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ABSTRACT

This paper conducts the first empirical assessment of theories concerning relationships among risk taking by banks, their ownership structures, and national bank regulations. We focus on conflicts between bank managers and owners over risk, and show that bank risk taking varies positively with the comparative power of shareholders within the corporate governance structure of each bank. Moreover, we show that the relation between bank risk and capital regulations, deposit insurance policies, and restrictions on bank activities depends critically on each bank's ownership structure, such that the actual sign of the marginal effect of regulation on risk varies with ownership concentration. These findings have important policy implications as they imply that the same regulation will have different effects on bank risk taking depending on the bank's corporate governance structure.

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1. Introduction

In this paper, we analyze relationships among risk taking by banks, their ownership structures, and national bank regulations. We focus on the potential conflicts between bank managers and owners over risk, and assess whether bank risk taking varies with the comparative power of shareholders within the corporate governance structure of each bank. Moreover, we examine whether the relation between national regulations and bank risk depends on each bank's ownership structure.

Policy considerations motivate this research. As emphasized by Bernanke (1983), Calomiris and Mason (1997, 2003a, b), Keeley (1990), and recent financial turmoil, the risk taking behavior of banks affects financial and economic fragility. In turn, international and national agencies propose an array of regulations to shape bank risk. Yet, researchers have not assessed how standard corporate governance mechanisms, such as ownership structure, interact with national regulations in shaping the risk taking behavior of individual banks. This gap is surprising because standard agency theories suggest that ownership structure influences corporate risk taking (Jensen and Meckling, 1976; John, Litov, and Yeung, 2008). This gap is also potentially serious from a policy perspective: The same regulations may have different effects on bank risk taking depending on the comparative power of shareholders within the corporate governance structure of each bank.

Existing research further advertises the value of simultaneously examining bank risk, ownership structure, and bank regulations. Studying non-financial firms, Agrawal and Mandelker (1987) find an inverse relationship between risk taking and the degree of managerial control, while John, Litov, and Yeung (2008) find that managers enjoying large private benefits of control select sub-optimally conservative investment strategies. Yet, research on bank risk taking typically does not incorporate information on each bank's ownership structure (Keeley, 1990; Kroszner and Rajan, 1994; Hellmann, Murdock, and Stiglitz, 2000; and Demircug-Kunt and Detragiache, 2002). In an influential exception, Saunders et al. (1990) find that owner controlled banks exhibit higher risk

taking behavior than banks controlled by managers with small shareholdings. They do not, however, test whether ownership structure and regulations jointly shape bank risk taking, or whether their results generalize beyond the United States to countries with distinct laws and regulations. Indeed, no previous research evaluates theoretical predictions concerning the interactive effects of national regulations and bank-specific ownership structure on the risk taking behavior of individual banks.

We frame our empirical analysis around three theoretical keystones. First, diversified owners (owners who do not have a large fraction of their personal wealth invested in the bank) tend to advocate for more bank risk taking than debt holders and non-shareholder managers (managers who do not have a substantial equity stake in the bank). As in any limited liability firm, diversified owners have incentives to increase bank risk after collecting funds from bondholders and depositors (Galai and Masulis, 1976; Esty, 1998). Similarly, managers with bank-specific human capital skills and private benefits of control will tend to advocate for less risk taking than stockholders without those skills and benefits (Jensen and Meckling, 1976; Demsetz and Lehn, 1985; Kane, 1985). From this perspective, banks with an ownership structure that empowers diversified owners will take more risk than banks where owners play a more subdued governance role.

Second, theory predicts that regulations influence the risk taking incentives of diversified owners differently from those of debt holders and non-shareholder managers. For example, deposit insurance intensifies the ability and incentives of stockholders to increase risk (Merton, 1977; Keeley, 1990). The impetus for greater risk taking generated by deposit insurance operates on owners, not necessarily on non-shareholder managers. As a second example, consider capital regulations. One goal of capital regulations is to reduce the risk taking incentives of owners by forcing owners to place more of their personal wealth at risk in the bank (Kim and Santomero, 1994). Capital regulations need not reduce the risk taking incentives of influential owners, however. Specifically, although capital regulations might induce the bank to raise capital, they might not force influential owners to

invest more of their wealth in the bank. Indeed, capital regulation might increase risk taking. Owners might compensate for the loss of utility from more stringent capital requirements by selecting a riskier investment portfolio (Koehn and Santomero (1980) and Buser et al. (1981)), which would intensify the conflicts between owners and managers over bank risk taking. As a final example, many countries attempt to reduce bank risk taking by restricting banks from engaging in non-lending activities, such as securities and insurance underwriting (Boyd et al., 1998). As with capital requirements, however, these activity restrictions may reduce the utility of owning a bank, intensifying the risk-taking incentives of owners relative to managers. Thus, the impact of regulations on risk depends on the comparative influence of owners within the governance structure of each bank.

Third, while banking theory suggests that bank regulations affect the risk taking *incentives* of owners differently from those of managers, corporate governance theory suggests that ownership structure and shareholder protection laws affect the *ability* of owners to influence risk (Jensen and Meckling, 1976). As argued by Shleifer and Vishny (1986), shareholders with larger voting and cash-flow rights have correspondingly greater power and incentives to shape corporate behavior than smaller owners. From this perspective, ownership structure influences the ability of owners to alter bank risk in response both to standard risk shifting incentives and to incentives created by official regulations. Shareholder protection laws also affect the ability of owners to adjust bank risk. Besides empowering equity holders, effective shareholder protection laws reduce the need for the emergence of a large shareholder to mitigate agency problems (Shleifer and Wolfenzon, 2002; John et al., 2000; Castro et al., 2004). Accordingly, large shareholders will play a less prominent role in shaping corporate behavior in economies with effective shareholder protection laws. Thus, we examine how ownership structure interacts with both shareholder protection laws and bank regulation in shaping the risk taking behavior of individual banks.

These theoretical keystones combine to make three testable predictions. First, diversified owners have stronger incentives to increase risk than non-shareholding managers, so banks with powerful owners will tend to be riskier than widely-held banks, holding other factors constant. Second, the role of large owners in shaping risk diminishes in economies with shareholder protection laws that effectively empower small owners. Finally, bank regulations – such as capital requirements, activity restrictions, and deposit insurance – affect the risk taking incentives of owners differently from managers, so the actual impact of regulations on risk taking depends on the comparative power of shareholder within each bank’s corporate governance structure. This framework, however, does not consider optimal risk taking. Rather, our more modest goal is to provide the first empirical assessment of theoretical predictions concerning how a banks’ ownership structure interacts with national laws and regulations in shaping bank risk taking.

To assess these predictions, we compile new data on individual banks from economies with different regulations, yielding a database of almost 300 banks across 48 countries. On ownership, we first measure whether the bank is widely-held, i.e., the bank does not have a large owner with at least ten percent of the bank’s voting rights. We next distinguish among banks with a large owner by computing the voting and cash-flow rights of the largest owner. We then collect bank-level data on both owners and managers since theory stresses potential tensions between stockholders and managers. If managers have accumulated bank-specific human capital or enjoy private benefits of control, they will seek less risk taking than stockholders without those skills and benefits (Demsetz and Lehn, 1985; Kane, 1985). Since tensions between owners and managers might be mitigated when senior managers hold large equity stakes (Houston and James, 1995), we calculate and control for (i) the voting and cash-flow rights of senior managers and (ii) whether large owners are on the board of directors. Theory also suggests that the risk taking incentives of owners will be mitigated if the owners have a large portion of their personal wealth invested in the bank. We would optimally like to

have information on each owner's personal portfolio, but these data are unavailable. Instead, we condition on the degree to which the bank is primarily family owned and also test whether there is a nonlinear relationship between the cash-flow and voting rights of the controlling shareholder and risk. We use three measures of bank risk taking: the bank's z-score, which is inversely related to the probability of bank insolvency, the volatility of equity returns equals, and the volatility of bank earnings.

The key findings are as follows. First, bank risk is generally higher in banks that have large owners with substantial cash-flow rights. Consistent with theory, greater cash-flow rights by a large owner are associated with more risk. This finding holds when conditioning on international differences in bank regulations or when including country fixed effects. Ignoring ownership structure provides an incomplete analysis of bank risk taking.

Second, although more cash-flow rights by a large owner are generally associated with greater bank risk, the importance of the large owner is weaker in economies with stronger shareholder protection laws. This supports the view that an effective legal system reduces the need for a large shareholder to advance the goals of shareholders. It is thus crucial to examine bank governance in assessing the determinants of bank risk.

Third, the relation between risk and regulation depends critically on each bank's ownership structure. Indeed, the relation between regulation and bank risk can actually change sign depending on ownership structure. For example, the results suggest that deposit insurance is only associated with an increase in risk when the bank has a large equity holder with sufficient power to act on the additional risk taking incentives created by deposit insurance. The data also suggest that owners seek to compensate for the utility loss from capital regulations and activity restrictions by increasing bank risk. Stricter capital regulations and more stringent activity restrictions are associated with greater risk when the bank has a sufficiently powerful owner, but stricter capital regulations have the

opposite effect in widely-held banks. Ignoring bank governance leads to erroneous conclusions about the risk taking effects of banking regulations.

To explore more fully the channels linking ownership, risk and regulation, we allow for the joint determination of bank risk and valuation. Laws, regulations, and ownership structure might influence bank risk primarily by altering bank valuations. We therefore allow for the simultaneous determination of risk and valuation by extending the work of Keeley (1990) and John et al. (2008). We confirm the paper's results when endogenizing bank valuations. Thus, all of this paper's findings on ownership, shareholder protection laws, regulations, and risk hold beyond any indirect connections operating through bank valuations.

The paper is organized as follows. Section 2 summarizes the data. Section 3 presents initial results. Section 4 assesses how the relation between risk and regulation varies with ownership structure. Section 5 simultaneously estimates risk and valuation. Section 6 concludes.

2. Data and Summary Statistics

We build a new database to examine (1) whether ownership structure affects bank risk, (2) whether the relationship between ownership structure and bank risk depends on shareholder protection laws, and (3) whether the impact of national regulations on bank risk depends on the ownership structure of individual banks. Data permitting, we collect information on the 10 largest publicly listed banks (as defined by total assets at the end of 2001) in those countries for which La Porta et al. (1998) assembled data on shareholder rights. We exclude New Zealand because all its major banks are subsidiaries of Australian banks, all of which are already included in the sample. Since some countries have data on fewer than ten publicly listed banks, this yields information on a maximum of 296 banks across 48 countries. Focusing on the largest banks enhances comparability since they tend to comply with international accounting standards and have more liquid shares,

reducing concerns that accounting or liquidity differences drive the results. On average, our sample accounts for over 80 percent of total banking system assets in each country. When eliminating countries for which the sample covers less than 50 percent of total banking assets, the results hold.

2.1 Ownership Structure: Control Rights and Cash-Flow Rights

We start with the Caprio et al. (2007) data on bank ownership in 2001, which classifies a bank as having a “large owner” if the shareholder has direct and indirect voting rights that sum to 10 percent or more. If no shareholder holds 10 percent of the voting rights, the bank is classified as widely held. This paper’s results hold when using a 20 percent cut-off to define a large owner.

While direct ownership involves shares registered in the shareholder’s name, indirect ownership involves bank shares held by entities that the ultimate shareholder controls. Since the principal shareholders of banks are frequently themselves corporations, it is necessary to find the major shareholders in these entities. Often, this indirect ownership chain must be traced backwards through numerous corporations to identify the ultimate controllers of the votes. For example, a shareholder has x percent indirect control over bank A if she controls directly firm C that, in turn, controls directly firm B, which directly controls x percent of the votes of bank A. The control chain from bank A to firm C can be a long sequence of firms, each of which has control (greater than 10 percent voting rights) over the next one. If there are several chains of ownership between a single shareholder and the bank, we sum the control rights across all of these chains to compute the control rights of that shareholder. When multiple shareholders have over 10 percent of the votes, we define the “large owner” as the owner with the greatest voting rights.

The large shareholder may hold cash-flow (CF) rights directly and indirectly. For example, if the large shareholder of bank A holds the fraction y of CF rights in firm B and firm B in turn holds the fraction x of the CF rights in bank A, then the large shareholder’s indirect CF rights in bank A

equals the product of x and y . If there is an ownership chain, we use the products of the CF rights along the chain. To compute total CF rights we sum direct and indirect CF rights.

By focusing on the large shareholder's CF rights, we capture both the incentives of owners toward risk and the ability of owners to influence risk. On ability, we first measure whether the bank has a large owner or whether the bank is widely held. Then, conditional on the bank having a large owner, we measure the cash-flow rights of the shareholder with the largest number of voting rights. CF rights are highly correlated with voting rights, so it provides additional information about the power of the largest owner. On incentives, CF rights provide a more direct measure of the risk taking incentives of owners than voting rights. Profitable outcomes are distributed to owners based on cash-flow rights, not through control rights. In robustness tests, we examine the wedge between voting and CF rights, which has been the focus of research on the private benefits of control.

2.2 Management Structure

We collect new data on each bank's board structure and managerial ownership. First, we set the dummy variable Large Owner on Mgt Board equal to one if the large shareholder has a seat on the management board, and zero otherwise. Next, to assess theories about managerial shareholding and risk, we compute the CF rights of executive managers and directors and refer to this variable as Management Ownership. We collect data on the year the bank was founded and whether the founder or the descendants of the founder are on the management or supervisory board. Data on these variables are hand-collected using a variety of sources, including Bankers Almanac, Bankscope, 20-F filings, annual reports, and company websites.

2.3 Bank Risk Taking

We primarily measure bank risk using the z-score of each bank, which equals the return on assets plus the capital-asset ratio divided by the standard deviation of asset returns. The z-score measures the distance from insolvency (Roy, 1952). Define insolvency as a state where losses

surmount equity ($E < -\pi$) (where E is equity and π is profits), A as total assets, $ROA (= \pi/A)$ as return on assets, $\sigma(ROA)$ as the standard deviation of ROA , and $CAR (= E/A)$ as the capital-asset ratio. The probability of insolvency can be expressed as $\text{prob}(-ROA < CAR)$. If profits are normally distributed, then $z = (ROA + CAR)/\sigma(ROA)$, which is the inverse of the probability of insolvency. Thus, z indicates the number of standard deviations that a bank's ROA has to drop below its expected value before equity is depleted.

A higher z -score indicates that the bank is more stable. Since the z -score is highly skewed, we use the natural logarithm of the z -score, which is normally distributed. For brevity, we use the label "z score" in referring to the natural logarithm of the z -score in the remainder of the paper.

We have data to calculate the z -score for 288 banks across 48 countries. As listed in Appendix 1, the number of banks per country varies from ten to one. The paper's results hold when excluding countries with data on only one or two banks. We calculate the average return on assets, its standard deviation and the capital-asset ratio over 1996-2001. The accounting data on banks are from Bankscope, a commercial database on major international banks.

We confirm our results when using the volatility of equity returns and the volatility of earnings as alternative measures of bank risk. Volatility of equity returns equals the annualized volatility of weekly equity returns in 2001, which is also used by Saunders et al. (1990) and Esty (1998). We use the total return index (that includes reinvested dividends) from Datastream. One advantage of the volatility of equity returns is that it is based on market, rather than accounting, data. One disadvantage is that using equity volatility as a measure of risk reduces our sample because we only have weekly data on stock market returns for 219 out of 288 banks. The Volatility of earnings equals the standard deviation of the ratio of total earnings before taxes and loan loss provisions to average total assets, computed over the period 1996-2001.

Finally, we also confirm the results using risk measures computed after 2001, which is the year in which we observe bank ownership. The advantage of this approach is that risk is measured after ownership. The disadvantage is that we lose a large portion of our sample because of mergers, acquisitions, and bank failures. The 2001-sample we focus on in the paper includes about 50% more countries and 60% more banks than the smaller sample based on post-2001 risk measures.

2.4 Investor Protection Laws

RIGHTS is the La Porta et al. (1998) index of the statutory rights of shareholders. It ranges from zero to six, where larger values indicate greater shareholder rights. The six components in this index are: (1) the country allows shareholders to mail proxy votes; (2) shareholders are not required to deposit shares prior to the General Shareholders' Meeting; (3) cumulative voting or proportional representation of minorities on the board of directors is allowed; (4) an oppressed minorities mechanism exists; (5) the minimum percentage of share capital that entitles a shareholder to call for an Extraordinary Shareholders' Meeting is less than or equal to 10 percent; and (6) when shareholders have preemptive rights that can only be waived by a shareholders meeting.

2.5 Bank Regulations

This paper evaluates theoretical predictions that key bank regulations interact with ownership structure to shape each bank's risk taking behavior. In selecting data on regulation from the Barth et al. (2006) database, we use two criteria. First, we choose regulations stressed by the Basel Committee. Second, we analyze regulations that theory highlights as affecting bank behavior. Thus, we examine deposit insurance, capital regulations, and regulatory restrictions on bank activities.

DI is a dummy variable that takes a value of one if the country has deposit insurance, and zero otherwise, and is calculated from Demirguc-Kunt et al. (2008). Note, DI equals one both when the country has explicit deposit insurance and when depositors were fully compensated the last time a bank failed if the country did not have formal deposit insurance.

CAPITAL is an index of regulatory oversight of bank capital from Barth et al. (2006). This index includes information on whether the source of funds that count as regulatory capital can include assets other than cash, government securities, or borrowed funds, and whether the authorities verify the sources of capital. CAPITAL also includes information on the extent of regulatory requirements regarding the amount of capital banks must hold.¹

RESTRICT is an index of regulatory restrictions on the activities of banks from Barth et al. (2006). This index measures regulatory impediments to banks engaging in (1) securities market activities (e.g., underwriting, brokering, dealing, and all aspects of the mutual fund industry), (2) insurance activities (e.g., insurance underwriting and selling), (3) real estate activities (e.g., real estate investment, development, and management), and (4) the ownership of nonfinancial firms.

2.6 Other Country-Level and Bank-Level Control Variables

We control for numerous country-level and bank-level characteristics. At the country-level, we control for the level of economic development, aggregate economic volatility, institutional development, the degree of competition in national banking markets, and whether the authorities have taken over a failing bank since 1995. At the bank-level, product market conditions influence the resolution of conflicting interests among stockholders, managers, and depositors. For instance, Gorton and Rosen (1995) argue that intense competition that lowers the franchise value of incumbent banks intensifies incentives for both stockholders and managers to increase risk. Consequently, we control for bank growth, size, liquidity, loan loss provisions, and whether the bank accounts for more than ten percent of the nation's deposits.

¹ The index is based on the following questions: (1) Is the minimum capital-asset ratio requirement risk weighted in line with the Basel guidelines?; (2) Does the minimum ratio vary as a function of market risk?; (3) Are market value of loan losses not realized in accounting books deducted from capital?; (4) Are unrealized losses in securities portfolios deducted?; (5) Are unrealized foreign exchange losses deducted?; (6) What fraction of revaluation gains is allowed as part of capital?; (7) Are the sources of funds to be used as capital verified by the regulatory/supervisory authorities?; (8) Can the initial disbursement or subsequent injections of capital be done with assets other than cash or government securities?; and (9) Can initial disbursement of capital be done with borrowed funds?

As stressed above and discussed in more detail below, we pay special attention to bank valuation. We measure bank valuation using the Tobin's Q of each bank, which equals the market value of equity plus the book value of liabilities divided by the book value of assets. We simultaneously estimate risk and valuation to better assess the potential channels linking regulations, ownership, valuations, and bank risk.

2.7 Summary Statistics

There is great variation in bank fragility across countries. Table 1 provides summary statistics and Appendix 1 lists the averages of key variables for each country's banks. Column (1) of Appendix 1 presents the average of z-scores across all banks for each country in the sample. The z-scores indicate that profits have to fall by more than 66 times their standard deviation in Austria to deplete bank equity, but profits only need to fall by less than one standard deviation in Thailand to eliminate bank equity. Our estimates of equity volatility of banks display a similar variation (Appendix 1, column 2). Volatility of equity returns vary from a low of 12 percent per annum in Austria to a high of 118 percent in Peru. The average equity volatility is 40 percent.

Ownership and management structure vary enormously. As shown in Table 1 and Appendix 1, the large owner averages more than 50 percent of the CF rights in 8 out of 48 countries, but in 5 other countries there is either no bank with a large owner or the average degree of CF rights is less than five percent. Although more than 90 percent of the banks in Canada, Ireland, and the United States (in our sample) are widely held, 22 out of 48 countries do not have a single widely held bank (among their largest banks). Overall, the cross-country average for widely held is only 29 percent so that in the average country, 71 percent of the largest, listed banks have a large owner. Furthermore, there is considerable variability in managerial ownership. For 35 percent of banks, the large owner (the largest owner with more than 10 percent of the voting rights) is also a senior manager. However, on average, managerial ownership is only 6% of total bank shares. Indeed, for half of the countries in

our sample, no bank has managerial shareholdings of greater than 1%. The standard deviation of managerial shareholdings is 15%. Finally, we find that the original founder of the bank continues to manage the bank in 3 percent of the banks in our sample, and a descendant of the founder is a manager in 14 percent of the banks. Thus, we consider a broad cross-section of countries to assess the relation between risk and ownership.

The simple correlation matrix in Table 2 shows that more stable banks (as measured by higher z-score or lower equity volatilities) have lower CF rights, and are located in countries with fewer activity restrictions. Furthermore, risk is higher in banks where the large shareholder is a senior manager. As shown below, however, the relationship between these private governance mechanisms and risk depends on national policies. Furthermore, the z-score and equity volatility are (negatively) correlated with a statistically significant correlation coefficient of 38 percent, while the correlation between z-score and earnings volatility is 37 percent and also statistically significant.

3. Bank Risk: First Results

In this section, we begin by examining the relationship between risk taking by banks and their ownership structures. The primary measure of ownership structure is the CF rights of the largest owner, where CF rights equals zero if the bank is widely held. We examine whether greater CF rights by the largest owner is associated with greater risk as suggested by Jensen and Meckling (1976) and John, Litov, and Yeung (2008). In the next section, we extend the analysis by testing whether the relation between risk and ownership structure varies with national laws and regulations. Finally, in section 5, we also allow for the endogenous determination of the Tobin's Q of each bank. This is crucial because laws, regulations, and ownership may influence bank risk by influencing bank valuations.

More formally, we estimate the following equation:

$$Z_{b,c} = \alpha * X_{b,c} + \beta * CF_{b,c} + \gamma * R_c + \delta * CF_{b,c} * R_c + u_{b,c},$$

where $Z_{b,c}$ is the z-score of bank b in country c , $X_{b,c}$ is a matrix of bank-level control variables, $CF_{b,c}$ is cash-flow rights of bank b in country c , R_c are country-level measures of bank regulations and shareholder rights, $u_{b,c}$ is the error term, and α , β , γ , and δ are vectors of coefficient estimates. As noted, in this section we do not consider interactions between bank-level ownership structure and national regulations and shareholder rights ($CF_{b,c} * R_c$). We examine these interactions in section 4. We begin by using ordinary least squares (OLS) with clustering at the country level. Then, in section 5, we use a simultaneous equations system to allow for the joint determination of risk and valuation.

3.1 Ownership Structure and Bank Risk: OLS and Country-Fixed Effects

The overarching message from the regressions presented in Table 3 is that greater CF rights by a large owner is associated with greater risk. In each of the ten bank-level regressions, the standard errors are adjusted to control for clustering at the country-level. Regression 1 simply controls for recent bank performance (Revenue growth) and the CF rights (CF) of the large owner, where CF equals zero if the bank is widely-held. CF enters negatively and significantly at the one percent level, indicating that the existence of a large owner with substantial cash-flow rights is associated with greater risk. The economic size of the coefficient on CF is consequential. A one standard deviation change in CF (0.28) is associated with a change in z-score of 0.42 ($=0.28 * 1.5$), where the mean of z-score is 2.8 and the standard deviation is about one.

These results are consistent with the following view: (1) Owners tend to advocate for more bank risk taking than managers and debt holders (Galai and Masulis, 1976; Demsetz and Lehn, 1985) and (2) Large owners with substantial cash-flow rights have greater incentives and power to increase bank risk taking than small shareholders (Jensen and Meckling, 1976; John et al., 2008). Thus, CF is positively associated with bank risk.

The positive association between CF and risk holds when controlling for country traits and even when including country-fixed effects. To control for the possibility that the relation between ownership structure and bank risk primarily reflects cross-country differences, rather than cross-bank differences, in ownership structure, we (a) control for many country-specific traits, including the level of economic development in each bank's country (Per capita income), and (b) include country fixed effects. As shown in Table 3, the results are robust to conditioning on Per capita income and numerous country characteristics (Regression 2). Furthermore, CF continues to enter negatively and significantly at the six percent level when controlling for country fixed effects (Regression 3). While the economic size of the coefficient on CF drops by about 50% when controlling for country fixed effects, the analysis still indicates that more CF rights by a large owner is associated with more risk taking. We also controlled for outliers. Specifically, exclude each country one-at-a-time to test whether the banks from any single country determine the results. All of the results hold.

These results suggest that the connection between risk and ownership structure does not simply reflect the possibility that successful countries adopt good laws, regulations, and institutions that (a) induce banks to behave prudently and (b) allow owners to diversify their holdings. Rather, when only focusing on cross-bank variation, we find a strong association between ownership structure and risk.

3.2. Alternative Measures of Bank Stability

Thus far, we have focused on the z-score of individual banks computed over the period 1996-2001. We used alternative measures of risk: (i) Equity volatility equals the volatility of the bank's equity returns over the period 1999-2001, (ii) Earnings volatility equals the volatility of the bank's earnings over the period 1996-2001, and (iii) Z-score (02-04) equals the z-score computed over the period 2002 to 2004, which measures the z-score a few years after we observe ownership structure. As noted, however, this reduces the sample quite substantially. Since the volatility of equity returns

and the volatility of earnings are positively related to risk, we expect the opposite signs on the estimated coefficients when these volatility measures replace z-score as the dependent variable.

As shown in Table 3, Regressions 5 to 7, the key results on ownership are robust to using alternative measures of bank risk taking. Higher CF is associated with greater risk taking. Though the result are somewhat weaker with Earnings volatility, CF enters negatively and significantly with a p-value of 0.06 even with this measure that can be subject to substantial manipulation by banks. In sum, the Table 3 results emphasize a robust connection between risk and ownership structure.

3.3 Additional Robustness Tests

We conducted a series of additional robustness tests. We had concerns about the ownership structure indicators. For instance, we are mixing firms with a large owner ($CF > 0$) with widely-held firms ($CF = 0$). We restricted the sample to only firms with a large owner and confirmed the results. We were also concerned about defining large owners using the ten percent voting rights cut-off. We confirmed all of the results using a 20 percent cut-off. We were also concerned that the state is the large owner in almost 20 percent of the banks. If the state has different attitudes toward risk from those of private equity holders, then state controlled banks should be treated separately. When we include a dummy variable for state banks, however, this dummy enters insignificantly and it does not alter the other results.

Critically, some theories suggest that owners with a very large proportion of their wealth tied to the bank will take less risk (for example, Jensen and Meckling, 1976, Saunders et al., 1990, and Kane, 1985). We included a dummy variable that takes on the value one if CF is above the sample median and zero otherwise. Including this dummy variable does not change the results, and it does not enter significantly. We also entered CF-squared to test for nonlinearities, but the quadratic term did not enter significantly. Moreover, we also controlled whether the bank is family owned and operated, which would suggest that the owners have a large amount of wealth and human capital

committed to the bank (Bennedsen et al., 2007, and Perez-Gonzalez, 2006). Specifically, we control for whether the founder of the bank, or a descendent of the founder, is on the banks' management or supervisory board. Controlling for family ownership did not alter any of the results.

Furthermore, considerable research focuses on pyramidal ownership structures in which voting rights are much greater than CF rights. The "Wedge" between voting and CF rights is used to gauge the degree to which owners have the power and incentives to expropriate bank resources (Caprio et al., 2007; Laeven and Levine, 2007, 2008). In focusing on risk, theory suggests that CF rights are crucial, not the Wedge. Indeed, Wedge does not enter this paper's regressions significantly and it does not affect our main results.

In addition, this paper's results hold when eliminating banks associated with major mergers and acquisitions. We were concerned that banks about to experience a major event might behave differently and these banks might drive this paper's results. Consequently, we trace the ownership history of each bank and identify whether the bank has undergone a major acquisition or merger between 2001 and 2005. All of the findings hold when eliminating these banks.

Finally, we computed ownership structure in 2005 for a sub-sample of 200 banks from the 2001 sample. Ownership structure is very stable over time. Except when banks experience a major event, such as a merger or acquisition, ownership structure does not vary. This indicates that ownership structure does not respond to short-run fluctuations in bank risk. It also implies that changes in ownership structure do not account for high frequency changes in risk. While economic and financial stability at low frequencies could influence ownership structure in the long-run, this paper's results hold when conditioning on the volatility of each country's Gross Domestic Product as we discuss below. In addition, since ownership structure does not change much unless a bank experiences a merger or acquisition and since mergers and acquisitions generally make accounting data incomparable over time, this reduces the value of panel studies in this context.

3.4 Ownership Structure and Bank Risk: Identification and Many Controls

We were concerned that the joint determination of risk and ownership structure could bias the results. For instance, high risk banks might form concentrated ownership structures if diffuse shareholders have difficulty monitoring risky investments. In the estimation equation, $z = b*Z + e$, where z is the vector of bank z-scores, Z the matrix of all explanatory variables, e the error term, and b the vector of estimated coefficients. OLS is consistent only if $\text{Cov}\{e, Z_i\} = 0$ for each regressor i , i.e., OLS is consistent only if there are no unobservable factors affecting both ownership and risk.

We address this concern using a variety of strategies. While none is perfect, they all yield the same conclusion: Larger CF is associated with greater risk. Nonetheless, we interpret the results very cautiously: These results on the partial correlation between risk and ownership structure represent some initial, descriptive findings that begin to integrate traditional corporate governance forces into the study of bank risk taking. Furthermore, the paper's major emphasis is on assessing whether the relation between bank regulations and bank risk will vary in a theoretically predictable manner with bank ownership structure. As we show in the next section, the empirical results are consistent with these predictions.

3.4.1 Many controls

A commonly used strategy for reducing concerns that $\text{Cov}\{u, X_i\} \neq 0$ is to “saturate” the regression with a large number of bank and country characteristics to capture as much of the error term u as possible (see also Demsetz and Lehn, 1985, and Bitler et al., 2005). We control for numerous country- and bank-level traits in Regressions 8 to 10 of Table 3. Besides Per capita GDP, we include indicators of capital regulations (Capital), activity restrictions (Restrict), deposit insurance (DI), shareholder protection rights (Rights), and the degree to which the law is fairly and effectively enforced in a country (Enforce). At the banking system level, we include a measure of banking system concentration that equals the percentage of banking system assets held by the five largest

banks (Concentration) since many debate the link between concentration and risk (Allen and Gale, 2000, and Boyd and De Nicolo, 2005). We also condition on the mergers and acquisitions activities of all firms in a country (M&A) since M&A activity might affect bank governance (Schranz (1993) and Berger et al. (1998)). Furthermore, in unreported regressions, conditioned on measures of official corruption, the degree to which the rule of law operates in the country, GDP volatility, and the return on assets averaged across all banks in each country. These did not affect the conclusions.

At the bank-level, we control for (1) the extent to which senior managers hold shares in the bank (Managerial ownership) and (2) whether the large owner (if there is a large owner) is on the management board (Large owner on mgt board). We also condition on revenue growth, size, loan loss provisions, and the liquidity ratio. Moreover, in unreported regressions, we also find that the results hold when including dummy variables of whether the bank holds more than ten percent of the country's deposits (to gauge if the bank is "too-big-to-fail") and whether the bank was recently intervened by the government.

Even when conditioning on all of these country- and bank-level characteristics, CF rights are positively associated with risk. In Table 3, Restrict and DI both enter negatively and significantly, suggesting that activity restrictions and deposit insurance increase bank risk, confirming findings by Demircuc-Kunt and Detragiache (2002) and Barth et al. (2004, 2006). Critically, CF continues to enter the z-score regression negatively and significantly, with the same coefficient size.

3.4.2 Instrumental variables

We use instrumental variables for each bank's ownership structure. We primarily use the average CF rights of other banks in the country, which captures industry and country factors explaining CF. A positive feature of this instrument is that innovations in the risk of one bank will not influence the cash-flow rights of other banks. If innovations in national bank risk affect bank ownership across all banks, however, then this instrument will not reduce endogeneity bias. Yet, this

seems unlikely because (i) we find that bank ownership changes extremely little over time and (ii) the results hold when controlling for national economic volatility.²

The instrumental variable results confirm that CF is negatively and significantly associated with bank z-score, supporting the view that a large owner with sufficient incentives tends to increase bank risk taking (Table 3, Regression 4). The instrument (i) enters the first-stage regression significantly at the one percent level as demonstrated by the F-test of excluded instruments, (ii) accounts for 17 percent of the variance of CF rights in the first-stage as indicated by the partial R-squared of excluded instruments, and (iii) yields a different vector of coefficient estimates from those obtained using OLS as shown by the Hausman test of endogeneity. The fact that the IV estimate of the coefficient on CF is larger in absolute value terms than the OLS estimate suggests that OLS underestimates the true causal effect of CF on bank stability.

In unreported regressions, we confirm these findings using alternative instruments. As a different instrument for CF, we identified the year in which the bank was founded (Founded). Older banks have had more time to diversify ownership. Also, Founded is unlikely to affect bank risk directly. Rather, by reducing CF of the largest owner, Founded affects the incentives of the owner to influence risk. Founded enters the first-stage regression with a p-value of 0.059, accounting for 3 percent of the variation of CF. If the age of the bank is correlated with an unobserved bank-specific trait that drives bank risk, however, then Founded is an invalid instrument; but, a test of the over-identifying restrictions does not reject the validity of Founded as an instrument. Next, we include a dummy variable denoting whether the founder of the bank is on the management or supervisory board (Founder) as an instrument. If the founder of the bank is still on the management or supervisory board, this implies a continuing large, controlling role with correspondingly high CF.

² For regressions using the average CF rights of other banks in the country as an instrumental variable, we exclude countries with only one bank because we can only compute the CF instrument for countries with more than one bank, which accounts for the drop in country coverage from 46 to 43 countries in regression 4.

The partial correlation coefficient between CF and Founder is 0.17. One concern with Founder is that shocks to risk might affect the probability of the founder being on the board. Again, the over-identifying restrictions test does not reject the validity of the instruments and we confirm the results in Table 3.

4. Bank Ownership, Shareholder Protection Laws, and Regulation

Beyond yielding predictions about the bivariate relation between risk and ownership structure, some theories suggest that the relation between bank risk and ownership structure will vary with national laws and regulations (e.g., Shleifer and Vishny, 1986, Buser et al., 1981, John et al., 2000, and John et al., 2008); theories do not simply yield predictions about the bivariate relation between risk and ownership structure. Thus, now examine whether the relation between risk and ownership structure depends on shareholder protection laws and bank regulations, consistent with theoretical predictions. If the empirical results on these conditional relations are consistent with theory, then any alternative explanation will also have to account for these interactive results, not simply the positive partial correlation between risk and CF.

Table 4 presents a series of regressions in which we examine the direct and interactive associations among ownership structure, shareholder protection laws, regulations, and bank risk. Specifically, we include Rights, Capital, Restrict, and DI in all five regressions.³ Then, we include the interaction term of each of these national traits with bank-level ownership structure.

Table 4 indicates that the relation between a bank's risk and ownership structure depends on shareholder protection laws. The Rights indicator does not enter significantly, indicating that

³ Since we are examining individual banks, we were not very concerned that an individual bank's risk will affect national regulations. Nonetheless, these results hold when using instrumental variables for regulations. Based on Beck et al. (2003, 2006) and Barth et al. (2006), we use legal origin and the religious composition of each country as instruments for bank regulation. Given that we condition on the level of income per capita, the most direct impact of religion and legal origin on bank risk runs through bank regulations, rather than by altering bank risk through an alternative channel. Moreover, we do not reject the hypothesis that the instruments only explain risk through their impact on regulation.

shareholder protection laws do not exert a direct effect on bank risk.⁴ This does not, however, imply that shareholder protection laws are unimportant for bank risk taking. If the legal system protects minority shareholder rights effectively, then ownership will not have to be as concentrated to induce managers to act in the interests of shareholders.

Consistent with theory predicting that investor protection reduces expropriation by controlling shareholders (for example, Shleifer and Wolfenzon, 2002, and John et al., 2008), we find that a marginal increase in CF is associated with a smaller increase in bank risk in countries with stronger shareholder protection laws (Table 4, regression 1). Indeed, in countries with the highest level of shareholder rights (Rights equals 5) a marginal increase in the CF rights of the largest shareholder is not associated with a significant increase bank risk. Thus, ignoring shareholder protection laws yields incomplete conclusions about the relationship between bank risk and ownership structure.

Next, consider capital regulations, which have been the focus of international and national regulatory approaches to promoting the safety and soundness of banking systems. To induce prudent risk taking, capital regulations require bank owners to have more of their wealth at risk and to increase the amount of capital at risk as a bank's assets become more risky. Nonetheless, since binding capital regulations reduce the utility of owning a bank, banks' owners might seek to increase risk in response to those capital regulations. Moreover, any adjustment to risk might depend on the incentives and power of the owner, as measured by CF.

Table 4 shows that the sign of the relationship between risk and capital regulations (Capital) depends materially on each bank's ownership structure. In the regressions that include the interaction between CF and Capital, Capital enters positively and significantly. Consistent with standard approaches to bank regulation, this finding indicates that the direct effect of capital regulations is to

⁴ Furthermore, uninsured creditors of the bank might reduce bank risk. Thus, we also examined whether economies with stronger legal protection of creditors, as measured by the La Porta et al. (1998) index of creditor rights, have lower levels of bank risk. In unreported regressions, we do not find a significant relationship between the creditor rights index and bank risk taking, and conditioning on this country-trait does not alter the findings on the other variables.

enhance bank stability. The results, however, also indicate that the impact of capital regulations depends on ownership structure. Note that the interaction term $CF*Capital$ enters negatively and significantly in regressions 2 and 5. This shows that the stabilizing effects of capital regulations diminish when the bank has a large owner with the incentives and power to increase bank risk. Indeed, with a sufficiently large owner, capital regulations will increase bank risk. Ignoring the interactions between national policies and the ownership structure of individual banks will lead to erroneous inferences about the impact of capital regulations on bank risk.

In terms of the economic effects, capital regulations have very different implications for the risk taking behavior of widely-held banks relative to banks with a majority owner. For instance, the estimates in Table 4 regression 2 suggest that bank risk will *fall* by 0.3 standard deviations if there is a one standard deviation increase in Capital (1.25) when the bank is widely-held (i.e., CF equals zero). But, bank risk will *rise* by 0.2 standard deviations if there is a one standard deviation increase in Capital when the bank has an owner where CF equals 50 percent. Both the reduction and increase in risk are statistically significant.

The association between risk and activity restrictions also depends crucially on the ownership structure of individual banks. While many countries attempt to reduce risk by restricting banks from engaging in non-lending activities, theory suggests that these regulations might have unintended effects. Bank owners might seek to compensate for the utility loss from stricter restrictions by increasing risk. Theory further suggests that owners will have greater incentives and power to increase risk if they have larger CF rights. In the regressions that include the interaction between CF and $Restrict$, $Restrict$ enters negatively, though insignificantly at the five percent level. Thus, an increase in $Restrict$ is not associated with a significant change in a bank's risk if the bank is widely-held. However, the interaction term $CF*Restrict$ enters negatively and significantly in regressions 3 and 5. When a bank has a large owner, activity restrictions boost risk. For instance, the estimates in

Table 4 regression 3 suggest that bank risk will rise by 0.4 standard deviations if there is a one standard deviation increase in Restrict (2.40) and if the bank has an owner where CF equals 50 percent.

The evidence on deposit insurance further emphasizes that ignoring the interactions between national regulations and the ownership structure of individual banks leads to flawed conclusions about the impact of regulations on bank risk. In particular, explicit deposit insurance has very different implications for the risk taking behavior of a widely-held bank relative to a bank with a majority owner. The estimates in Table 4 regression 4 suggest that bank risk will rise by a statistically significant 0.4 standard deviations in response to a one standard deviation increase in DI (0.41) if the bank has a large owner with CF equal to 50 percent. But, DI is not associated with a significant increase in bank risk when the bank is widely-held. From this perspective, explicit deposit insurance does not have much of an effect on bank risk in a country like the United States where all ten of the largest banks are widely-held. In India and Indonesia where large banks tend to have concentrated ownership, however, deposit insurance is associated with significantly greater risk.

5. Simultaneous Determination of Bank Valuation and Risk

To assess more comprehensively the mechanisms relating bank ownership, shareholder protection laws, regulation, and risk, we allow for the joint determination of bank risk and bank valuations. Laws, regulations, and ownership structure might influence bank risk by affecting bank valuations. If laws and regulations reduce a bank's value, this could increase the risk taking incentives of owners as argued by Koehn and Santomero (1980) and Buser et al. (1981). However, regulation might affect risk through an assortment of other channels, including the response by borrowing firms to changes in interest rates induced by regulation (Boyd and De Nicolo, 2005), the

screening incentives and capabilities of investors (Calomiris and Kahn, 1991), and the degree of competition in banking (Hellmann et al., 2000).

Following Keeley (1990), we control for the endogenous determination of risk and bank valuation and test whether there is an association between risk and bank regulations independent of bank valuation. In the second stage of a two-stage least squared system, Z-score is modeled exactly as in Table 4, except that we also include Tobin's Q. In the first stage, Tobin's Q (Q) is modeled both as a function of (1) the numerous bank-level and country-level control variables used in the risk equation and (2) as a function of variables excluded from the second stage. These excluded variables include (i) a dummy variable for whether the bank is listed on the New York Stock Exchange (NYSE), (ii) a dummy variable for whether the country has entry restrictions that protect banks from competition, and (iii) the bank's market share as measured by assets. As in Keeley (1990), the identifying assumption is that these excluded variables explain cross-bank differences in valuation but the excluded variables only explain bank risk through their impact on Q.

Keeley (1990) uses the liberalization of laws governing branch restrictions in the US as an instrument for Q to assess the impact of exogenous changes in Q on bank risk taking. He argues that these liberalizations are an "easily observed exogenous factor with respect to bank risk taking". At the same time, these regulatory entry barriers reduce competition between banks, enhancing the market power and franchise value of banks, as captured by Q, and are thus a potentially valid instrument for Q. Following Keeley (1990), we use a regulatory index of entry barriers at the country-level as instrument for Q. We also include the bank's market share of assets in the set of instrumental variables to proxy for market power. The results are qualitatively similar when we use the market share of deposits. The NYSE listing dummy variable is included to capture other valuation trends not related to changes in market power, such as the liquidity enhancing effect of a NYSE listing. Also, valuation may be enhanced by the strict disclosure requirements of NYSE listings.

Table 5 presents the complete first-stage and second-stage results. Table 5 gives the partial R^2 and the F-test of the excluded instruments in the first-stage to assess whether these instruments explain cross-bank differences in Q. The three instrumental variables explain between 8 and 13 percent of the cross-bank variation in Q. The F-tests reject the hypothesis that these instruments can be excluded from the first-stage at the one percent significance level. Furthermore, in all of the specifications, the overidentification test supports the hypothesis that the instruments are valid, i.e., we do not reject the assumption that the instruments only explain bank risk through their effect on Q. Also, the first-stage results indicate that Q is higher in countries with stronger shareholder protection laws, which is consistent with the findings in Caprio et al. (2007).

Table 5 confirms all of this paper's results while controlling for the endogenous determination of Q.⁵ First, the relationship between risk and ownership structure depends on shareholder protection laws. When the legal system protects minority shareholder rights effectively, a marginal increase in the cash-flow rights of the largest shareholder is not associated with an increase in bank risk.

Second, although capital regulations have a direct, positive association with bank stability, they also increase the risk-taking incentives of bank owners. The net effect of capital regulations on risk, therefore, depends on the ability of the owner to increase bank risk. We find that capital regulations are actually associated with greater risk when the bank has a sufficiently large owner. Ignoring the interactions between regulations and the ownership of individual banks yields invalid conclusions about the impact of regulations on risk.

Finally, the results are similar for deposit insurance and activity restrictions. To promote stability, many countries restrict banks from engaging in non-lending activities. But, bank owners might seek to compensate for the utility loss by increasing risk. This is what we find. When a bank has a large owner, activity restrictions are associated with an increase bank risk, but activity

⁵ The results also hold when simply including Tobin's Q into the OLS regressions in Table 4.

restrictions are associated with an increase in risk when the bank is widely-held. Similarly, countries adopt deposit insurance to eliminate bank runs, but deposit insurance intensifies standard moral hazard problems. The ability of owners to act on these incentives depends on bank ownership structure. Even when controlling for Q, we find that bank risk does not rise in response to deposit insurance when the bank is widely-held. When a large bank owner has sufficient CF rights, however, deposit insurance is associated with an increase in risk.

6. Conclusions

In this paper, we conducted the first empirical assessment of theories concerning the relationships among risk taking by banks, their ownership structures, and national bank regulations. Theory highlights the potential conflicts between bank managers and owners over bank risk taking and stresses that the same bank regulation will have different effects on bank risk taking depending on the comparative power of shareholders in the governance structure of each bank. Besides assessing theories from corporate finance and banking, this analysis is crucial from a public policy perspective because bank risk taking affects economic fragility, business cycle fluctuations, and economic growth.

We find that banks with more powerful owners tend take greater risks, but the relation between ownership and risk weakens in economies with stronger shareholder protection laws. This is consistent with theories predicting that (i) equity holders have stronger incentives to increase risk than non-shareholding managers and debt holders, (ii) large owners with substantial cash flows have the power and incentives to induce the bank's managers to increase risk taking, but (iii) effective legal protection of small shareholders reduces the need for the emergence of large owners to mitigate agency problems in order to boost bank risk taking.

Furthermore, the impact of bank regulations on bank risk depends critically on each bank's ownership structure. Indeed, the effect of the same regulation on a bank's risk taking can be positive – or negative – depending on the bank's ownership structure. Consistent with theory, we find that ignoring ownership structure leads to incomplete and sometimes erroneous conclusions about the impact of capital regulations, deposit insurance, and activity restrictions on bank risk taking.

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Table 1. Summary statistics

This table reports summary statistics of the main variables. Z-score is the z score of the bank; the higher the score, the lower the probability of bank default. Equity volatility is the 3-year period volatility of the equity returns of the bank. Earnings volatility is the 5-year period average standard deviation of the ratio of total earnings before taxes and loan loss provisions to average total assets. CF is cash flow rights of the largest shareholder of the bank. Large owner on mgt board is a dummy variable that takes a value of one if a large shareholder has a seat on the management board of the company. Managerial ownership equals the total cash-flow rights of senior management. Revenue growth is the growth in total revenues of the bank over the past year. State is a dummy variable denoting whether the state is the largest shareholder in the bank. Market share is the bank's share in total deposits in the country. NYSE takes a value of 1 if the bank is listed or has an ADR on the NYSE. Size is the log of total assets. Loan loss provision ratio is the ratio of the bank's loan loss provisions to net interest income. Liquidity ratio is the bank's liquid assets to liquid liabilities. Too-big-to-fail is a dummy variable that takes a value of one if the bank's share in the country's total deposits exceeds 10%. Per capita income is the log of GDP per capita of the country. Rights is an index of anti-director rights. Capital is an index of capital regulation. Restrict is an index of activity restrictions. DI is a dummy variable indicating whether the country has explicit deposit insurance (and/or has made depositors whole the last time a bank failed). Enforce is an index of enforcement of contracts. Law is a measure of law and order tradition. M&A activity is the percentage of traded companies listed on the country's stock exchange that have been targeted in completed mergers or acquisitions deals during the 1990s. GDP volatility equals the standard deviation of the logarithm of real annual GDP growth over the period 1996-2001.

Variable	Number of banks	Mean	Std. Dev.	Min	Max
<i>Bank-level</i>					
Z-score	287	2.85	0.99	-1.56	5.14
Equity volatility	219	0.47	0.36	0.03	4.50
Earnings volatility	263	0.86	1.45	0.03	12.17
CF	296	0.27	0.28	0.00	1.00
Large owner on mgt board	296	0.35	0.48	0.00	1.00
Managerial ownership	292	0.06	0.15	0.00	0.68
Revenue growth	269	0.02	0.23	-0.86	1.87
State	296	0.18	0.38	0.00	1.00
Market share	254	0.14	0.21	0.00	1.84
NYSE	296	0.12	0.33	0.00	1.00
Size	271	16.19	2.08	10.94	20.77
Loan loss provision ratio	263	0.24	0.36	-2.56	2.64
Liquidity ratio	260	0.04	0.05	0.00	0.50
<i>Country-level</i>					
Per capita income	48	8.79	1.49	5.54	10.70
Rights	48	2.98	1.31	0.00	5.00
Capital	41	3.12	1.25	0.00	5.00
Restrict	41	9.02	2.40	5.00	14.00
DI	47	0.79	0.41	0.00	1.00
Enforce	47	7.13	2.15	3.55	9.99
Law	48	6.78	2.62	1.90	10.00
M&A	44	23.90	18.65	0.00	65.63
GDP volatility	48	0.03	0.02	0.00	0.12

Table 2. Correlation matrix

This table reports the correlations between the main variables. Z-score is the z score of the bank; the higher the score, the lower the probability of bank default. Equity volatility is the 3-year period volatility of the equity returns of the bank. Earnings volatility is the 5-year period average standard deviation of the ratio of total earnings before taxes and loan loss provisions to average total assets. CF is cash flow rights of the largest shareholder of the bank. Revenue growth is the growth in total revenues of the bank over the past year. Large owner on mgt board is a dummy variable that takes a value of one if a large shareholder has a seat on the management board of the company. Managerial ownership equals the total cash-flow rights of senior management. Per capita income is GDP per capita. Rights is an index of anti-director rights. Capital is an index of capital regulation. Restrict is an index of activity restrictions. DI is a dummy variable indicating whether the country has explicit deposit insurance. P-values denoting the significant level of each correlation coefficient are in parentheses.

	Z-score	Equity volatility	Earnings volatility	CF	Revenue growth	Large owner on mgt board	Managerial ownership	Per capita income	Rights	Capital	Restrict
Equity volatility	***-0.329 (0.000)										
Earnings volatility	***-0.695 (0.000)	***0.282 (0.000)									
CF	***-0.377 (0.000)	***0.265 (0.000)	***0.392 (0.000)								
Revenue growth	-0.036 (0.556)	0.002 (0.980)	***0.317 (0.000)	**0.137 (0.025)							
Large owner on mgt board	***-0.230 (0.000)	***0.211 (0.002)	***0.184 (0.003)	***0.458 (0.000)	0.086 (0.162)						
Managerial ownership	-0.040 (0.502)	***0.202 (0.003)	0.041 (0.510)	***0.229 (0.000)	0.054 (0.383)	***0.236 (0.000)					
Per capita income	***0.306 (0.000)	***-0.274 (0.000)	***-0.337 (0.000)	***-0.313 (0.000)	***-0.191 (0.002)	***-0.395 (0.000)	** -0.139 (0.018)				
Rights	***0.171 (0.004)	** -0.160 (0.018)	***-0.192 (0.002)	***-0.183 (0.002)	-0.048 (0.431)	-0.070 (0.228)	-0.059 (0.313)	0.040 (0.492)			
Capital	** -0.155 (0.014)	0.008 (0.915)	**0.166 (0.012)	0.037 (0.555)	**0.135 (0.039)	*0.104 (0.095)	*-0.107 (0.088)	-0.077 (0.213)	0.052 (0.407)		
Restrict	***-0.329 (0.000)	***0.347 (0.000)	***0.325 (0.000)	***0.235 (0.000)	0.097 (0.138)	***0.343 (0.000)	0.049 (0.434)	***-0.294 (0.000)	*-0.113 (0.068)	***0.236 (0.000)	
DI	** -0.151 (0.010)	-0.045 (0.508)	**0.146 (0.018)	0.031 (0.595)	-0.031 (0.615)	-0.070 (0.231)	-0.055 (0.351)	***0.219 (0.000)	*-0.097 (0.096)	***0.414 (0.000)	***-0.162 (0.009)

Table 3. Bank stability, ownership and bank supervision

Dependent variable is Z score, computed over the period 1996-2001, unless otherwise noted. Dependent variable in regression (5) is the volatility of equity returns over the period 1999-2001 based on weekly total equity returns. Dependent variable in regression (6) is earnings volatility over the period 1996-2001 calculated as the 5-year period average standard deviation of the ratio of total earnings before taxes and loan loss provisions to average total assets. Dependent variable in regression (7) is Z score, computed as in Table 4 but over the period 2002-2004. The sample includes the 10 largest listed banks in the country in terms of total assets, if available. Revenue growth is the bank's average growth in total revenues during the last year. CF is the fraction of the bank's ultimate cash-flow rights held by the large owner (zero if no large owner). We use 10 percent as the criteria for control. Per capita income is the log of GDP per capita of the country. Rights is an index of anti-director rights for the country. Capital is an index of capital regulation. Restrict is an index of activity restrictions. DI denotes whether the country has explicit deposit insurance or not. Enforce is a country index of enforcement of contracts. Concentration is the 5-bank concentration ratio in terms of total assets. M&A activity is the percentage of companies listed on the country's stock exchange that have been targeted in completed mergers or acquisitions deals during the 1990s. Size is the log of total assets. Loan loss provision is the ratio of loan loss provisions to net interest income. Liquidity is the ratio of the bank's liquid assets to liquid liabilities. Large owner on mgt board is a dummy variable that takes a value of one if a large shareholder has a seat on the management board of the company. Managerial ownership equals the total cash-flow rights of senior management. Bank-level data are for the year 2001. Regressions are estimated using OLS, except regression (4) which is estimated using instrumental variables. Regression (2) includes country fixed effects. As instrument for CF in regression (4) we use the average CF of other banks in the country. In regression (4) we exclude countries with one bank. For regression (4) we also include the p-values of the Hausman test of endogeneity and the F-test of excluded instruments. In addition we report the partial R-squared of excluded instruments. The Hausman test is based on regressions that do not control for clustering. Standard errors that control for clustering at the country-level are reported in parentheses. * significant at 10%; ** significant at 5%; *** significant at 1%.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
		Fixed effects		IV	Equity volatility	Earnings volatility	Z score (02-04)			
Revenue growth	0.063 (0.528)	0.288 (0.293)	0.181 (0.527)	0.330 (0.456)	-0.063 (0.107)	1.555 (1.190)	0.836 (0.570)	0.180 (0.396)	-0.199 (0.337)	-0.199 (0.337)
CF	-1.473*** (0.407)	-0.622* (0.327)	-1.251*** (0.391)	-3.116*** (1.051)	0.239*** (0.085)	1.613* (0.851)	-0.663** (0.311)	-1.021*** (0.373)	-0.946** (0.417)	-0.946** (0.417)
Per capita income			0.125** (0.051)	0.012 (0.085)	-0.052** (0.022)	-0.185** (0.085)	0.064 (0.065)	0.118** (0.058)	0.333 (0.215)	0.333 (0.215)
Rights								0.082 (0.079)	0.144 (0.090)	0.144 (0.090)
Capital								0.029 (0.082)	0.044 (0.093)	0.044 (0.093)
Restrict								-0.122*** (0.036)	-0.098** (0.041)	-0.098** (0.041)
DI								-0.665*** (0.233)	-0.598** (0.245)	-0.598** (0.245)
Enforce									-0.091 (0.118)	-0.091 (0.118)
Concentration									-0.549 (0.625)	-0.549 (0.625)
M&A									-0.001	-0.001

									(0.006)	(0.006)
Size									-0.095*	-0.095*
									(0.053)	(0.053)
Loan loss provision									-0.123	-0.123
									(0.198)	(0.198)
Liquidity									-0.924	-0.924
									(1.197)	(1.197)
Large owner on mgt board										0.148
										(0.215)
Managerial ownership										0.335
										(0.705)
Hausman test of endogeneity (p-value)	--	--	--	0.001***	--	--	--	--	--	--
Partial R ² of excluded instruments	--	--	--	0.174	--	--	--	--	--	--
F-test of excluded instruments	--	--	--	0.000***	--	--	--	--	--	--
Number of countries	46	46	46	43	42	46	39	40	37	37
Observations	268	268	268	265	198	250	192	235	209	209
R-squared	0.16	0.14	0.19	--	0.09	0.26	0.09	0.32	0.34	0.34

Table 4. Interactions between CF and Country Characteristics

Dependent variable is Z score. Revenue growth is the bank's average growth in total revenues during the last 3 years. CF is the fraction of the bank's ultimate cash-flow rights held by the large owner and zero if there is no large owner. We use 10 percent as the criteria for control. Rights is an index of anti-director rights for the country. Capital is an index of capital regulation. Restrict is an index of activity restrictions. DI denotes whether the country has explicit deposit insurance or not. Regressions are estimated using OLS with clustering at the country-level. Standard errors that control for clustering at the country-level are reported in parentheses. * Significant at 10%; ** significant at 5%; *** significant at 1%.

	(1)	(2)	(3)	(4)	(5)
Revenue growth	0.267 (0.366)	0.289 (0.310)	0.392 (0.302)	0.162 (0.372)	0.462* (0.272)
CF	-2.694*** (0.879)	1.407** (0.659)	1.875* (0.976)	0.673* (0.391)	2.265** (0.912)
Per capita income	0.159*** (0.052)	0.112* (0.058)	0.105* (0.060)	0.103* (0.056)	0.130** (0.052)
Rights	-0.046 (0.070)	0.066 (0.075)	0.087 (0.078)	0.077 (0.081)	-0.043 (0.059)
Capital	0.039 (0.070)	0.257** (0.101)	0.019 (0.073)	0.032 (0.075)	0.193** (0.086)
Restrict	-0.119*** (0.033)	-0.129*** (0.041)	-0.036 (0.043)	-0.130*** (0.034)	-0.072* (0.038)
DI	-0.660*** (0.206)	-0.732** (0.274)	-0.635*** (0.223)	-0.208 (0.235)	-0.374* (0.221)
CF * Rights	0.588** (0.234)				0.524*** (0.185)
CF * Capital		-0.773*** (0.214)			-0.542*** (0.154)
CF * Restrict			-0.309*** (0.107)		-0.204*** (0.073)
CF * DI				-1.961*** (0.544)	-1.348*** (0.330)
Number of countries	40	40	40	40	40
Observations	235	235	235	235	235
R-squared	0.35	0.39	0.36	0.35	0.44

Table 5. Bank risk and valuation

Dependent variable is Z score. The sample includes the 10 largest listed banks in the country in terms of total assets, if available. Revenue growth is the bank's average growth in total revenues during the last year. CF is the fraction of the bank's ultimate cash-flow rights held by the large owner and zero if there is no large owner. We use 10 percent as the criteria for control. All bank-level data are for the year 2001. Per capita income is the log of GDP per capita of the country. Rights is an index of anti-director rights for the country. Capital is an index of capital regulation. Restrict is an index of activity restrictions. DI denotes whether the country has explicit deposit insurance or not. Tobin's Q is the bank's Tobin's Q, calculated as the market value of equity plus the book value of liabilities divided by the book value of assets. Regressions are estimated using instrumental variables with clustering at the country-level. As instruments for Tobin's Q we use the bank's market share in total deposits, a dummy variable that indicates whether the bank is listed or has an ADR traded on the NYSE, and an index of entry regulation for the country. We report both the first and second stage regression. We also include the p-value of the F-test of excluded instruments, the p-value of the overidentification test of excluded instruments, and the partial R-squared of excluded instruments. Standard errors that control for clustering at the country-level are reported in parentheses. * significant at 10%; ** significant at 5%; *** significant at 1%.

	(1)	(2)	(3)	(4)	(5)
Second-stage: Z-score					
Tobin's Q	-5.004 (4.179)	-1.515 (3.549)	1.944 (3.660)	1.671 (3.442)	0.555 (3.286)
Revenue growth	0.224 (0.553)	0.210 (0.409)	0.304 (0.349)	0.446 (0.282)	0.535** (0.272)
CF	-1.331*** (0.366)	-1.021*** (0.365)	-3.115*** (0.964)	-0.407 (0.977)	2.650** (1.342)
Per capita income	0.174 (0.115)	0.132 (0.103)	0.152 (0.095)	0.125 (0.090)	0.098 (0.093)
Rights	0.190* (0.103)	0.125 (0.106)	-0.071 (0.119)	-0.084 (0.105)	-0.030 (0.096)
Capital		0.033 (0.086)	0.034 (0.081)	0.280** (0.118)	0.202** (0.094)
Restrict		-0.119*** (0.038)	-0.113*** (0.034)	-0.128*** (0.038)	-0.069* (0.038)
DI		-0.610*** (0.216)	-0.671*** (0.212)	-0.717*** (0.254)	-0.327 (0.218)
CF * Rights			0.751*** (0.281)	0.684*** (0.244)	0.509** (0.248)
CF * Capital				-0.813*** (0.198)	-0.557*** (0.143)
CF * Restrict					-0.233*** (0.090)
CF * DI					-1.386*** (0.412)
First stage: Tobin's Q					

Revenue growth	-0.000 (0.013)	-0.002 (0.013)	-0.005 (0.014)	-0.006 (0.014)	-0.007 (0.015)
CF	0.006 (0.015)	-0.000 (0.016)	0.068** (0.032)	0.047 (0.064)	-0.064 (0.062)
Per capita income	0.010*** (0.004)	0.010** (0.004)	0.008** (0.003)	0.008** (0.003)	0.010*** (0.003)
Rights	0.008** (0.004)	0.008** (0.004)	0.013*** (0.005)	0.013*** (0.005)	0.012*** (0.004)
Capital		0.004 (0.005)	0.004 (0.004)	0.002 (0.005)	0.005 (0.005)
Restrict		0.001 (0.002)	0.000 (0.002)	0.000 (0.002)	-0.001 (0.002)
DI		0.009 (0.015)	0.009 (0.014)	0.010 (0.014)	-0.011 (0.013)
CF * Rights			-0.025** (0.011)	-0.024* (0.012)	-0.018 (0.011)
CF * Capital				0.006 (0.011)	-0.004 (0.010)
CF * Restrict					0.006 (0.005)
CF * DI					0.080* (0.041)
Market share	0.010 (0.014)	0.012 (0.014)	0.015 (0.014)	0.015 (0.014)	0.014 (0.014)
NYSE	0.050*** (0.013)	0.044*** (0.012)	0.039*** (0.013)	0.039*** (0.013)	0.042*** (0.013)
Entry restrictions	0.006 (0.005)	0.004 (0.005)	0.002 (0.005)	0.003 (0.005)	0.002 (0.005)
Partial R ² of excluded instruments	0.134	0.104	0.082	0.083	0.094
F-test of excluded instruments	0.000***	0.001***	0.007***	0.007***	0.007***
Overidentification test (p-value)	0.495	0.862	0.821	0.921	0.758
Number of countries	38	38	38	38	38
Observations	216	216	216	216	216

Appendix 1 Bank risk, Ownership structure, and Regulations by Country

Country	Z score	Equity volatility	Earnings volatility	CF	Large owner on mgt board	Managerial ownership	Rights	Capital	Restrict	DI	# of banks
Argentina	3.47	0.56	0.65	0.47	1.00	0.00	4	3	8.75	1	1
Australia	3.54	0.23	0.27	0.01	0.00	0.00	4	3	8	0	9
Austria	4.04	0.20	0.05	0.40	0.00	0.00	2	5	5	1	3
Belgium	3.20	0.33	0.18	0.54	0.00	0.00	0	4	9	1	1
Brazil	2.22	0.80	1.55	0.42	0.86	0.11	3	5	10	1	7
Canada	3.80	0.31	0.19	0.00	0.00	0.00	5	4	7	1	7
Chile	3.18	0.40	0.34	0.24	0.75	0.23	5	3	11	1	4
Colombia	2.67	0.39	1.59	0.32	0.40	0.00	3	n.a.	n.a.	1	5
Denmark	3.32	0.19	0.33	0.15	0.00	0.00	2	2	8	1	10
Ecuador	2.89	n.a.	1.52	0.52	1.00	0.17	2	n.a.	n.a.	1	5
Egypt	3.14	0.44	0.49	0.19	0.86	0.00	2	3	13	0	7
Finland	2.94	0.34	0.31	0.37	0.33	0.00	3	4	7	1	2
France	3.11	0.28	0.15	0.40	0.00	0.00	3	2	6	1	6
Germany	3.12	0.40	0.18	0.32	0.20	0.00	1	1	5	1	5
Greece	2.60	0.56	1.03	0.33	0.88	0.02	2	3	9	1	8
Hong Kong	3.06	0.43	0.42	0.35	1.00	0.18	5	n.a.	n.a.	1	7
India	2.73	0.40	0.42	0.62	1.00	0.00	5	3	10	1	9
Indonesia	0.72	0.82	5.73	0.75	1.00	0.06	2	5	14	1	7
Ireland	3.21	0.37	0.40	0.00	0.00	0.00	4	1	8	1	6
Israel	3.29	0.85	0.29	0.43	0.38	0.03	3	3	13	0	8
Italy	3.05	0.36	0.28	0.13	0.00	0.00	1	4	10	1	10
Japan	2.00	0.57	0.52	0.26	0.00	0.00	4	4	13	1	5
Jordan	3.16	n.a.	0.51	0.23	0.57	0.13	1	5	11	1	7
Kenya	2.33	0.41	1.63	0.18	0.25	0.02	3	4	10	1	4
Korea, Rep. of	1.61	0.76	1.20	0.26	0.30	0.01	2	3	9	1	10
Malaysia	2.28	0.53	0.54	0.30	0.33	0.11	4	3	10	0	6
Mexico	3.01	0.67	0.60	0.58	1.00	0.58	1	4	12	1	1
Netherlands	3.40	0.32	0.20	0.17	0.00	0.00	2	3	6	1	2
Nigeria	2.51	n.a.	1.54	0.15	0.14	0.01	3	5	9	1	7
Norway	3.43	0.26	0.25	0.05	0.11	0.00	4	n.a.	n.a.	1	9
Pakistan	2.46	0.31	0.91	0.50	0.71	0.20	5	n.a.	n.a.	0	7
Peru	3.09	0.86	0.87	0.55	0.00	0.06	3	3	8	1	3
Philippines	3.32	0.49	0.81	0.29	0.30	0.21	3	1	7	0	10
Portugal	3.54	0.25	0.23	0.24	0.29	0.22	3	3	9	1	6
Singapore	3.49	0.49	0.31	0.27	0.50	0.27	4	1	8	0	2
South Africa	2.54	0.40	1.33	0.15	0.00	0.00	5	4	8	1	10

Country	Z score	Equity volatility	Earnings volatility	CF	Large owner on mgt board	Managerial ownership	Rights	Capital	Restrict	DI	# of banks
Spain	3.52	0.26	0.23	0.18	0.20	0.00	4	4	7	1	10
Sri Lanka	3.14	0.44	0.41	0.14	0.40	0.00	3	0	7	0	5
Sweden	3.28	0.30	0.28	0.09	0.00	0.02	3	3	9	1	3
Switzerland	3.60	0.30	0.36	0.26	0.00	0.20	2	3	5	1	5
Taiwan	3.32	0.49	0.17	0.23	0.50	0.00	3	2	12	0	10
Thailand	0.46	0.60	1.58	0.52	1.00	0.08	2	4	9	1	7
Turkey	1.64	0.95	3.57	0.53	0.30	0.20	2	1	12	1	10
United Kingdom	3.64	0.40	0.21	0.02	0.00	0.00	5	3	5	1	6
Uruguay	3.14	n.a.	0.45	0.00	0.00	0.00	2	n.a.	n.a.	n.a.	1
USA	2.98	0.42	0.46	0.00	0.00	0.01	5	4	12	1	10
Venezuela	2.80	0.70	1.64	0.32	0.33	0.24	1	3	10	1	3
Zimbabwe	2.77	n.a.	2.08	0.06	0.00	0.00	3	n.a.	n.a.	0	1
Total	2.85	0.47	0.86	0.27	0.35	0.06	3.13	3.11	9.23	0.78	287