Ownership, control, and pyramids in Spanish commercial banks

Valentín Azofra, Marcos Santamaría

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Abstract
Using the law and finance approach we analyze how the ultimate ownership and control structure influences the performance of Spanish commercial banks during the period 1996–2004. Our evidence shows that 96% of Spanish commercial banks have an ultimate controlling owner. Also, we observe that whenever there is a gap between the ultimate controlling owner’s cash flow and control rights, than the bigger the gap, the poorer the bank’s performance. We find that whenever there is no difference between the ultimate controlling owner’s cash flow and control rights, there is a non-monotonic relation between ownership concentration and the bank’s performance.

1. Introduction

Research in corporate governance for the financial sector has always appeared to be a step behind studies of corporate governance for non-financial firms. However, this lag contrasts with the leading role that financial entities have in the economy. These entities transform and create financial assets (Benston and Smith, 1976), manage intertemporal risk (Allen and Santomero, 2001), and they also monitor and reduce asymmetric information between economic agents (Leland and Pyle, 1977; Diamond, 1984). As a result, most recent studies show that a proper implementation of these functions has a positive effect on the economic development of a country (Levine, 1998). But these functions can be negatively influenced by corporate governance problems, such as the lack of mechanisms to protect external investors’ wealth from expropriation by insiders (La Porta et al., 2000).

The Basel Committee on Banking Supervision (2010) highlighted the relevance of the corporate governance problem in the banking sector in its report “Principles for enhancing corporate governance”. The Committee points out that poor corporate governance may contribute to bank failures and the possibility of broader macroeconomic implications, such as contagious risk and impact on payment systems, and that within this corporate governance framework, ownership structure plays a key role. The Committee’s report adds “there are unique corporate governance challenges posed where bank ownership structures are unduly complex, lack transparency, or impede appropriate checks and balances. Challenges can also arise when insiders or controlling shareholders exercise inappropriate influences on the bank’s activities” (p. 6). Thus, the opaque ownership and control structures facilitate the extraction of private benefits by insiders, i.e., managers and large shareholders (Caprio and Levine, 2002). In the banking industry, the extraction of private benefits is detrimental not only to minority shareholders, but also to the depositors, who are the major providers of financial resources. This is because shareholders and managers are willing to take high-risk projects to exploit moral hazard incentives from deposit insurance (Merton, 1977) which, at last, intensifies the governance problems in the banking entities.

The law and finance approach has updated the classical view of corporate governance problems derived from the ownership structure (La Porta et al., 1998; Beck et al., 2003). According to this theoretical framework, in common law countries, which have dispersed control and ownership structures, the main corporate conflict arises between owners and managers. But in civil law countries, which have concentrated control and ownership structures, the main governance problem emerges between minority and large shareholders. Thus, ownership structure has greater importance in the civil law countries where protection and safeguard of shareholders’ rights is weak (La Porta et al., 1998). There is a double consequence of this poor legal protection in the
financial sector. On the one hand, the banking industry is a cornerstone of the financial system instead of capital markets (La Porta et al., 1998, 2000, 2002; Beck et al., 2003; Roe, 2003; Levine, 2005). In those countries in which institutions effectively protect investors (common law countries), the capital markets are developed, and corporate ownership is diffuse. Following these arguments, the main governance problem in common law countries has a vertical dimension because the problem derives from the agency conflict between shareholders and managers. But those countries with weaker legal protection of investors (civil law countries) have less developed financial markets, and as a consequence, corporate ownership is concentrated in a few hands. Thus, the main governance problem in civil law countries has a horizontal dimension because it stems from the agency cost of conflicts between the controlling owner and minority shareholders.

Although it shares the conceptual basis with the corporate governance of non-financial firms, studies on the corporate governance of banks have some characteristics that are mainly derived from the idiosyncrasy of the banking business. Traditional studies on banking examine three different specific characteristics of these entities (Prowse, 1997a; Freixas and Rochet, 1997; Caprio and Levine, 2002; Macey and O’Hara, 2003; Levine, 2004). First, banking entities are characterized by a high opacity, which relates to higher information asymmetries and to the complexity of bank business. Levine (2004) defines opacity as the difficulty that external participants have in monitoring the behavior of the internal participants. Information asymmetries are accentuated in the banking sector because the quality of credit investments is not easily observable and the financial products are highly complex. Thus, it is much simpler for the internal participants to expropriate rents from the external participants (Andrés and Vallelado, 2008).

Second, governance theoretical framework for the financial entities cannot avoid the fact that the major providers of financial resources in the commercial banking industry are not shareholders but depositors. Depositors play the main character in another clear agency conflict in financial entities as their interests are different from both the shareholders and managers. According to the moral hazard problem of banks, shareholders and managers are more disposed to carry out high-risk projects that increase share value at the expense of the deposits value. Depositors are risk adverse stakeholders as they receive a fixed remuneration for their deposits independently from the banking strategy, and also they can lose their money if the bank fails as a consequence of taking on high risks (Prowse, 1997a; Macey and O’Hara, 2003). In addition, this conflict becomes stronger because depositors lack both the motivation and experience to monitor the bank management. Depositors are not experienced in monitoring because they are primarily involved in domestic economies that bear the effects of high information asymmetries, and because there is a free-rider problem in acquiring information. Also, they lack incentives to control managerial or ultimate owners’ behavior as there exists a deposit insurance in most of the developed countries that covers depositors’ losses in case the bank goes bankrupt.

Finally, the third characteristic of banks is close to the previous one. Banking entities have a very high debt ratio, which exposes them to a major risk of insolvency in case of a bank run. Although bank resources are mostly invested in non-liquid assets, they are usually 90% financed with debt in the form of bank deposits (Macey and O’Hara, 2003). Therefore, if depositors decide to withdraw their deposits all at once, then the bank may face insolvency or liquidity problems.

These three characteristics and the external costs related to the bank bankruptcies show that financial institutions are subject to an intense regulation. But the question is, do these distinctive features of financial institutions lead to a governance problem that is different from that of non-financial firms?

According to prior empirical studies, banking regulation does not change the basic vertical (shareholders vs. managers) and horizontal (controlling shareholder vs. minority shareholders)
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