Interlocking directorates, access to credit, and business performance in Chile during early industrialization

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ABSTRACT

How do businessmen counteract credit constraints when the financial market does not provide adequate external financing? Based on novel primary corporate data, network techniques and regression analysis, we explore the role of interlocking directorates with banks as a way for companies to face this limitation in early twentieth century Chile. Since both linkages and credit were unregulated, this setting provides us with a quasi-natural laboratory to test the role of interlocking directorates as a device for dealing with credit constraints. The paper finds that firms connected to banks had better access to credit as reflected in higher leverage ratios, had higher valuations, and better chances of surviving. These facts show that business networks, through interlocking directorates, can play a valuable role for companies in dealing with an environment of financial constraints.

1. Introduction

Corporate networks through interlocking directorates are an essential feature shaping the business environment. Indeed, very few of the largest corporations around the world are not part of a network through interlocking of board directors (Stockman, Ziegler, & Scott, 1985) and this has been the case for a long time (David & Westerhuis, 2014). Theories relate these interlocking to a series of important functions (Mizruchi, 1996; Larcker, Sob, & Wang, 2013; Scott, 1991; Davids, 1996, among others). These include shaping relations across firms such as easing contracting costs, coordination, and communication, within firms and with others outside the business community – social, class cohesion, political. Interlocks can also be related to market power and can be used as a mechanism to facilitate collusive agreements. It is increasingly clear that the relevance of each theory is very much context dependent but this exploration is only beginning. A case in point is the little understanding that we have of the recent phenomenon of the sharp decline in the density of the corporate network (David & Westerhuis, 2014).

Importantly, networks can serve as a device for enforcing contracts when formal institutions do not work properly (Lamoreaux, 1994). One particular sector in which, because of its very nature, the enforcement of contracts is crucial for transactions to be conducted is the financial one (La Porta, López-de-Silanes, Shleifer, & Vishny, 1997). Business ties could provide an alternative arrangement to increase corporate access to external financing when financial systems are underdeveloped because of lack of institutions that guarantee the legal protection of creditors. Better access to finance, in turn, would translate into better firm performance and valuation (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 2002) and faster economic growth (King & Levine, 1993; Rajan & Zingales, 1998).

The aim of this paper is to explore these issues by means of studying the Chilean corporate sector at the early twentieth century based on novel primary balance sheet and market data covering up to 252 firms and more than 1800 board seats. We look at (interlock) linkages among companies that occur when at least one individual (director) belongs to more than one company board and with special focus on interlocking with banks. Using network techniques and regression analysis, we address three interrelated hypotheses: whether firms that were connected to banks through interlocking directorates: a) had higher leverage, b) commanded higher valuations in the market, and c) had higher probability of survival into the future. We provide evidence in support of all three.

Our case study is relevant because Chile was at a time a small open and natural resource-based developing economy, with an under-developed financial system like many other developing countries today. This was also a period without any legal restrictions to the numbers of boards a person could sit in, or to the bankers’ presence either on board positions or as shareholders of non-financial firms. Moreover, banks faced no regulatory restrictions when dealing with related institutions or requirements to extend credit to firms or specific sectors. These last two features imply that we have a precious laboratory free from...
regulatory constraints that typically limit the scope of such analyses conducted with current data.

2. Literature review

There is a very large literature dealing with business networks on sociology, economics, management science, history, among other fields. Because it encompasses the very general issue of the relation between firms working together pursuing related goals, the body of managerial research on the issue is also rich. For instance, there has been significant research on the shape, location, evolution, and management of these relations (Anderson, Håkansson, & Johanson, 1994; Hennебerg, Naudé, & Mouzas, 2010; Törnroos, Halinen, & Medlin, 2016). Interlocking directorates is one particular way in which firms can form networks, though it has been very studied and influential (Hauschild & Beckman, 1998; Mizruchi, 1996 and Mizruchi & Stearns, 1988). One of the primary focus of interlocking research has been to document and measure the relative importance of business networks thus conceived across countries, their evolution and the identification of central firms (see Windolf, 2002, Cronin, 2011, David & Westerhuis, 2014, for discussion and survey).

Based on resource dependence theory, board interlocking can be seen as a rational cost-benefit mechanism available to firms (Brennecke & Rank, 2017; Pfeffer & Salancik, 1978). According to this view interlocking allows firms to gain access to a wide spectrum of valuable external resources, including strategic information, technology (Westphal, Seidel, & Stewart, 2001) and serve as a substitute to regulation for dealing with agency problems (Booth, Cornett, & Hassan, 2002). It also appears that interlocking can improve firm performance through innovation, product development and the adoption of best managerial practices (Mazzola, Perrone, & Kamuriwo, 2016; Shropshire, 2010), while firms with better connected boards of directors exhibit better performance either by profitability (Richardson, 1987) or superior stock returns (Larcker et al., 2013). Our paper contributes to this literature on the reasons for the existence of linkages by showing that these positive effects are a pervasive feature of these interlocks since they exist in a context very different from the ones that have been studied before. We also add new evidence on how these affect the very long-term survival of the firm.

Resource dependence theory can also be applied to understand whether interlocking directorates can be used to gain better access to external financing, particularly when firms have board ties with credit suppliers. At these regards several studies find that banks appear to be central firms in interlocking networks, although a declining trend has been observed for the for the US since the 1980s (Davis & Mizruchi, 1999). The latter suggests that directorate ties with credit suppliers can matter and, more specifically, that banking ties can perform a central role in directing capital flows (Mintz & Schwartz, 1985; Mizruchi, 1996). Based on contemporary data, part of the research found that companies tied to bankers might face lower barriers for credit access, thus affecting its capital structure (Booth & Deli, 1999; Byrd & Mizruchi, 2005; Krosnzer & Strahan, 2001; Sislí-Ciamarra, 2012). The link between the financial/banking channel and firm performance has been less explored though. Engelberg, Gao, and Parsons (2012) shows that firms connected with capital suppliers enjoy more favorable terms of lending and improved credit ratings and stock returns. On the other side, banking interlocking with nonbanking firms can have a negative effect on bank performance because of unsound lending (Kossev, 2009; Okazaki, Sawada, & Yokoyama, 2005) and reduced R&D and innovation (Ghosh, 2016).

One difficulty when conducting research linking interlocks and credit with contemporary data is that neither credit nor linkages are the outcome of unrestricted choice by the agents involved. Nowadays, either directly or indirectly connected directors or instruments such as subsidized lending, or state guarantees, or indirectly -via the computation of bank capital requirements- bank lending is almost nowhere completely unhindered. Likewise, firm linkages have been restricted or controlled on grounds of antitrust reasons (Baccini & Marroni, 2016; Jacobs, 2014; OECD, 2008). In addition, regulatory mandates such as the Sarbanes-Oxley Act in the US had impacted the board structure of firms (Link, Netter, & Yang, 2007), while Codes of Best Practices in Corporate Governance around the world make recommendations on board structure and composition (Denis & McConnell, 2003) that includes restrictions on interlocks in several countries (Van den Berge, 2012). In Chile board positions per person were limited to a maximum of three between 1970 and 1981, and since 1960 board interlocks are prohibited between banks. More recently, in 2017, the Chilean antitrust law forbidden the participation on boards of competing firms. Our paper looks at a time and place where the linkages and credit we see are more likely to be the outcome of the optimal choice of agents facing particular credit conditions, which is a basic requirement for using these data to test the theory.

In Latin America, several studies have analyzed interlocking directorates. These include Lluch and Salvaj (2012) who compare the Chile and Argentinean corporate networks at the beginning of the 1970s, Couyoumdjian and Salvaj (2016) on the relation between the state Chilean business groups during the 1970–2010 period and Silva, Paredes, and Majluf (2006) on the effect of interlocking and family ties in Chile in the early 2000, and Santos, Silveira, and Barros (2012) on the effect of interlocking on firm performance in Brazil from 2001 to 2005. Using data from a similar period than the one we analyze in this paper, Musacchio and Read (2007) and Musacchio (2009) document the importance of business networks, including its ties to banks, in Mexico Brazil and the US during in early XXIst century.

We contribute to the understanding of interlocking directorates and business networks in Latin America by looking at a country (Chile) in a period not as well-studied relatively to the others. This allows having additional data to test not only the financial channel as we do here but also other theories by comparing the Chilean network of firms and their performance with their Latin American peers undergoing different institutional developments.

One novelty of our work is that we look at the entire chain of the credit mechanism. That is, we start by documenting the role of bank interlocking in easing credit access -the impact on the firm’s leverage-, and then move into showing that there is an effect on the firms’ performance -as measured by market value-, and then finally in its long-term survival. We address these interrelated hypotheses using network techniques and regression analysis. To our knowledge this is the first paper that explores this question in such a comprehensive manner for a developing economy, thus making a significant contribution to the related literature.

The remainder of this paper is structured in three sections: Section 3 presents our methodology, data description and the main characteristics of the Chilean interlocking network, Section 4 discuss our results and Section 5 concludes.

3. Data and methods

If the reason that firms link to banks is that arms-length lending is expensive because there are market failures in financial markets -such as poor creditor protection or information quality-, firms that are connected to banks would have better access to credit. Enhanced financing would allow these firms to increase investment to its optimum level and therefore perform better and be more valuable. This will ensure the long-term survival of the firm. We measure the impact of connections, particularly with banks, on firm market valuation and on its survival probability. In particular, our three hypotheses are:

H1. Firms connected to banks have higher leverage.

H2. Firms connected to banks command higher market valuations.

H3. Firms connected to banks have a higher probability of long-term
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