



Capital structure and firm performance: A new approach to testing agency theory and an application to the banking industry [☆]

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Abstract

Corporate governance theory predicts that leverage affects agency costs and thereby influences firm performance. We propose a new approach to test this theory using profit efficiency, or how close a firm's profits are to the benchmark of a best-practice firm facing the same exogenous conditions. We are also the first to employ a simultaneous-equations model that accounts for reverse causality from performance to capital structure. We find that data on the US banking industry are consistent with the theory, and the results are statistically significant, economically significant, and robust.

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1. Introduction

Agency costs represent important issues in corporate governance in both financial and nonfinancial industries. The separation of ownership and control in a professionally managed firm – one source of agency conflicts – may result in managers exerting insufficient work effort, indulging in perquisites, choosing inputs or outputs that suit their own preferences, or otherwise failing to maximize firm value. In effect, the agency costs of outside ownership equal the lost value from professional managers maximizing their own utility, rather than the value of the firm.

Theory suggests that the choice of capital structure may help mitigate these agency costs. Under the *agency costs hypothesis*, high leverage or a low equity/asset ratio reduces the agency costs of outside equity and increases firm value by constraining or encouraging managers to act more in the interests of shareholders. Since the seminal paper by Jensen and Meckling (1976), a vast literature on such agency-theoretic explanations of capital structure has developed (see Harris and Raviv, 1991 and Myers, 2001 for reviews). Greater financial leverage may affect managers and reduce agency costs through the threat of liquidation, which causes personal losses to managers of salaries, reputation, perquisites, etc. (e.g., Grossman and Hart, 1982; Williams, 1987), and through pressure to generate cash flow to pay interest expenses (e.g., Jensen, 1986). Higher leverage can mitigate conflicts between shareholders and managers concerning the choice of investment (e.g., Myers, 1977), the amount of risk to undertake (e.g., Jensen and Meckling, 1976; Williams, 1987), the conditions under which the firm is liquidated (e.g., Harris and Raviv, 1990), and dividend policy (e.g., Stulz, 1990).

Whereas increased leverage may reduce the agency costs of outside equity, the opposite effect may occur for the agency costs of outside debt arising from conflicts between debt holders and shareholders. When leverage becomes relatively high, further increases may generate significant agency costs of outside debt from risk shifting or reduced effort to control risk that result in higher expected costs of financial distress, bankruptcy, or liquidation. These agency costs result in higher interest expenses for firms to compensate debt holders for their expected losses. As pointed out by Jensen and Meckling (1976), the effect of leverage on total agency costs is expected to be nonmonotonic. At low levels of leverage, increases will produce positive incentives for managers and reduce total agency costs by reducing the agency costs of outside equity. However, at some point where bankruptcy and distress become more likely, the agency costs of outside debt overwhelm the agency costs of outside equity, so further increases in leverage result in higher total agency costs.

Agency costs and capital structure issues raise particularly important research and policy questions regarding the banking industry. This industry plays crucial roles in providing credit to nonfinancial firms, in transmitting the effects of monetary policy, and in providing stability to the economy as a whole. Agency costs may be particularly large in this industry because banks are by their very nature informationally opaque – they hold private information on their loan customers and other credit counterparties. In addition, banks' access to government deposit insurance and other safety net protections may increase incentives for risk shifting or lax risk manage-

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