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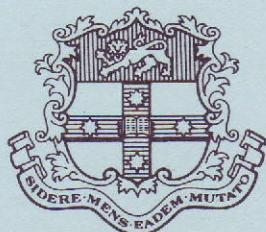
Prudential Regulation of
Bank Ownership and Control

by

W.P. Hogan and I.G. Sharpe,

No.122 January, 1989.

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1. Introduction

The purpose of this paper is to analyse the significance of controls on bank ownership to the workings of prudential regulation. Renewal of interest in the topic, which was the subject of intense debate in the late 1940s, has arisen with the opening up of the Australian financial services sector to new bank participants in 1985 and the abandoning of many controls on the conduct of banking and foreign exchange activities. In this environment concern for prudential behaviour largely reflects the statutory obligations of the Reserve Bank of Australia (RBA) to protect bank depositors. This is one of three objectives of prudential policy being pursued by the RBA, the other two being maintaining the integrity of the payments system and the stability of the financial system as a whole. (Johnston, 1985, p.7)

The paper is arranged in the following way. Section 2 provides an historical perspective, albeit a condensed one, on prudential regulation of bank ownership in Australia. This is followed by an analysis of economic considerations bearing upon restraints on bank ownership. Given those perspectives, the available evidence about the impact of ownership on banking activities is examined in Section 4. The concluding segment draws some implications from the theoretical analysis and the applied studies.

2. Historical Development

Examination of bank ownership restrictions in Australia reveals both prudential and national interest considerations, the latter including foreign ownership. These restrictions originated in the 1945 Banking Act and were incorporated later in Section 63 of the Banking Act 1959. They require the prior consent of the Federal Treasurer before a bank may:

- i. sell or dispose of its banking business by amalgamation or other means;
- ii. enter into a partnership with another bank; or
- iii. effect a reconstruction.

Furthermore Commonwealth Government policy from 1945 was against the granting of any further authorities to foreign participants for the conduct of banking business in Australia. (Snedden, 1971; p.2717)

These provisions were deemed inadequate in the context of a potential takeover early in 1970 of the Bank of Queensland, then known as the Brisbane Permanent Building and Banking Company Limited. The response to this prospective takeover came in May 1970 when the then Federal Treasurer announced his Government's intention to bring down legislation giving powers to control the acquisition by domestic or foreign interests of large shareholdings of banks incorporated in Australia. The original aim was to ensure that the Government had similar powers to control changes in ownership of existing banks as it had through Sections 8 and 9 of the Banking Act in authorising new banks. That is, "the Government would need to be fully satisfied that the applicant company has the financial strength, and the persons in a position to control or influence its operations a standing, commensurate with the responsibilities involved in operating an authorised bank". (Bury, 1970)

The legislation, known as the Banks (Shareholdings) Act 1972, restricted holdings by a person or corporate entity and associates to 10 per cent of the equity capital outstanding subject to approval of any additional proportion by the Governor-General in Council. In the decade following the proclamation of the Act no new bank authorities were granted while the only amalgamation of an existing bank involved the Bank of Adelaide which was merged under duress into the ANZ Banking Group in order to protect its depositors. Also worthy of mention was the repatriation of the ANZ Banking Group in August 1976 when the domicile of the head office shifted from London to Melbourne. By

shifting the country of incorporation to Australia, the change conformed with long-standing policies for Australian ownership in banking.

When reporting in September 1981, the Committee of Inquiry into the Australian Financial System, familiarly known as the Campbell Committee, rejected the need for ownership controls and recommended repeal of the Bank (Shareholdings) Act 1972. It argued, but without evidence, that:

- i. wide dispersion of ownership might give unwarranted security of tenure to bank management and thus contribute to inefficiency and inhibit innovation;
- ii. substantial shareholders would be able to contribute additional capital to a bank more effectively than many small shareholders;
- iii. there are no obvious prudential reasons for restricting ownership participation should an effective general prudential arrangement be in place; and
- iv. if market power is of concern in an imperfectly competitive financial services market, this concern may be met more appropriately through the Trade Practices Act rather than prudential regulation and supervision. (Committee of Inquiry into the Australian Financial System; 1981, pp. 298-299)

While recommending repeal of the Banks (Shareholdings) Act, the Campbell Committee went on to propose that the RBA should be fully aware of the identity of substantial shareholders, defined as 10 per cent or more of the voting rights, and be empowered to order divestment of shares in excess of the 10 per cent benchmark where this would be in the best interests of depositors. This is a curious recommendation. The Campbell Committee, having argued against specific ownership controls in the presence of effective general prudential arrangements and trade practices legislation, seemed to be hedging its position. Explanations for this apparent confusion, not spelt out by the Campbell Committee, could lie in a lack of confidence in the effectiveness of general prudential arrangements or a concern that the initial recommendation

would abrogate to the Trade Practices Commission the determination of steps necessary to protect depositors where the RBA has specific legislative responsibility. Again, the Campbell Committee was silent on procedures whereby divestment could be secured.

In these circumstances it is not surprising that the Review Group on the Australian Financial System, familiarly known as the Martin Group, examined further the role of controls on bank ownership. The Martin Group, in its December 1983 Report, offered five grounds for specifying a wide dispersion of bank ownership:

- i. avoids control of a bank's activities by one or a few interested parties;
- ii. protects depositors against one or a few dominant shareholders using the bank's resources to further their own-interests;
- iii. ensures the bank's viability independent of the particular interests of a major shareholder or shareholders;
- iv. ensures the continuity and reasonable independence of management; and,
- v. facilitates the raising of capital when required. (Report of the Review Group, 1983, pp.56-57)

The Martin Group acknowledged the importance of a stable banking system when stating, "... undoubted confidence in banks is crucial to a well-functioning and stable financial system". Furthermore this Group considered that a system stability objective could be inconsistent with an active takeover market for bank shares. (Report of the Review Group, 1983, p.53)

The Martin Group also listed some reasons for eliminating restrictions on ownership of banks including:

- i. they restrict entry of new banks and increase concentration;
- ii. the minimum requirement of eleven unrelated shareholders restricts the scope for initiating proposals for a new bank;

- iii. an innovating shareholder could not expect to gain more than 10 per cent of the shares which would be a disincentive for sponsorship;
- iv. wide dispersion of ownership works against takeovers and mergers thus securing advantages for existing management which may in turn inhibit thrusts for greater competitive efficiency; and,
- v. a few large shareholders may more easily and quickly generate additional capital. (Report of the Review Group 1983, pp.56-57).

The Martin Group judged that while the Banks (Shareholdings) Act could provide depositor protection through ownership dispersion, it also constrained entry of new banks. Hence, while arguing for retaining the Act, amendments to provide greater scope for administrative flexibility were proposed. Among suggested amendments were:

- i. the threshold in the Act for new banks be increased from 10 per cent to 15 per cent but be maintained at 10 per cent for existing banks;
- ii. no single party or an associated group or groups of parties be allowed to hold an interest of 10 per cent or greater in more than one bank; and,
- iii. increases in an equity interest of 3 per cent or more in a bank be subject to approval by the RBA. (Report of the Review Group 1983, pp. 56-57).

Subsequently, the Government went much further in relaxing ownership requirements than was suggested by the Martin Group. The changes were embodied in the 1985 amendments to the Banks (Shareholdings) Act which provided for two tranches of shareholdings. The 10 per cent shareholding was preserved as a benchmark with provision for an additional 5 per cent holding where it was not against the national interest as perceived by the Federal Treasurer. A person or corporate entity seeking to hold more than 15 per cent would be required to show that approval would be in the national interest; with this category the

onus of proof was on the applicant and not the Federal Treasurer. These amendments made explicit what had been dormant in the original 1972 legislation. Should it have wished to do so any government could have authorised shareholdings greater than 10 per cent as was made explicit by the then Federal Treasurer in his second reading speech, "The Bill does provide, however, for the Government to have an opportunity to consider specific applications. Any interests seeking to acquire a controlling stake in a bank would need to demonstrate, for instance, that the acquisition would not be contrary to the national interest". (Snedden, 1971, p.2718)

Nevertheless these 1985 amendments signalled a watershed in the stance on bank ownership and control accepted by successive governments since 1945. From 1985 any form of bank ownership was open for consideration. While the steps taken were necessary to bring more competition and flexibility to banking arrangements, the extent of the shift in policy was remarkable even by comparison with recommendations from the Martin Group let alone the Federal Treasurer's own position the previous year. In September 1984 he indicated that the national interest involved, "... taking account of the importance of the banking system to the community and the need to ensure the protection of depositors..." and that this required there to be a wide dispersion of proprietors in each bank. (Keating, 1984) However, in authorising new banks in 1985 wholly-owned subsidiaries and joint ownership were permitted.

A deficiency in the Banks (Shareholdings) Act emerged in 1986 with the recognition that ownership is not necessarily synonymous with control. Specifically, the possibility that a shareholder could significantly influence bank management through a disproportionate representation on the Board, while meeting the requirements of the Banks (Shareholdings) Act, prompted the RBA to clarify its attitude towards the ownership and control of banks. Its view is that "no single shareholder (or group of associated shareholders) should be in a position to exercise an undue measure of control or influence over the policies or operations of the banks. ... The objective is to ensure

that banks pay due regard to the interest of depositors (and this is likely if the bank's) policies and operations have the support of the broad range of its shareholders. (Hence) control of a bank should be in the hands of a board of directors which is representative of the shareholders as a whole". (RBA January, 1987, p.24) As a general rule the Reserve Bank expects a shareholder with up to 15 per cent of voting shares in a bank to be represented by no more than one director in a board of six or fewer directors or by two directors in a board of seven or more.

Interest in the specific purposes of these restraints on equity participation arose again with the decision of the Federal Treasurer to permit David Jones Ltd. to increase its holdings in the National Australia Bank(NAB) to 15 per cent of the total outstanding equity. Under the Banks (Shareholdings) Act such an application can only be refused if the Treasurer is satisfied that it would be against the national interest. A revealing aspect of the Treasurer's decision was the linking of this national interest requirement with "established banking policy requirements" under the Banking Act. As described above, in the interest of depositor protection, the RBA requires that a shareholder and associates should not be in a position to control a bank by reason of the increased shareholding. Thus the Treasurer advised that the RBA in its prudential supervision is "to ensure that David Jones Ltd. does not exercise, either by itself or in concert with other shareholders, an undue measure of control or influence on the policies and operations of NAB which could be detrimental to depositors' interests". (Keating, September 1987) In essence, the national interest criterion of the Bank (Shareholdings) Act has been used to incorporate measures of depositor protection provided under the Banking Act.

However, concern for the national interest extends beyond a concern for depositor protection. When pointing out that the exemption could be revoked, the Treasurer noted this could occur "in a situation where it is considered that the bank concerned has a number of substantial shareholders with similar interests which could be in conflict with those of the bank's depositors or other clients." At issue

here is not just the possible undue influence of a large shareholder in preferred access to funding. There are the more subtle influences upon the borrowing possibilities of rival firms to the large shareholder, and access to information on a bank's clients who might be possible targets for acquisition or whose condition might furnish insights on the workings of competitors. Moreover, these effects on banks' borrowers may be more pronounced for small or medium size borrowers with limited access to direct financing markets, domestically and abroad.

In summary, this survey of the historical development of bank ownership restrictions in Australia draws attention to four important features:

- i. The main focus of bank ownership restrictions between 1985 and 1987 shifted from the prevention of foreign ownership towards the joint objectives of depositor protection and system stability;
- ii. There also appears to be an emerging concern for the protection of bank clients other than depositors, specifically borrowers;
- iii. The RBA views diffuse ownership of banks as a means of achieving the objectives of depositor protection and system stability; and
- iv. Recognition that diffuse ownership may inhibit new bank entry, and hence the efficiency of the financial services industry, has led to the adoption of a more flexible regulatory approach towards bank ownership in which the new banks are treated differently to the established ones.

Finally, the Federal Treasurer, in announcing new arrangements for bank ownership, has been much more specific in stating the concerns about the influence of ownership than his predecessors. In this respect the statements are a welcome clarification for understanding the directions being taken in banking ownership policy.

3. Economic Analysis

The suggestions on bank ownership and control offered by the Campbell Committee and the Martin Review were not supported by evidence and the analysis was limited, being more implicit in the commentaries advanced rather than specified in a systematic way. Yet this lack of explicit treatment should not be viewed too critically because there has, until quite recently, been very little attention given to examining the role ownership plays in relation to the stability of the banking system and the protection of depositors both of which are the essence of prudential regulation in the Australian setting.¹

a. Ownership and Value Maximisation

There is now a developing economic literature focusing on organisational roles of large-block shareholders in firms. From an economics perspective the central issue is whether concentrated ownership increases or decreases the value of the firm. In this respect, there are four main propositions:

- i. The monitoring hypothesis;
- ii. The convergence of interests hypothesis;
- iii. The expropriation hypothesis; and
- iv. The entrenchment hypothesis.

The first two hypotheses suggest that concentrated ownership is value increasing while the latter two suggest a value decreasing role of concentrated ownership. Value increasing behaviour should reduce the probability of bank failure, thus contributing to the prudential objective of system stability.

Central to any assessment of ownership and control is the relationship between proprietors and management. Management acts as agent on behalf of proprietors and the question is the extent to which a

concentrated ownership, that is few proprietors, is consistent with maximisation of the value of the firm.

The definition of an agency relationship is the establishment of an explicit or implicit contract by one or more persons as principals, in this instance the proprietors, engaging another person or group to act as their agents, in this case as management, in the pursuit of activities on their behalf. (Smith, 1987)² This delegation involves costs for enforcing the integrity of the contracts and hence of the activities of the agents. In effect these contracting costs are agency costs.

Agency costs cover the expenditures on monitoring the performance of management to pursue the interests of proprietors. These may be performance-related rewards additional to salary or options to purchase equity. Yet there are limits to enforcement realised when the costs of monitoring exceed the likely losses arising from non-compliance of management.³ Thus there are always some agency costs, the extent of which may be most dependent upon the superior knowledge, or informational asymmetry, of management to that of owners and potential owners.

The scope for informational asymmetry brings to the fore the connection between diffused and concentrated ownership in relation to agency costs.⁴ Where managers have great opportunities to depart from maximising the value of the firm a concentrated ownership might be a means of containing agency costs. Nevertheless there are a variety of market forces which restrict these agency costs such as freedom of entry to markets for goods and services and an effective market for corporate control. There are also possibilities for substituting internal monitoring systems for market influences to control managerial behaviour including managerial incentive or bonding schemes and the use of external directors. In this context such directors should be viewed as monitors for the proprietors.

Given these circumstances one of the major tasks of ownership in a modern firm is the monitoring of management, the so-called monitoring hypothesis. This approach suggests that concentrated ownership may be value increasing. Large shareholdings, in contrast to diffuse ownership, may curtail agency costs by engaging in "active" monitoring of management. Moreover such ownership may go further by fostering the market for corporate control to more effectively monitor management; see Demsetz and Lehn (1985), Shleifer and Vishny, (1987) and Garvey (1987). The presence of large shareholdings may "facilitate third-party takeovers by splitting the large gains on their own shares with the bidder". (Shleifer and Vishny, 1986, p.463)

Moreover the more diffuse the ownership of a firm, the greater the incentive for individual proprietors to shirk the monitoring responsibility because it is unlikely that any one of the many proprietors will reap the rewards or benefits commensurate with his or her monitoring effort. In other words, the benefits would be spread across all proprietors and would not reflect the distribution of individual monitoring costs. In this situation responsibility falls heavily on directors, acting as representatives of proprietors, to monitor the activities of management. Directors are required to discharge their duties in a responsible manner and are open to legal censure should their efforts be proven inadequate.

The second hypothesis, the convergence of interests of hypothesis as enunciated by Jensen and Meckling (1976), is closely linked to the monitoring hypothesis. As managers' ownership interest in the firm increases, the interests of managers and proprietors become increasingly aligned. In the extreme a single proprietorship would be synonymous with management. The costs of deviation from value maximisation declines as management ownership rises because management are less likely to expropriate corporate wealth when they are bearing a larger share of these costs. Hence in this hypothesis, market value increases with management ownership.

In contrast, the expropriation hypothesis as formulated by Fama and Jensen (1983) recognises various ways in which management who, through share ownership control the Board of Directors, may expropriate corporate wealth. The various mechanisms through which the value of the firm may be diminished include payment of excessive salary, sweetheart deals with related companies and investment in negative NPV projects. It is important to note, however, that if a shareholder wishes to expropriate corporate wealth, then there is little point in holding more than the minimum number of shares necessary to secure control. (Holderness and Sheehan, 1988)

The final hypothesis, the entrenchment theme, is best specified by Stulz (1988). This approach recognises the possibility that large managerial ownership could protect the manager from dismissal and hence produce behaviour which could reduce the value of the firm. This behaviour may be associated with management resisting a value-increasing takeover offer so as to protect their jobs.

The main "asset" of management is its human capital reflecting accumulated work experiences, some part of which is specific to the firm, and therefore not readily transferable without some transactions cost. In this circumstance management may be more risk-averse than proprietors who may more readily diversify their assets. Greater risk aversion would be reflected in moderating the gearing of borrowings, caution in the pursuit of new activities and restraint in the acceptance of perquisites.

In section 4 some empirical evidence as it relates to the four hypotheses is examined.

b. Supply of Equity Capital

Both the Campbell Committee and Martin Review Group refer to the relationship between ownership concentration and bank responsiveness to regulatory calls for additional capital. The Martin Review Group summarised two polar views on the issue; diffuse ownership spreads the

not for raising additional capital while concentrated ownership may be more effective in generating additional capital quickly.

It is difficult on theoretical grounds to distinguish between the polar views. If financial markets work sufficiently well to be an effective means of allocating investment funds, then neither diffuseness of ownership nor concentrated ownership should be barriers to generating new capital provided the expected return/risk combination of the new capital is appropriately priced.

Diffuseness brings diversification advantages associated with capital raisings from a diverse population. Flexibility is provided for in Australian listing requirements which permit private placements, such as with dividend reinvestment plans, up to 10 per cent of the issued share capital each year.

The advantages of concentration of ownership appear to hinge on the financial strength of the major shareholder or shareholders. However a major shareholder whose financial strength is positively correlated with the net worth of the bank concerned may not be well-placed to contribute new capital in times of financial strain. Yet this is deceptive for, in an efficient market, a major shareholding may be acquired by another party or parties with adequate financial resources to take advantage of the perceived favourable opportunity for equity participation arising from the need to inject new capital into the bank.

An important reservation associated with the argument on this last point is where the large shareholder is unwilling to forego control. That reluctance is itself witness to the advantages of having a major shareholding. A further reservation, which should be carefully distinguished from the preceding one, arises if the market is inefficient thereby preventing the ready liquidation of a large shareholding.

All told, judgments on the relative merits of diffuse and concentrated ownerships in providing new capital are fraught with

difficulty. There is no direct empirical evidence linking ownership structure to the supply of equity capital.

4. Empirical Studies

Evidence on the relationship between ownership concentration and banking performance is almost inevitably drawn from the United States. Even so the extent of empirical work is limited. What evidence that is available bears upon the existence of a market premium for corporate control, the relationship between ownership structure and the value of the firm, and the determinants of ownership concentration across firms.

a. The Control Premium

Based upon a large sample of banks in the U.S. Tenth Federal Reserve District for the 1964-1975 period, Meeker and Joy (1980) test the hypothesis that controlling shares sell at a premium price relative to shares being only a minority interest. For such a premium to exist:

- i. control must provide special benefits not available to minority shareholders;
- ii. control group members must, individually, be able to exploit those benefits of control; and
- iii. control shares must be effectively isolated from minority shares in the market". (Meeker and Joy, 1980, p.298).

The results are consistent with the hypothesis; there were premiums of 50 to 70 per cent on controlling shares. In addition, where the controlling shares were held by smaller groups of people, the premium was highest. Looser coalitions involving more participants were still prepared to pay a premium but not so high as with concentrated ownership. Hence the implications are that control is valuable and has rewards not enjoyed by minority shareholders.

b. Ownership and Firm Value

It is another matter altogether to spell out how value is derived from a controlling interest in a bank. Four propositions were identified earlier being the:

- i. Monitoring Hypothesis;
- ii. Convergence of Interests hypothesis;
- iii. Expropriation Hypothesis; and
- iv. Entrenchment Hypothesis.

The few empirical studies relating ownership concentration to operating efficiency, both within banking and across industries, are inconclusive. Hannan and Mavinga (1980), when developing a model of an imperfect banking market, advance the hypothesis that the degree to which management may engage in non-profit maximising behaviour, that is, expense preference behaviour, is inversely related to both the degree of owner control and the amount of competition in the banking market. Based on a study of 365 banking firms operating in a number of identified local markets within Pennsylvania during 1970, their results are consistent with the hypothesis that owner control or concentrated shareholdings restrain managerial behaviour. However, their conclusions rest upon evidence of higher spending on occupancy costs and furniture and equipment in managerially-controlled banks and not upon excess labour costs. As this type of behaviour is what one would expect in circumstances of non-price competition found in imperfect markets (Shepherd, 1985, p.239), no firm conclusion can be drawn on the scope for management to extract higher salaries and related benefits in banks with widely diversified ownership.

A subsequent study by Glassman and Rhoades (1983) of 1405 U.S. banks in 1975 and 1976 found that owner-controlled banks tend to have higher profit rates than manager-controlled banks. Yet again results of their tests linking cost permissiveness to management control were mixed. Expenses on premises were found to be significantly related to management control. With no significant relationship being detected for

employee expenses, their results are no less inconclusive than those of Hannan and Mavinga listed in the preceding paragraph.

Similar results are evident in multi-industry studies. For example, Demsetz and Lehn (1985) examine the Berle and Means (1933) and Galbraith (1967) hypothesis about profitability and ownership concentration being positively related. They find no evidence of a relationship in a multi-industry U.S. study. They suggest this result is consistent with Demsetz's (1983) hypothesis that any increase in profit associated with an increase in ownership concentration would be offset by higher capital acquisition costs or other costs.

In the context of U.S. banking, Brickley and James (1987) examine Williamson's (1983) hypothesis that the market for corporate control and a "strong" board of directors which is independent of management are substitutes in that they each provide a means of monitoring agency costs arising from non-profit maximising behaviour of management. Their findings are consistent with the hypothesis that the market for corporate control, use of outside directors, and concentrated ownership are means for controlling managerial behaviour but are not perfect substitutes. However, a difficulty in the empirical analysis is controlling for other factors which may bear upon the use of outside directors. For example, outside directors may be enlisted for strategic planning, customer development or loan evaluation purposes rather than, or additional to, management monitoring. These alternative objectives cannot be observed in the published data used in this study, even though they are consistent with monitoring of management.

A very recent study by Holderness and Sheehan (1988) examines the position where concentrated ownership is majority ownership represented by at least half the equity. This study is general in its coverage not being confined to banks. Their interest in concentrated ownership is to judge the effects of concentrated ownership where most wealth effects of management decisions would be internal, majority control insulates against hostile takeovers, and ownership, directors and management are synonymous. In a comparison of majority shareholder firms with

diffusely-held firms, they find that chief executive salaries are statistically equivalent for the two samples. Moreover, salaries of individual majority shareholders where they were also the chief executive officers, were marginally higher than their counterparts in diffusely-held firms. However, the result appears to have been driven largely by outliers or skewed data. The authors note that it is hard to imagine majority shareholders investing an average of \$66 million to achieve majority ownership in order to achieve excess annual compensation of \$23,000 to \$34,000.

Finding little evidence in executive salaries to support either the expropriation hypothesis or the monitoring hypothesis, Holderness and Sheehan compare investment policies, accounting rates of return, and Tobin's Q ratio for majority shareholder firms with those of diffusely held firms. The data suggests that majority-owned firms have identical investment policies to those of diffusely-held firms and that majority shareholders have no pronounced effects on accounting returns or Tobin's Q. Moreover, should the main interest of majority or concentrated shareholders be the expropriation of corporate wealth then the expectation would be for the gradual elimination of the firms concerned, at least from public listing and trading of shares. Holderness and Sheehan note that this has not taken place. As a whole this evidence is inconsistent with the expropriation hypothesis.

Morck, Shleifer and Vishny (1988) examine the relationship between management share ownership, defined as that of board members, and the value of the firm. The study is similar to that of Holderness and Sheehan in that it is not specific to banks and rests upon the use of Tobin's Q ratio as the proxy for market valuation of a firm's assets. It draws upon a 1980 sample of 456 companies where the shares held by board members and corporate officers can be identified. Their results are complex; where board ownership is between 0 and 5 per cent there is a positive correlation between ownership and Q, this relationship is negative though less pronounced in the range between 5 and 25 per cent, and then there is a positive relationship again where board holdings rise above 25 per cent.

It is important to note, however, that the measures of firm performance used by Holderness and Sheehan and Morck, Shleifer and Vishny are based on accounting data and hence must be viewed as noisy signals of performance. Furthermore, use of Tobin's Q ratio is likely to be biased against finding a positive value-increasing effect associated with concentrated ownership. This is because the Q ratio does not incorporate any premium associated with a control block of shares. Holderness and Sheehan emphasise that the larger the control premium, the greater the understatement in the market value of majority shareholder firms in their tests.

Evidence relating to the entrenchment hypothesis is also available from the Holderness and Sheehan study. They find, contrary to this hypothesis, that there are at least as many transfers in control in majority shareholder firms as in firms with diffuse ownership. Furthermore, the type of majority ownership appears to be of some relevance in that the frequency of transfers of control is greater when corporations are the majority shareholder. Moreover, where members of the family which founded the firm are involved in management, the value of Tobin's Q is adversely affected.

To summarise, empirical research into the relationship between ownership concentration and the value of the firm is in its infancy. Generally speaking, there is little evidence available at present of the existence of either a systematic positive or negative relationship between these variables. Moreover, much of the existing research suffers from the use of accounting-based rather than market-based data and this may induce a bias against finding a positive relationship as predicted by the monitoring or convergence of interest hypotheses.

c. Determinants of Ownership Structure

In contrast with the empirical studies examined above which focus on the role of ownership structure in explaining managerial performance and the value of the firm, Demsetz and Lehn (1985) endeavour to explain

differences in ownership concentration across firms in terms of their value-maximising size, control potential, and the presence of regulation. On size, they argue that the larger the firm, the more diffuse ownership structure may be because of the existence of a wealth constraint and risk averse behaviour of individual investors. Moreover control in large firms requires a smaller proportion of the shares than in smaller firms. Control potential relates to the profit to be gained from exercising more effective control over management behaviour and hence relates directly to the monitoring hypothesis. In general, the greater the uncertainty in the firm's operating environment, reflected in profit instability, the greater the likelihood of agency costs and the greater the payoff to owners in maintaining tighter control. Finally, they argue regulation is a substitute for owner-based monitoring and hence regulated industries may experience more diffuse ownership structures. The empirical analysis was performed on a 1980 sample of 511 firms drawn from major sectors of the U.S. economy. Their results were consistent with the principal hypotheses, providing some support for the monitoring hypothesis. It is important to note that this study does not differentiate between corporate and individual owners of shares. Holderness and Sheehan subsequently found that the inverse relationship between ownership concentration and firm size only holds where the majority shareholding is held by individuals.

The Holderness and Sheehan study also speculates on the underlying motivation for majority shareholdings. Noting that 90 to 95 per cent of majority shareholders have directorships or are officers of their firms, and that there is little evidence of expropriation, Holderness and Sheehan conclude that there must be benefits in managerial large-block ownership which motivates majority shareholdings. Typically, majority shareholders lead management teams. However, the nature of the benefits is not clear because the results of the study by Demsetz and Lehn, to which reference has been made earlier, show no tie between ownership concentration and profitability.

d. Summary

The empirical evidence, reviewed in this section, is drawn from United States data. As the institutional structure of banking in Australia differs greatly from that in the United States, care needs to be taken in extrapolating these results to the Australian environment.⁵ Moreover, the United States evidence is incomplete and has obvious shortcomings. Nevertheless, the following tentative conclusions may be drawn. First, controlling interests in banks appear to have value above that of minority interests though the reason for the premium is unclear. Second, management costs arising in agency situations may be no less amenable to control in firms with diffuse ownership than in those with concentrated ownership. But the evidence is inconclusive hampering any firm conclusions. Thirdly, consistent with the monitoring hypothesis, ownership structure is more concentrated in firms with volatile profits. Fourthly, a concentrated ownership should be analysed for its origins in individual or corporate holdings as well as family connections at the time of establishment of the firm. Fifthly, the evidence is broadly consistent with the hypothesis that regulated industries have more diffuse ownership. Finally, there may be benefits in managerial large block ownership which motivates majority shareholdings, an interpretation quite consistent with the evidence on the premium paid for controlling interests in banks.

5. Conclusion

Australian governments have for more than a quarter of a century linked the supervision of bank ownership and control to prudential objectives associated with depositor protection. More recently supervision of ownership and control has been linked to other objectives such as accessibility of banking services for all classes of borrowers and preservation of system stability. Even so, the issues bearing upon ownership restrictions raised in this paper do not unambiguously support the current regulatory position.

Both the theory and empirical evidence relating ownership concentration to the prudential objective of system stability are inconclusive. It is not possible to determine, a priori, the expected sign of the relationships between ownership concentration and both the supply of equity capital and the value of the banking firm.

In a broader study of the relationship between market discipline and administrative controls associated with Australian prudential regulation, Hogan and Sharpe (1988) have shown how bank regulation has effectively eliminated market discipline on bank risk-taking through the deposit and debt markets. The ownership controls discussed in this paper could further accentuate this problem through restricting the possibility of large shareholders monitoring and thereby disciplining bank management. Moreover, existing prudential regulation creates a "moral hazard" problem; that is, by failing to relate the regulatory costs incurred by individual banks to their risk exposure, the regulation may induce increased risk taking. As the theory and empirical evidence considered in this study fails to establish a clear-cut relationship between ownership structure and bank risk, ownership controls cannot be justified as a means of overcoming the moral hazard problem. Indeed, Hogan and Sharpe (1988) argue that there are more efficient means of eliminating this problem. Specifically, these concerns could be met by the imposition of capital requirements adequately reflecting risk exposures or, perhaps better still, of risk-weighted deposit insurance premiums.⁶

Footnotes

1. The stated objectives of prudential policy in the Australian context have been critically analysed in another paper. (Hogan and Sharpe, 1988 Section 3). The conclusion is that prudential policy should be directed to the objective of maintaining the stability of the financial system rather than on depositor protection. This focus might well be supplemented by measures designed to overcome distortions created by transactions costs and imperfect information.
2. The commentary is restricted to agency relationships between owners and management. The broad concept of agency incorporates all relationships embodying explicit or implicit contracts to perform on behalf of others; for example, between owners and debtholders.
3. Agency costs arise from three main sources: i) consumption of various benefits or perquisites by management; ii) transfer of wealth from debtholders to owners by undertaking high risk activities under limited liability; and, iii) information asymmetry where the management possesses superior information and the signalling of that information is costly. (See Barnea et al., 1985, p.31)
4. The influence of asymmetric information extends well beyond what is discussed here. If each agent is not certain what other agents in the market know and each is uncertain as to what every other agent knows what that agent knows, then the derivation of probable outcomes in markets is handicapped. Perceptions of appropriate risk premiums may be misplaced leading to higher costs for the users of banking services. (see Postlethwaite, 1987)
5. With relatively few banks in Australia when compared with the United States, similar investigations in this country to those reviewed in this paper would be handicapped by a quite limited statistical base.
6. The risk-adjusted capital adequacy requirement perceived for this purpose should not be identified with the new risk-weighted capital adequacy provisions announced recently by the RBA (RBA August 1988). These new requirements encompass credit risk in an ad hoc manner and do not incorporate adjustments for interest rate, liquidity or foreign exchange risks. To apply the term risk adjustment to this procedure is deceptive if not grossly misleading. See Hogan and Sharpe (1988) for a critical assessment of risk-weighted capital adequacy requirements.

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