

# THE INVOLVEMENT OF BANKERS IN THE CORPORATE GOVERNANCE OF NON-FINANCIAL FIRMS

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## **Abstract:**

*The core instability generated by a fractional-reserve banking system provides strong incentives for commercial banks to control the financial operations of large depositors as well as to supply financial support and even take the initiative towards the concentration of the industrial entities. Such an argument provides fresh insights regarding the historical trend of economic consolidations at the end of the XIXth century as well as what has been called financial capitalism. It argues that all the subsequent regulatory reactions missed a significant cause of the phenomenon of business consolidation in the global economy.*

**Key words:** *fractional-reserve banking, corporate governance, bankers in corporate boards*

**JEL classification:** *K21, N21, G21*

Fractional reserve banking is a form of commercial banking that dominates the contemporary law and practice of the banking industry. In simple terms, it is the system that allows financial depository institutions to grant loans from resources deposited by clients under the form of demand deposits. A demand deposit, as opposed to a time deposit, is a monetary deposit that allows the depositor to withdraw a ratio or the full quantity of money any time after the making of it. While time deposits allow such a withdrawal only at maturity, demand deposits do not have a specific maturity. Several economists (Ludwig von Mises, Murray Rothbard, Jesus Huerta de Soto and others) have argued that fractional reserve banking determines what could be called a double accounting of money: if a commercial bank grants loans to a client while it promises to meet any demand of withdrawal from the part of the other client – the depositor – it „multiplies” the money supply in the economy.

The risk of a sudden withdrawal of the resources held in demand deposits by clients is one of the core challenges to the business of commercial banking, in its fractional-reserve form. Besides other incentives, we argue that the attempt of the commercial banks to control the economic behavior of their depositors – especially large-scale depositors – is also one of the effects of this systemic instability of the fractional-reserve banking. It is even more pronounced in absence of central banking.

The attempt of the commercial banks to control the financial behavior of the depositors, which impacts their cash holdings in banks, is realistic only when the bank takes into consideration big depositors like business clients. Otherwise, it may meet not only formidable challenges in terms of costs dealing with each small depositor but also may put its reputation into jeopardy. Big business clients, on the other hand, have naturally large resources placed on demand and, maybe more importantly, their decision to suddenly change the depository institution where they hold cash may have, in a fractional-reserve system, a dramatic impact on the liquidity of that institution.

In this context, the depository institution has powerful incentives to attempt to influence the financial decisions of these big depositors. Such a motivation must be differentiated from those of controlling the opportunism of investment decisions of the depositors (Mulbert, 2006, page 19) or the ability of the shareholders to expropriate

resources because of the gaps in corporate law (Bachner, 2009). These are related from the quality of clients as debtors to the bank. For example, creditors attempt to reduce credit risk and avoid being expropriated by the adoption by their debtors of an increased-risk strategy in their investments. Memel and others argue that „*Relationship lending implies close ties between borrower and lender; this facilitates the information exchange between the two parties and thereby enables credit rationing to be avoided. Lenders invest in gathering information from their client firms, and borrowers are more inclined to reveal proprietary information*” (Memel, 2007, page 3). But it can be argued that this is another factor which deals with the risk-management of the assets of the bank, which could also be met in a 100% reserve-banking system. But the specific interest of the fractional-reserve banks is also targeted towards the risk management of the liabilities side of its balance sheet. It is additional to other concerns specific to banking as credit intermediation.

There are different entrepreneurial approaches a bank can take in order to mitigate that risk. It is differentiated not only by inner motivations but also by the legal approach:

1. develop „*relationship-based finance*” through which the commercial bank and depositor agree to informally alter their behavior in order to accommodate the preferences of the other party. Taking into consideration the long-term horizon of the relationship, depositors prefer to let the banks know *ex ante* their future important financial decisions. But there are also cases of “*opportunism*” or “*cheating*” (Williamson, 1985, page 47), when the client can get higher profits on a short term by abandoning the relationship and playing one bank against the other;

2. “*get a voice*” in the corporate board of directors (Black, 1992, page 811). As each business and strategic decision has an impact on the treasury of the company, being present in the corporate board of the depositor is a natural choice when banks want to be warned in advance of the future significant decisions of their client with impact on its resources placed on demand in the bank. The presence of the banker in the board of directors may pose costs to “*cheating*” from the part of the depositor or simply reduce the uncertainty;

3. take a control stake in the company. Such choice not only offers the bank “*a voice*” but also may allow it to influence the financial decisions of their client. Sometimes, in order to “*get a voice*” in the corporate board, a bank must have a control stake in that company;

4. take a direct investment position which qualifies the bank as an associate entrepreneur in that business. It may initiate strategic decisions of the company and even veto those that do not match its economic (and financial) interest. Larger the financial stake of the bank in the corporate client, more other factors may play a more significant role for the bank besides the liquidity problem. The bank becomes concerned with the economic risk of the business it shares the control and it assumes in this case the quality of entrepreneur in the sense that it advances present goods (capital) in order to gain uncertain future goods (profit). It assumes the uncertainty related to the preferences of the producers which the business serves. From a general perspective, Rothbard [2004, page 439] qualifies all creditors as being, in fact, from an economic perspective, associate entrepreneurs to a business: “*We must conclude that economically and even in basic law, there is no difference between shareholders and productive creditors; both are equally suppliers of capital, both receive interest return as determined on the general time market, both own their proportionate share of the company’s assets. The differences between the two are only technical and semantic*”. Such a conclusion can be qualified as an overstatement, especially from a legal perspective which is however relevant.

The fact that the commercial banking is strongly dependent on the economic

behavior of the large depositors has long been recognized in the banking industry. In fact, before the establishment of a central bank, governments significantly controlled the banking industry by the placement of Treasury resources in demand deposits in banks. It not only operated as an incipient central banking but put also banks in a weak position relative to government, making them dependent on it (Cleveland, 1908, page 120).

### **Bankers in corporate boards: the theoretical explanations**

The presence of the financial intermediaries in the corporate governance of non-financial organizations has been a continuously scrutinized issue in the political economy of the firm. The core arguments that have been advanced in this direction are usually differentiated by the perspective adopted. This could be the case of the non-financial entity and the bank itself while always, in the background, lies the interests of public policy.

The description of the motives of non-financial entities to invite a banker in their own corporate boards is more elaborated and the significant literature in this field usually pointed out in the following directions:

- Access to capital and liquidity: the long term relationship induces the bank to have a certain non-market (concessionary) approach to such a client in what regards explicit pricing and risk;
- A good advice in the financial management of the company: as the bank attempts to keep a certain reputation regarding its competences;
- A certification role (Kroszner, 2001, page 421);
- A preferential treatment in case of bankruptcy and reorganization, including the case of a general business bust: the bank can lose more than its credit, in the case that it holds also an equity participation so on;

When speaking of the involvement of the investment bankers in the corporate board of their clients, specially railroad companies, Carosso pointed out that *“the banker’s presence on the board facilitated sales of a road’s securities; it gave investors confidence that their interests were being better served; and appeared to constitute either an endorsement of the issue’s investment quality or practically guaranteed it”* (Carosso, 1970, page 32). On the other hand, *“the banker had the primary concern ... of warning against corporate policies that might lead to financial difficulties and of encouraging those that promoted profits and stability. Very often this meant endorsing more conservative solutions to problems and rejecting unfamiliar ones”*.

Obviously, all these objectives can be reached without necessarily an equity-holding of the bank in the industrial company but such an equity participation – or even a cross-equity one – provides stronger incentives for both entities to accommodate their strategic behavior. Some argue that this is an *“exchange of hostages”* (Perotti, 1992, page 45) situation while others qualify it as a partial integration of the entities. It is, for example, the historical case of keiretsu groups in Japan (Gerlach, 1992, page 105).

The motives of banks for a presence in the corporate governance of non-financial entities are somehow more confusingly assessed in the literature. Moreover, this seems to be, in certain cases, almost a paradox, given the significant costs, especially in modern times, implied by an active involvement, like the creditor liability imposed by the American legislation. They are usually:

- expand in size beyond the financial industry;
- hold captive the corporate client, denying access to competitive sources of capital and liquidity;
- managing the credit risk by monitoring the investment (and other financial) decisions of the borrower;

The body of the literature analyzing the motives of commercial banks to

influence the control of non-financial has ignored the interest towards risk-management of liabilities from the part of the bank.

**The involvement of fractional-reserve banks in the control of large industrial corporations: a quest for liquidity?**

Facing the challenges of the illiquidity risk, commercial banks have strong incentives to control the financial decisions of large depositors with impact on their liquidity and, in consequence, of their own liquidity. There are two effects of this control:

In the first case, banks prefer to have a stable pool of liquidity to call upon in case of emergency. *Ceteris paribus*, they prefer that – at least a part of – their large corporate clients hold a larger cash balance in demand deposits. From this perspective, the banks may prefer to transfer the obligation to provide liquidity to their own other depositors to the informal engagement of the business clients to maintain a higher liquidity in their own demand deposits. In fact, commercial banks transfer the “*opportunity costs*” associated with cash holding to their larger depositors. In this case, banks involved in the control of these clients may experience lower liquidity ratios while their corporate clients experience higher liquidity ratios.

For example, Fohlin found that in the period preceding the First World War, the German banks (subject to a universal banking regime which allowed the participation of banks in the ownership of non-financial entities) had lower liquidity ratios – measured by both cash/deposits and cash/assets ratios indicators – than the British banks, which choose to specialize and avoid performing both commercial and investment banking (Fohlin, 1998, page 38). It confirms this hypothesis that such universal banks, which were more capable in influencing the decisions of such clients, were experiencing lower liquidity ratios and, ultimately, reserves on demand.

Empirical studies that have attempted to demonstrate that non-financial entities with a banker presence in their corporate boards maintain a higher than the average liquidity ratio may be however in fault by an error in causality. In fact, both bankers’ presence in the corporate board as well as high liquidity ratios can be different effects of the same causal factor, which is a higher preference for liquidity of the management of the non-financial entity. Moreover, the comparison should always be *per a contrario*, that is, with what would have been the liquidity ratios of the entity absent the presence of the financial institutions in its corporate governance. Pointing to differences between the liquidity ratio of a particular company and the industry average, for example, can miss other factors such as subjective preferences of the management of that company towards liquidity.

In the second case, banks will not always prefer that all of their corporate clients have a higher liquidity ratio by holding extra-cash in demand deposits. The simple fact that the business decisions of these clients – as depositors – are somehow controlled or at least anticipated by banks through their insider presence provides them with a powerful illiquidity risk-reduction device. This is by itself rewarding. In this case, in such corporate clients, liquidity can be even lower than in the case of other categories of depositors.

**Conclusions**

The causes of the involvement of banks in their corporate clients can be, in consequence, extremely varied and, at some points, apparently contradictory. But the illiquidity risk-reduction mechanism remains and, in the case of fractional-reserve banking, one of the core drivers of banks’ behavior. The simple preference of the banks demonstrated by their shareholding or presence in corporate boards cannot but confirm the illiquidity-risk management hypothesis.

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