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Returning Capital and Agency Costs in Bank Ownership and Management Structure

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RETURNING CAPITAL AND AGENCY COSTS IN BANK OWNERSHIP AND MANAGEMENT STRUCTURE

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This paper attempts to add to existing research on corporate payout by focusing on the role that the principal-agent problem, which is inherent between managers and owners, plays on dividend policies of companies, while controlling for factors that have been previously shown to influence corporate payout. While owners desire to have the greatest return on their contributed capital, managers often have incentive to grow the firm beyond its optimal size. Therefore, in order to minimize the agency problems with managers, owners usually demand for capital to be returned when they see a buildup in cash from retained earnings.

In order to test the principal-agency problem, my paper will focus on the banking sector because both private and public banks have to file publicly viewable call reports with the Federal Reserve Banks. Therefore, the difference between public and private banks decisions to return capital to owners can be tested using ordinary least squares regressive analysis. The main difference between public and private banks is their ownership structure. While public banks tend to have many shareholders who are disconnected from management, private banks generally have fewer owners who tend to be more actively engaged in managing or overseeing the banks management. Therefore, we would expect public owners to have a higher cost in monitoring the decisions of management and would demand banks to return more of their earnings. As expected, this study lends evidence that private banks have a different cost curve when it comes to retaining earnings and will be more willing to let retained earnings build up without returning them to owners in the form of dividends or stock repurchases.