned literature, especially Cai, Garner, & Walkling (2009), who recently conducted a comprehensive study of uncontested director elections across all industries and found that even poorly performing directors receive at least 90% favorable votes in regards to their nominations. These authors also find that directors of poorly performing firms receive statistically significantly fewer votes for reelection [3]. As virtually all of the major American bank holding companies suffered decreases in profits or losses during the Financial Crisis, our study seeks to determine the extent to which shareholders attributed banks' poor performance to their respective boards of directors. In this study, shareholders are therefore assumed to disapprove of a director when fewer than 90% of votes cast in that election comprise "votes for" the director. In order to best capture the opinion of shareholders, it is useful to study this phenomenon in each year from 2006 to 2010.

It is hypothesized in H_{1a} that shareholders of bank holding companies signaled their dissatisfaction by reelecting director nominees by statistically significant lower percentages over time, beginning in 2006 and declining each year through 2010. It is further hypothesized in H_{1b} that bank directors received statistically significant lower reelection percentages versus their colleagues on non-bank boards during the same time period.

H_2: Individual director election outcomes determined by board nominee characteristics

If bank shareholders did in fact disapprove of incumbent directors' performance, the outcome of each election may be predicted by the characteristics of each nominee or the state of the firm itself. The aforementioned literature implies shareholders may have been more likely to vote against incumbent directors who were in charge during the Financial Crisis (a period of drastically poor firm performance), or those with comparatively longer board tenures or membership on important board committees. Additionally, shareholders may also have penalized directors on classified boards or certain board committees; directors with particular professional or academic backgrounds; or when the firm's stock price decreased since the previous director election. Such a scenario would imply that shareholders may have taken these characteristics into account when casting their votes for director elections.

Sample Selection and Data Collection

The sample of banks chosen for this study began with the United States Federal Reserve's list of the top fifty domestic bank holding companies by assets, which is publicly available and continuously updated on the internet. Twelve banks that are not publicly listed and those that are not domiciled in the United States were excluded from the sample to control for regulations and governance standards and to ensure uniform data availability. Institutional Shareholder Services (ISS) provided data on the votes cast in individual director elections from 2006 to 2010 for 1,882 publicly traded firms; we use this larger source of director election results to compare bank director election results versus non-bank director election results. Votes cast by shareholders were assigned to one of four categories: votes for, votes withheld (against), votes in abstention, and broker non-votes (another form of abstention). Three banks for which director

election vote data was unavailable from ISS were also excluded, for a total of 35 sample firms. Thus this study examines 1,673 separate bank director elections from 2006 to 2010.

Information regarding director characteristics was manually collected from DEF-14A "Definitive Proxy Statements," which each firm generates every year and sends to shareholders in order for them to vote in upcoming elections. These statements are posted for public access on the Security and Exchange Commission's internet-based EDGAR database. The aforementioned collected data was accordingly added to each director election. Finally, each bank's stock price on the day of the shareholder meeting to elect directors was collected from Yahoo! Finance. The author calculated the change in the stock price from the previous election.

Descriptive Data Analysis and Model Testing

Table I, which describes bank director turnover by year and board type, indicates that a greater percentage of directors left their positions during 2008 and 2009, and mostly from non-classified boards. Of the 476 bank directors in this study between 2006 and 2010, 146 directors were replaced, thereby implying a 30.6% turnover rate across these five years.

Table I: Instances of bank director turnover

Year	Non-Classified		Classified		Total	
	Number	%	Number	%	Number	%
2010	32	10%	2	1%	34	9%
2009	35	12%	8	2%	43	12%
2008	30	11%	8	2%	38	11%
2007	15	6%	16	5%	31	9%
2006	15	7%	14	5%	29	10%
TOTAL	**127**	**9%**	**48**	**15%**	**175**	**10%**

Table II lists the number of times director nominees, both from the bank sample and from all other firms in the larger population, were elected with fewer than 90% of votes cast in favor, indicating shareholder disapproval. The results from Table II indicate that shareholders strongly disapproved of bank board members during and after the Financial Crisis (2007-2009); throughout this study, shareholders are assumed to disapprove of directors when fewer than 90% of votes cast in a director election comprise "votes for" the director.

Table II: Instances of shareholder disapproval of directors

Year	Banks in Sample						All Other Firms	
	Non-Classified		Classified		Total		Total	
	Number	%	Number	%	Number	%	Number	%
2010	249	77%	30	8%	279	76%	5,473	60%
2009	48	17%	13	4%	61	17%	1,776	20%
2008	41	15%	8	2%	49	15%	1,193	14%
2007	14	5%	2	1%	16	5%	1,049	13%
2006	12	6%	5	2%	17	6%	786	10%
TOTAL	**364**	**27%**	**58**	**18%**	**422**	**25%**	**10,277**	**24%**

Several other initial observations can be made through descriptive statistics. The data shows 23 instances of a firm in the sample changing its CEO between 2006 and 2010. Fewer

than half of the bank CEOs who were in office at the beginning of 2007 (shortly before the Financial Crisis began) remained in their positions at the end of 2010. If a bank director was elected with less than 90% shareholder confidence, that director's board fired the CEO 8% of the time, and decreased the size of the board in the subsequent year 12% of the time. Further, directors of classified boards who were elected with less than 90% shareholder confidence immediately declassified that board 12% of the time. It is also worth noting that not one of these 1,673 director elections resulted in the failure of a board nominee to secure election. Nominees were withdrawn in only two separate instances; further, the votes of 11 CIT Group Inc. director elections were also not disclosed. Otherwise, all director nominees were elected.

The results of testing hypothesis H_1

Hypothesis H_{1a} asserts that the percentage of shareholder votes cast in favor of bank director nominees decreased in a statistically significant way during and after the Financial Crisis. Specifically, we seek to determine whether affirmative vote percentages decreased beginning in 2007 through 2010 relative to 2006. In order to test this hypothesis, we run a separate two-sample, one-tail t-test for each of the sample means for each time period in question, using the mean proportion of votes cast in favor from 2006 as a benchmark. This method tests whether the actual mean for each given time period is statistically less than the benchmark year's mean in 2006. Table III summarizes the results of each t-test.

Table III: Director nominee affirmative vote percentage: two-sample t-test

Year	**Observations**	**Vote For % Mean**	**Ha: diff < 0**	**Ha: diff = 0**	**Ha: diff > 0**
			p-value	**p-value**	**p-value**
2010	365	0.8459	1.0000	0.0000	0.0000
2009	354	0.9316	1.0000	0.0000	0.0000
2008	322	0.9482	0.9970	0.0059	0.0030
2007	335	0.9591	0.6332	0.7336	0.3668
2006*	**284**	**0.9604**	**-**	**-**	**-**

Significant at $\alpha = 0.05$
Difference ("diff") = mean(2006) – mean(year in question)
* Benchmark year

The low p-values of each t-test enable us to accept H_{1a} for 2008, 2009, and 2010.

Additionally, we run a two-sample Wilcoxon rank-sum test to determine whether the differences between median affirmative vote means are statistically significant, as summarized below in Table IV.

Table IV: Director nominee affirmative vote percentage: rank-sum test for median difference

Year	**Observations**	**z**	**Prob. > |z|**
2010	365	17.845	0.0000
2009	354	6.645	0.0000
2008	322	3.610	0.0003
2007	335	3.230	0.0012
2006*	**284**	**-**	**-**

Significant at $\alpha = 0.05$
Difference ("diff") = mean(2006) – mean(year in question)
* Benchmark year

The differences between median affirmative vote means are statistically significant for each year, confirming our decision to accept H_{1a} and conclude that bank directors received statistically fewer proportions of affirmative both during and after the Financial Crisis for 2008, 2009, and 2010.

H_{1b} asserts that bank directors received statistically significant lower reelection percentages versus their colleagues on non-bank boards during 2007, 2008, 2009, and 2010. We run the same t-tests to test the differences between mean votes in favor of bank directors versus non-bank directors, using 42,928 director elections across 1,873 other publicly traded firms from 2006-2010 as our sample for the latter. The results are summarized in Table V.

Table V: Director nominee affirmative vote percentages (banks vs. non-banks): two-sample t

Year	Observations (Banks)	Vote For % Mean	Observations (Non-Banks)	Vote For % Mean	Ha: diff < 0 p-value	Ha: diff = 0 p-value	Ha: diff > 0 p-value
2010	365	0.8459	9,195	0.8543	0.9277	0.1446	0.0723
2009	354	0.9316	8,975	.92438	0.1347	0.2694	0.8653
2008	322	0.9482	8,523	0.9454	0.2637	0.5273	0.7363
2007	335	0.9591	8,029	0.9482	0.0050	0.0100	0.9950
2006	284	0.9604	7,744	0.9603	0.0316	0.0632	0.9684

Significant at α= 0.05
Difference ("diff") = bank mean(year) – non-bank mean(year)

We therefore observe that shareholders of non-banks approved of their directors more than did shareholders of banks during 2006 and 2007, before the Financial Crisis. However, during and after the Financial Crisis (2008-2010), we cannot conclude with statistical confidence whether the means of shareholder votes in favor for director nominees was different. H_{1b} is therefore not accepted.

The results of testing hypothesis H_2 Hypothesis H_2 asserts that the percentage of shareholder votes cast in favor of bank director nominees during the Financial Crisis can be accurately predicted based upon certain firm, board, or individual director characteristics.

The independent variables included in the testing of this hypothesis include the following about each director nominee, where applicable: board tenure in years; whether the nominee was in office during the Financial Crisis (2007 or 2008); committee membership (Audit, Governance, and/or Nominating Committees); whether or not the board was classified at the time of the election; the percent change in the firm's stock price since the previous director election; whether the nominee had any prior experience in business, or the financial services industry; whether the nominee had previously served as a CEO, CFO, or director of a firm; the number of previous directorships the nominee had held; special professional experience (as an academic, a legal professional, or an elected or appointed member of the government); and whether the nominee was determined to be "independent" of the firm, as per SEC law. This hypothesis is partially accepted on the basis of a multiple regression analysis, presented in Table VI on the next page.

In this model, we consider any variable with a p-value less than 0.10 to be statistically significant. Therefore, we conclude that shareholders tended to penalize bank directors for each year of incumbency; for having prior experience in government or the law; and for being an independent of the firm. Conversely, shareholders tended to favor directors who were in charge during the crisis; for serving on the board's nominating committee; and for positive percent changes in stock price. We cannot conclude with statistical confidence that the other independent variables in this model accurately predict shareholder sentiment towards the directors of the firms in this sample. These results are discussed in the following section.

With an overall p-value of zero to four decimal places, the model itself is statistically significant. Approximately 36% of the variability in the proportion of shareholder votes cast in favor of each director accounted for by the model.

Discussion & Conclusion

The hypothesis tests and regressions performed in this study confirm several important features of bank director elections during and after the Financial Crisis. Primarily, we observe that the directors of bank boards received statistically fewer shareholder votes in favor as a proportion of total votes cast in their annual, or semi-annual, uncontested elections. This strongly suggests that shareholders do in fact penalize bank boards for the Financial Crisis. Notably, however, shareholder disapproval seemed to be stronger after, and not during, the event, which this study defines as occurring in 2007 and 2008. Accordingly, shareholder's attitudes towards directors during times of macroeconomic or industry-wide crisis may not be observable until several years of time have elapsed. It is also plausible that shareholders may prefer director continuity during times of crisis, but are willing to expel or signal their disapproval of directors once the crisis has largely passed.

Bank shareholders likely took several aforementioned individual, board, and firm-wide factors into account. Notably, however, our model suggests that shareholders penalized independent directors and preferred directors who were in charge during the crisis. These seemingly counter-intuitive outcomes may be explained by board turnover. It is likely that directors who performed exceptionally poorly in the eyes of shareholders were not re-nominated

or resigned from their boards rather than running for election. As a consequence, shareholders may not have been able to formally render a verdict on especially poor directors. Nonetheless, voters tended to penalize long-serving directors. However, if a director was not replaced after the Financial Crisis, he or she seems to be performing relatively better than new directors.

In terms of corporate governance policy, it is likely that bank shareholders desire a stronger mechanism to remove poorly performing directors and nominate new people to these positions. Despite the fact that 76% of bank director nominees were not approved of by shareholders in 2010, only 9% of those directors were not renominated in 2011. The agency problem inherent between shareholders and boards of directors may be mitigated if directors become more vulnerable to shareholder disapproval. Perhaps shareholders should be permitted to usurp board nominating committees and put fourth director nominees of their own when directors fail to amass a particular percentage of votes in favor (say, for example, less than 90%).

Table VI: Summary output of H_2 multiple regression analysis (with year effects)

	Coefficient	**Std. Error**	**T**	**P-Value**
Board Tenure*	-0.0005796	0.0002236	-2.59	0.010
Director During Crisis**	0.0184993	0.0081864	2.26	0.024
Audit Committee**	-0.0045091	0.0035715	-1.26	0.207
Compensation Committee**	0.0003048	0.0036162	0.08	0.933
Nominating Committee**	0.0067825	0.0037386	1.81	0.070
Classified Board**	0.0022146	0.0041918	0.53	0.597
%Δ in Current Stock Price	0.0225343	0.0043353	5.2	0.000
Business Background**	0.0032327	0.007203	0.45	0.654
Financial Services Background**	0.005549	0.0034684	1.6	0.110
Prior CEO Experience**	-0.0056285	0.0035973	-1.56	0.118
Prior CFO Experience**	0.0091253	0.0077135	1.18	0.237

N =					1528
R-					
Prior Director Experience**	-0.0020225	0.0043883	-0.46	0.645	
Number of Other Directorships**	-0.001638	0.0007112	-2.3	0.021	
Academic Background**	0.0043775	0.0059519	0.74	0.462	
Government Background**	-0.0090353	0.0049279	-1.83	0.067	
Legal Background**	-0.0136396	0.0065926	-2.07	0.039	
Independent Director**	-0.0084642	0.0045081	-1.88	0.061	
Year Effect: 2007	0.0002294	0.0053878	0.04	0.966	
Year Effect: 2008	-0.0010568	0.0056781	-0.19	0.852	
Year Effect: 2009	-0.0114201	0.0059452	-1.92	0.055	
Year Effect: 2010	-0.123036	0.0058393	-21.07	0.000	
Constant	0.9535792	0.0125236	76.14	0.000	

Squared = 0.3626 Adjusted R-Squared = 0.3537 Prob > F = 0.0000 F(21, 1506) = 40.79

Significant at α= 0.05

* Tenure given in terms of consecutive years

**Binary Variable, where 1 = Yes, 0 = No

Limitations and Further Research

Data for this study was rather limited, and only focused on director elections from 2006-2010, for a total of five distinct years. However, the effects of the Financial Crisis have not entirely passed. Further research on this topic may seek to look at years prior to 2006 and after 2010 for a more complete understanding of the Financial Crisis's effects on bank shareholders, boards, and management. Moreover, this study did not take into account firms that collapsed or merged with other firms. For example, firms like Merrill Lynch, Bear Stearns, and Lehman Brothers were not part of the sample. These exclusions were made in order to ensure uniformity in the data; care was taken to be sure that the data for each firm in the sample could speak to shareholder sentiment before, during, and after the Financial Crisis.

The models and methods offered in this study may also facilitate additional research on the behavior of shareholders and directors of firms within industries suffering from similar pervasive crises, such as the American automotive industry crisis of 2008-2010.

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