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Journal of Financial Economics 70 (2003) 351–383
JOURNAL OF Financial ECONOMICS
www.elsevier.com/locate/econbase

Boundaries of the firm: evidence from the banking industry☆

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Received 11 September 2000; received in revised form 7 June 2002

Abstract

Agency theory implies that asset ownership and decision authority are complements. Using 1998 data from Texas commercial banks, we test whether the likelihood of local ownership of bank offices increases with the importance of granting local managers greater decision authority (for example, due to location or customer base). Our empirical evidence is consistent with this hypothesis. It suggests that complementarities between strategy and organizational structure can foster differentiation among firms in terms of location, customers, and products. It also supports the growing view that small locally-owned banks have a comparative advantage over large banks within specific environments.

JEL classification: G32; L22

Keywords: Boundaries of the firm; Banking; Economics of organizations; Ownership incentives; Agency theory; Decision authority; Locational decisions; Riegle–Neal Act; Community banks; Interstate branching

☆We would like to thank Mark Flannery, Lee Heavner, Francine LaFontaine, Laura Lindsey, Michael Pagano, Joe Sinkey, Jerry Zimmerman, seminar participants at Emory, Georgia, Purdue, Rochester, TCU and the Western Finance Association Meetings as well as two anonymous referees for useful comments. We also thank Doug Freeman for research assistance, Sharon Boston and Dorsey Davis at the Dallas Federal Reserve, and Pat Relich of the FDIC, for providing data.

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0304-405X/$ - see front matter
doi:10.1016/S0304-405X(03)00170-3

1. Introduction

Incentive theory implies that asset ownership and decision authority are complements. Asset ownership reduces agency problems and thus the costs of granting the owner more decision authority. Substantial decision authority, in turn, increases the benefits of giving the agent an ownership interest in the assets. This theory suggests at least two testable implications. First, asset ownership and decision authority will be positively correlated.[1] Second, the agent will have greater ownership rights and decision authority in environments in which it is important to grant the agent significant decision-making authority (for instance, due to the agent's specific knowledge).

In this paper, we use 1998 data from the Texas banking industry to provide evidence on these propositions. Following the convention of regulators and past researchers, we classify banks as either large or small depending on whether they have more than one billion in assets (similar results hold if we use a $500 million cutoff). Nakamura (1994), for example, indicates that the managers of the individual branch offices within large banks generally are granted limited decision rights, are required to follow standardized operating procedures, and are monitored by supervising managers from the large bank's headquarters or a nearby banking center. Specialists from these major offices handle many of the more complex products and services. In contrast, local office managers of small banks tend to have broader decision-making authority.

We begin by documenting that the ownership of small bank offices is highly concentrated among local office managers and investors from the local community. In contrast, branch managers in large banks have virtually no ownership interests in either the bank or its branches. These findings, coupled with what we know about the decision authority of the managers in large and small bank offices, are consistent with the incentive-theory implication that asset ownership and decision authority will be positively correlated.

Our main empirical tests focus on the joint hypothesis that (1) bank offices will be owned by small banks in environments where it is important to grant significant decision-making authority to local office managers; and, (2) It it is more important to grant significant decision-making authority to local office managers in smaller urban and rural areas than in major cities. We expect that it will be relatively more important to grant decision authority to local managers in smaller urban and rural areas for two reasons. First, in major cities it is less expensive to refer inquiries about more complex products and services to specialists at a nearby regional banking center. In more rural markets it is more likely to be efficient to have local bank managers handle a broader set of products and services; thus, specialization is limited by the size of the market. Second, the major loan customers in small urban and rural areas are often small businesses without audited financial statements. The

[1] Complementarity along with some additional assumptions relating to the exogenous variables implies positive cross-sectional correlations among the decision variables. See Holmström and Milgrom (1994) for details.