Discussion

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The "Problem"

Together, the credit and governance effects can come into direct conflict. Kroszner and Strahan (2001, 416) observe:

> The potential for conflict becomes clear when a bank executive is on the board of a non-financial firm. The fiduciary duty of directors to promote interests of shareholders can lead to a conflict with the banker-director's role as lender or potential lender due to different payoff structures of debt and equity . . . .

The governance relationship may also run from corporations to banks. Corporate officers themselves serve on the boards of banks. Like bank officers on corporate boards, other officers serving on bank boards also face the potential for conflict. While their fiduciary duty as bank directors obliges them to promote the interests of bank shareholders, this duty can conflict with the corporation's interest as a potential borrower from the bank. In addition to corporate officers, directors may also serve on the boards of banks and other corporations. To the extent that these corporations rely on the same banks for finance, directors serving on the boards of both must also juggle the different interests.

Using this logic, empirical work then tries to identify relationships between the presence of a board connection and firm characteristics (size, risk), between the share of bank loans from a connected bank and firm characteristics, or between the interest rate on loans to connected borrowers and firm characteristics.

I have been thinking about this, and I am uncomfortable with the conjecture. Presumably, if we recognize this is an issue, then so do the bank and the "related" corporation. Would they not try to deal with it? What is corporate governance all about? The following excerpt is from Caprio and Levine (2002).

> The standard agency theory of corporate governance focuses on the separation of ownership and control and investigates the mechanisms via which the suppliers of capital—diffuse and concentrated debt and equity holders—influence managerial decisions with varying degrees of success (Shleifer and Vishny, 1997). Consider first the problem faced by diffuse equity and debt holders. Small shareholders may seek to exert corporate governance by voting directly on major decisions, electing boards of directors, and signing incentive contracts with managers that link pay to performance. Similarly, diffuse debt holders may seek to constrain managerial discretion through covenants, such that default or violation of a covenant typically gives debt holders the right to repossess collateral, initiate bankruptcy and/or reorganization proceedings, and vote on removing managers.
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> In practice, however, small equity and debt holders find it very difficult to exert corporate governance effectively. For instance, managers generally enjoy large informational advantages and investors with little wealth at risk frequently lack the skills and incentives to rigorously monitor managerial decisions. Furthermore, managers frequently "capture" the board of directors, so that the board does not reflect the interest of small shareholders. Incentive contracts, which are written with the board of directors, will be correspondingly less likely to solve the corporate governance problem . . . .
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> The corporate governance problem is likely to be worse in banks. In particular, while informational asymmetries plague all corporations, banks are particularly opaque; it is very difficult for outsiders to monitor and evaluate bank managers. This opaqueness makes it more difficult for diffuse equity and debt holders to write and enforce effective incentive contracts, to use their voting rights as a vehicle for influencing firm decisions, or to constrain managerial discretion through debt covenants. Moreover, this opaqueness makes it easier and more likely for managers and large investors to manipulate boards of directors and exploit the private benefits of control. More specifically, opaqueness enhances the ability of bank

> insiders to shift the activities of the bank quickly and massively for their own gain and at the cost of other stakeholders in the bank. Opaqueness, however, is not the only factor intensifying bank corporate governance problems.

(*Let us add deposit insurance to the mix.)*

> . . . the more pernicious effect of deposit insurance is that it reduces the need for banks to raise capital from large, uninsured investors who have the incentives to exert corporate control. Furthermore, the resulting capital structure—low equity and high diffuse, insured debt—intensifies the incentives and abilities of bank managers to shift into higher risk activities. The heavy hand of government regulation also limits the textbook mechanisms of corporate control: the legal and bankruptcy systems . . . .
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> In banking, competition is also less likely to ameliorate the corporate governance problem than in many other industries. Product market competition pressures firms to minimize costs, including the adoption of corporate governance devices that lower the cost of external finance. While some areas of banking are subject to intense pressure, the information-intensive nature of relationship banking makes it naturally monopolistic and therefore less prone to market competition than some other industries. Takeovers may also help corporate control. Potential corporate takeovers can create a market for corporate control that pressures managers to maximize firm value. While takeovers do not play a substantive corporate governance role outside of the United States and the United Kingdom even in non-financial corporations (Shleifer and Vishny, 1997), the problems are exacerbated in banking. Large informational barriers imply that outside bidders will neither have sufficient information to initiate a takeover, nor will outsiders generate a sufficient takeover threat to limit managerial discretion. Also, regulatory restrictions on entry and takeovers reduce competition for corporate control in banking. Thus, from many angles, the opaqueness of the banking industry along with pervasive government regulations severely limits effective corporate governance of banks.

We evidently have a serious problem in monitoring the managers of banks. The following comment, also from Caprio and Levine (2002), is of particular relevance to John Chant's paper.

> . . . large creditors, like large owners, may use their influence to shift corporate activities to reflect their owner interests, rather than maximizing the value of the firm.

How do large creditors and large owners do this? What does the bank official responsible for approving a large loan (and it will be a very senior official) get out of giving approval? And furthermore, large loans generally come before the board for review. What incentive is there for the board to approve a loan that is clearly not in the interests of the bank? And, if it is in the interests of the bank, what is the problem?

What if we move out of the comparative statics world that is generally used to analyze this problem into a dynamic one, where points in time matter? Think of a repeated game—when players interact by playing a similar stage game numerous times. Unlike a game played just once, a repeated game allows for a strategy to be contingent on past moves, thus allowing for reputation effects and retribution.

In this world, if the bank and the "related" corporation are in business over a multi-period horizon, then the conflict noted arises because the lender and the borrower may have different views of the probability that the firm will repay the loan. But this conflict arises at the operational level, when the loan is being evaluated. Unless this is a significant loan and a bank officer has approved the loan, it will not be brought to the board. (If the loan were turned down by the appropriate officer, who would probably be a very senior one, it would only be brought to the board by the company representative who would attempt to have the refusal overturned. In this case, the weight of the argument is against the loan, and it would be difficult to envision an argument that would persuade other members of the board to overturn the decision.) If the loan has been approved, then the "related" board member would not have to play a role unless board questioning made approval unlikely. Assuming the bank officer is respected by the board, there would be little incentive to do this.

Would the bank give the "related" borrower better terms on a loan than other borrowers, *ceteris paribus*? In a competitive world, there is an equilibrium rate that gives the bank a normal rate of return. During the adjustment process to the equilibrium rate, similar borrowers may obtain different rates. But a profit-seeking bank will readily lower its price for a loan to attract a customer, as long as the price charged will earn the bank "normal" profit. And in the case of a single loan, if a lower price will then attract related and future business, the bank is pricing in a broader format—looking at the returns the bank can earn from this borrower over time and across a number of activities. In this case, what does the analysis of the price of a single loan tell us?

What is the incentive to provide a loan on unfavourable terms to the bank? We need a theory of reciprocal favours. If the answer is incompetence on the part of the bank, there is no reason to expect "related" firms to be treated any better, or worse, than unrelated ones.

Furthermore, given the realities of board operations, what do we really expect from them? A recent Conference Board survey revealed that the average board meets about six times a year and spends approximately four hours per meeting. How much oversight is really possible?

What if we view the membership of boards as signals to the market about our relative success—our place on the totem pole? There is a limited supply of marquee directors relative to the demand. Banks, other financial institutions, as well as non-financial institutions, seek "esteemed" members of the business community to sit on their boards as a signal of the strength of these institutions. They will, of course, be institutions that obtain better loan terms and that garner valuable bank connections. What is the direction of causation?

References

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