



THE OWNERSHIP SOLUTION:

THE LINK BETWEEN FINANCIAL PERFORMANCE AND GOVERNANCE YIELDS STRATEGIES FOR BUSINESS

Banks in which the senior managers have a significant ownership stake in the institution were top performers, researchers at the Federal Reserve Bank of Kansas City found.

Their research elicited a link between how well a firm performs with how it is governed. Similarly, they found that boards of directors were more effective at encouraging efficient bank operations when the directors had a financial stake in their bank.

Hitting on the correct management strategy is a challenge for any institution, banks included. Most businesses choose a structure that ranges from being composed of hired managers with little or no stock ownership to owner managers controlling virtually all of their company's stock.

Federal Reserve Bank of Kansas City economists studied a group of Tenth District banks to determine which model was most effective. Senior Policy Economist Kenneth Spong and Senior Economist Richard Sullivan focused on

banks with total assets of under \$1 billion, the size of a typical community bank. However, the issues they explored were those that other small- or medium-sized businesses might face as they address issues concerning management and ownership structure, board oversight, and financial incentives.

Spong and Sullivan have been researching these issues over a period of time when corporate governance issues have taken on renewed significance, particularly with corporate scandals and the resulting passage of the Sarbanes-Oxley Act of 2002. While headlines have focused on large, publicly traded companies, these are issues that anyone in business should be thinking about, whether in the start-up phase or planning for management and ownership succession.

Owner managers versus hired managers

Spong and Sullivan studied two scenarios for management structure: management composed of principal owners versus hired managers. Results suggest that owning stock in a business may help ensure that the manager serves the interests of stockholders.

Motivations for hired managers will vary greatly from motivations for owner managers. The efforts of owner managers, for instance, not only will be rewarded through salary compensation, but also will be reflected in the stock returns they will receive as principal shareholders in the firm. As a result, owner managers will have an added incentive to perform well.

However, there are a variety of factors that may affect these motivations and financial incentives. Hired managers, for instance, are likely to have other incentives to perform well. They must be concerned about their reputations and value in the job market. Also, they must respond to stockholders and boards of directors, who monitor the performance of hired managers to ensure it aligns with stockholder interests.

In some instances, hiring a manager is the only option for a business. Perhaps the

owner has another business to manage, or the owner wants to retire and no other family members or stockholders have an interest in running the enterprise.

“Sometimes it is better to hire a manager with skills that a member of the ownership might not have,” Spong says. “Then it becomes an issue of how to motivate this hired manager.”

While owner managers may not have to answer to others, they can still have complex motivations.

“Owner-managed banks have a number of goals, and profitability is just one,” Sullivan says. “They are free to pursue whatever goals they want. It’s difficult to say whether that’s good or bad.”



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For instance, some owners in a small town might choose to place a higher priority on activities that benefit the local community than activities that maximize current profits.

For these reasons, it is difficult to directly compare the effectiveness of owner managers with hired managers. But, whatever the situation, certain steps can improve the effectiveness of management.

“Research shows that some businesses fail to match the performance of other businesses because they have shortcomings in the structure of their management, ownership and

agers that are more diversified investors,” Sullivan says.

Less straightforward is the second scenario, in which hired managers run the firm as agents of the bank’s owners. In that case, the principal compensation is salary.

“With hired managers, you have the issue of how much effort they will exert, since they will not receive the same stock returns that an owner manager would receive,” Spong says.

The possibility exists that hired managers will seek to serve their own interests rather than that of the firm. This takes on a variety of forms, according to Spong and Sullivan. A hired manager may not work as hard or may exploit the perquisites of the position. To protect their jobs, hired managers also may be averse to risk-taking, thus avoiding projects that stockholders would be willing to pursue. This behavior results in “agency” costs, and overcoming these costs is a normal part of business.

One way for businesses to address the agency costs is to have these hired managers become stockholders, thus aligning their interests more closely with that of principal shareholders.

In their research Spong and Sullivan found that their sample banks performed best when hired managers had a 17 percent ownership stake. Below this level bank performance continues to improve as the hired manager’s ownership position increases. Beyond the 17 percent ownership level, Sullivan says that “there may be a balance of power issue and more serious

policy conflicts between hired managers and the principal owners.” A hired manager acquiring enough stock, for instance, may be able to disregard the views of other stockholders and escape the danger of being dismissed.

As a result, additional ownership eventually may cause the manager to look more to his or her own interests, and performance could begin to suffer.

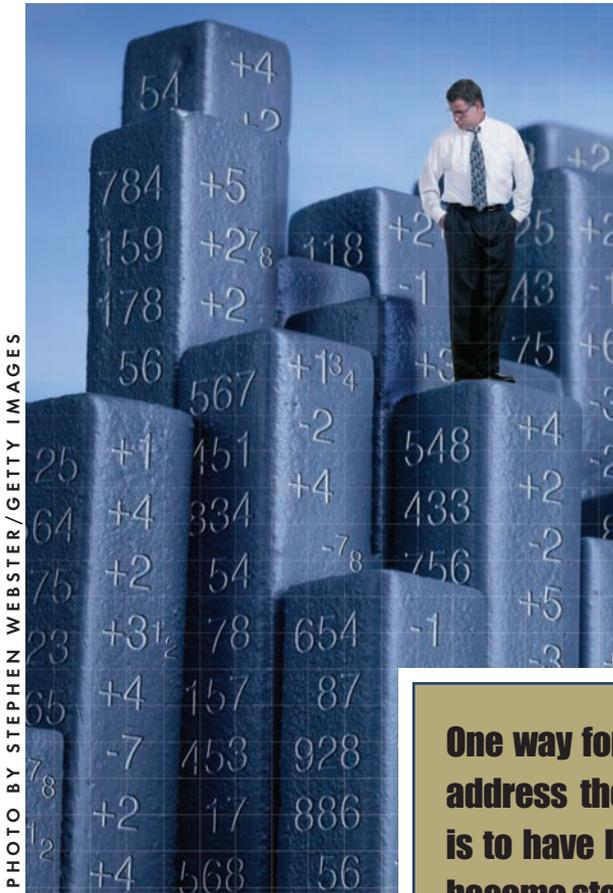


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board of directors—shortcomings that the research suggests can be addressed in a number of ways,” Spong says.

“In the case of owner managers, you assume they are motivated to act in the best interest of shareholders,” Spong says, “and they will put a strong effort into generating returns.”

Spong and Sullivan find, however, that owner managers may not all have the same attitudes toward risk.

“When owner managers have most of their wealth tied up in their banks, they tend to be more conservative than owner man-

“I think it is interesting that while we did find this pattern in the data, only a few banks in the study suffered from this type of problem,” Sullivan says.

Spong and Sullivan caution that this 17 percent ownership solution should be viewed as a guide, since it is a statistical estimate based on a particular sample of banks. At any company, a desirable ownership position for hired managers also will depend on a variety of factors, including size of the business, effectiveness of board and ownership oversight, other incentives affecting a manager’s performance, and the existing ownership structure.

Boards of directors

Spong and Sullivan compared the effectiveness of boards of directors based on their bank’s cost efficiency and earnings.

“One surprising result pertains to the advice you hear about how it is good to have more outside directors,” Sullivan says. “By definition, an outside director has little ownership stake. What we found was that top-performing banks had directors with an ownership stake.”

The makeup of the boards at these banks did not differ significantly from the poor performers with regard to number of directors, average age or length of tenure. However, directors at the top banks had a higher median net worth, had greater ownership share in their bank and were less likely to be outside directors. These banks also tended to have more frequent board meetings, better attendance rates and higher director fees.

“That’s not to say you need to go out and get rich people for the board,” Sullivan says. “It’s more an indicator of the personal success they have had. There’s a relationship between a person’s capability and wealth, and we think that better-performing banks have been successful at recruiting motivated, capable directors.”

Optimizing firm performance

Spong and Sullivan say that research suggests there are a couple of steps that stockholders and directors can take to address shortcomings in their ownership/management structure. These steps reflect the role that

wealth and ownership play in business ventures.

First, ensure adequate board oversight. Second, provide appropriate incentives.

“One of our key findings is that an ownership stake for hired managers can help improve firm performance and align the interests of managers more closely with that of stockholders,” Spong says.

However, he cautions against thinking of this as a magic bullet: “If you give a hired manager 17 percent stock ownership, there’s no guarantee it will be a magic solution if he or she doesn’t have skill,” Spong says. “But it does provide incentive.”

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BY TONI LAPP, SENIOR WRITER

FURTHER RESOURCES

“The Effect of Wealth and Ownership on Firm Performance” is a summary of five papers published by Kenneth Spong and Rick Sullivan.

“THE EFFECT OF WEALTH AND OWNERSHIP ON FIRM PERFORMANCE”

“MANAGERIAL WEALTH, OWNERSHIP STRUCTURE, AND RISK IN COMMERCIAL BANKS”

“WHO’S MINDING THE STORE? MOTIVATING AND MONITORING HIRED MANAGERS AT SMALL, CLOSELY HELD COMMERCIAL BANKS”

“HOW DOES OWNERSHIP STRUCTURE AND MANAGER WEALTH INFLUENCE RISK? A LOOK AT OWNERSHIP STRUCTURE, MANAGER WEALTH, AND RISK IN COMMERCIAL BANKS”

“WHAT MAKES A BANK EFFICIENT? A LOOK AT FINANCIAL CHARACTERISTICS AND BANK MANAGEMENT AND OWNERSHIP STRUCTURE”

Links to the full text of papers are available at www.KansasCityFed.org/TEN

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