Economic Policy Uncertainty and Corporate Governance in Bank Risk Management

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Abstract: Since the 2008 global financial crisis, global commercial banks have faced increasingly complex economic environments marked by rising economic policy uncertainty (EPU) driven by events like the 2018 U.S.-China trade tensions and 2020 COVID-19 pandemic. While regulatory reforms such as Basel III aim to enhance banks' risk control capabilities, their effectiveness under high EPU remains underexplored. This study investigates the impact of corporate governance on bank risk and performance during periods of high EPU, and tests whether EPU moderates the relationship between corporate governance and bank outcomes. By examining how EPU shapes banking governance structures, risk management practices, and performance across diverse economic settings, this research seeks to fill gaps in understanding how economic uncertainty alters banks' strategic decisions, providing insights for strengthening banking stability and resilience in volatile environments.

Keywords: Economic Policy Uncertainty; Corporate Governance; Bank Risk Management; Bank Stability; Regulatory Reforms; Volatile Economic Environments

Introduction

The introduction should set the tone of the article and provide the reader with a good understanding of the problem statement. Please keep in mind that the problem statement should match the Abstract's motivation/problem statement[1].

Problem Statement

Since the 2008 global financial crisis, global commercial banks have faced increasingly complex economic environments. With the acceleration of globalization, advancements in financial innovation, and rising macroeconomic uncertainty, banks are confronted with multiple risk challenges while striving to maintain operational stability and profitability. Following the financial crisis, the global banking industry underwent regulatory reforms like the Basel III framework, aimed at strengthening banks' risk control capabilities. However, the effectiveness of these reforms during periods of high economic policy uncertainty (EPU) remains underexplored.

In recent years, economic policy uncertainty (EPU) has become a significant factor influencing financial markets and the stability of the banking sector. Major events like the 2018 U.S.-China trade tensions and the 2020 global pandemic significantly raised EPU levels, leading to extreme fluctuations in the banking environment. Banks, as key players in the financial system, have seen substantial impacts on their asset-liability management, lending activities, and profitability. Especially during the COVID-19 pandemic, government interventions through monetary policy adjustments and fiscal stimulus exacerbated economic uncertainty, presenting unprecedented risks and challenges for the banking sector.

This study explores the impact of corporate governance on bank risk and performance during periods of high EPU, testing whether EPU moderates the relationship between corporate governance and bank risk/performance. By examining how EPU influences banking governance structures, risk management, and performance across different economic settings, this paper will investigate how economic uncertainty alters banks' strategic decisions and risk management practices.

Literature Review and Knowledge Gaps

2.1 The Impact of Corporate Governance on Bank Risk and Performance

Corporate governance plays a crucial role in shaping the risk profile and overall performance of banks. Existing studies have shown that effective governance mechanisms are positively correlated with improved financial performance and reduced risks. For instance, Aziza and Aviola [1] argue that robust governance mechanisms enhance the financial performance of banks by ensuring operational efficiency. Similarly, Khalfaoui and Guenichi [2] emphasize that strong governance mitigates risks associated with economic policy uncertainty, improving bank performance. Bahoo et al. [3] further suggest that sound corporate governance frameworks strengthen risk management practices, highlighting their importance during financial crises and periods of uncertainty.

In the banking sector, ownership structure plays a significant role in shaping risk management and performance. La Porta et al. [4] and Shleifer and Vishny [5] argue that ownership dispersion can prevent the abuse of power by dominant shareholders, improving governance and performance. Conversely, concentrated ownership may enhance oversight and reduce agency costs but could also lead to conflicts between large and minority shareholders, negatively impacting performance [6][7].

Board size also plays a crucial governance role. Larger boards may provide more oversight, enhancing decision-making and reducing risks, though excessively large boards can lead to inefficiencies [8][9].

2.2 The Moderating Role of Economic Policy Uncertainty (EPU)

EPU has been shown to significantly influence corporate decision-making, especially in the banking sector. Baker et al. [10] argue that EPU reduces the transparency and predictability of economic policies, affecting market expectations and investment decisions. Increased EPU typically suppresses investment and financial market activities. For banks, higher EPU exacerbates external uncertainty, shifting credit decisions, lending practices, and risk management strategies [11]. During high-EPU periods, banks may adopt more conservative risk management strategies, reducing lending and profitability.

Recent studies on EPU's impact on banks include Wang and Duan [12], who found that EPU significantly affects loan restructuring in China, and Saputra and Hendri [13], who studied EPU's impact on bank credit growth in Indonesia. However, while much research focuses on EPU's effects on non-financial firms, studies on how EPU influences governance structures in the banking sector remain limited.

Research Gap

Despite significant progress in understanding corporate governance, bank risk, and performance, and the effects of EPU on corporate decisions, several gaps remain:

- **Moderating Role of EPU:** Research has largely focused on direct effects of corporate governance on bank risk and performance, but how EPU moderates this relationship, especially during high EPU periods, remains underexplored.
- **Cross-Regional Analysis:** Much research is confined to specific regions, limiting generalizability. This study will analyze data from 29 countries and regions, offering a broader perspective.

Integrated Governance Structure: Many studies examine isolated governance factors, such as board independence or ownership structure. Few integrate multiple governance factors. This study will consider factors like ownership dispersion, ownership concentration, and board size in a comprehensive analysis.

Regional Factors in EPU's Effects: While regional differences in the effects of EPU on bank performance and risk have been mentioned, they remain under-studied. This research will analyze how EPU affects banks differently across regions.

Research Hypotheses

The study proposes the following hypotheses:

Hypothesis 1: Corporate governance mechanisms (e.g., ownership dispersion and board size) significantly influence bank risk, with more dispersed ownership potentially reducing risk exposure.

Hypothesis 2: Economic policy uncertainty (EPU) moderates the relationship between corporate governance and bank risk, weakening the effectiveness of governance mechanisms in mitigating bank risk during high EPU.

These hypotheses will be empirically tested to explore the moderating effect of EPU on the relationship between corporate governance and bank risk/performance.

Conclusion

This study addresses significant gaps by exploring the moderating role of EPU in the relationship between corporate governance and bank risk/performance. By conducting cross-national analysis and integrating multiple governance factors, it will reveal how EPU influences the effectiveness of governance mechanisms. The findings will provide insights into how banks can optimize governance and risk management, especially in periods of high economic uncertainty.

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