Journal of Banking & Finance 35 (2011) 1464–1476

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Ownership, control, and pyramids in Spanish commercial banks

Valentín Azofra [a], Marcos Santamaría [b,*]

[a] Department of Finance and Accounting, University of Valladolid, Spain
[b] Department of Economy and Business Administration, University of Burgos, Spain

ARTICLE INFO

Article history:
Received 31 August 2009
Accepted 30 October 2010
Available online 4 November 2010

JEL classification:
G21
G34

Keywords:
Ownership
Control
Banks
Pyramids
Corporate governance

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

* Corresponding author. Tel.: +34 947 258 968; fax: +34 947 258 960.
E-mail addresses: vazofra@eco.uva.es (V. Azofra), msanta@ubu.es (M. Santamaría).

0378-4266/$ - see front matter © 2010 Elsevier B.V. All rights reserved.
doi:10.1016/j.jbankfin.2010.10.029

financial sector. On the one hand, the banking industry is a cornerstone of the financial system instead of capital markets (La Porta et al., 1997). On the other hand, banks' ownership is more concentrated than in common law countries (Caprio et al., 2007), because it also happens in non-financial firms. Due to these arguments, we believe it is necessary to address issues such as identifying the controlling owners of these financial entities, discovering which kind of mechanisms they use to control banks or calculating how many control (or voting) rights and ownership (or cash flow) rights they hold.

In this paper we study the effect of ownership and control structure on the Spanish commercial banks' performance over the period 1996–2004. As a civil law country, Spain is characterized by a banking-oriented financial system and concentrated ownership structures. The study of Spanish banks' ownership structure is even more important because during this period, many of the banks did not quote on the Spanish stock exchange (only 14 out of the 75 Spanish banks that operated in December 2004 were publicly traded), which increases the sector's opacity and the controlling owners' discretionary behavior. Also, Spanish banks play an important role as shareholders of Spanish non-financial firms. Azofra et al. (2007) show that nearly half of non-financial Spanish firms listed on the stock exchange has a commercial bank that owns an average of 10% of their equity.

To study the relation between banks' ownership structure and their performance, we build the control chains of Spanish banks, i.e., the pyramids and cross-holdings. In doing so, we identify the ultimate controlling owner. We examine not only the quantitative dimension, i.e., the proportion of ownership and control rights, but also the qualitative dimension, i.e., the nature of the controlling shareholder. Our data shows that 96% of the Spanish banks have an ultimate controlling owner. This figure shows that the governance problem of Spanish banks is between controlling owners and the rest of financial providers (minority shareholders and depositors). This governance problem affects the banks' performance in two ways that are related to the ownership and control of the ultimate controlling owner. On the one hand, when there is a gap between cash flow and control rights of the bank's ultimate controlling owner, then the bigger the gap, the poorer the bank's performance. On the other hand, when there is no difference between both types of rights, we find a non-monotonic relation between the ownership concentration and the bank's performance. Thus, we find a negative relation between ownership concentration and performance at lower levels of ownership and a positive relation for high enough levels of ownership held by a large shareholder.

The paper proceeds as follows. First, in Section 2, we introduce the law and finance approach and describe the idiosyncrasies of the corporate governance problems in the banking sector. Thus, in Section 3 we introduce the role of the ownership structure on the corporate governance problem and we derive a set of testable hypotheses. In Sections 4 and 5 we present the methodology of our empirical analysis, which includes the model, the sample data, and the method of the control chains we use to identify the ultimate controlling owner of Spanish banks. In Section 6 we explain the results of testing the hypotheses and their robustness. We close our paper in Section 7 with a brief discussion of our results and the most relevant conclusions of our research.

2. The problem of corporate governance in the law and finance approach. What is different about banks?

The law and finance approach places the origin of the corporate governance problem on a double dimension (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)