



## **BANK RELATIONSHIPS AND CORPORATE GOVERNANCE: A SURVEY OF THE LITERATURE FROM THE PERSPECTIVE OF SMEs**

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### **Abstract**

The aim of this work is to review and systematise the literature on how bank relationships, corporate governance and the interdependence between them can influence corporate performance. The banks and the enterprises establish relationships which enable them to overcome problems of asymmetrical information thereby alleviating difficulties felt in obtaining financial resources. In addition, the specificities that SMEs face, namely their ownership structure, as they are often owned and controlled by families, lead us to study the role played by corporate governance and the various control mechanisms in achieving corporate objectives. These features confer an important supervisory role on credit institutions which stem from the information they hold.

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## 1. INTRODUCTION

In recent years small and medium-sized enterprises (SMEs) have been the object of a number of studies for their capacity to create jobs and for the role they play as creators of wealth. In market systems, questions of survival, complexity and vitality of the corporate environment have required an increasingly deep knowledge of organizations as well as the variables or factors which one knows as the key drivers of performance.

Several authors have highlighted internal factors which affect corporate performance with an emphasis on: bank relationships (Degryse and Ongema, 2001; Ongema and Smith, 2001), corporate governance (Bhagat and Bolton, 2008), human resources (Rogoff, Lee and Suh, 2004), marketing Kara, Spillan and Deshields, 2005), quality, innovation, technological resources (Donovan, 1996), cultural values and the systems of information (Tse and Soufani, 2003). This study focuses the first two of these.

Difficulties felt by SMEs in obtaining the financial resources needed to finance operations and expansion, along with scarcity of access to capital markets has led the credit market to become their primary source of financing. The study of intermediation by banks is, therefore, particularly pertinent especially to assess the contribution of such intermediation to corporate performance (Boot, 2000). The importance of the relationships with their creditors is positively related with information asymmetry.

Meanwhile, SMEs have experienced several transformations as a result of: i) a growing separation between ownership and management and ii) the opening of their capital to external investors. This places them in a new paradigm which requires how the firm's governance affects performance to be assessed. As Denis and McConnell (2003) claim this revolves around two great currents of research: i) one concerned with the variables related to ownership structure and ii) another highlighting more institutional aspects such as those connected to the board and the CEO.

Furthermore, a greater involvement of financial entities within firms is occurring in Europe, either as creditors and shareholders, or as participants in management (Byers, Fields and Fraser, 2008).

The specificities which are inherent to SMEs – in terms of informational asymmetry, of the value of the information produced, and of vested interests which at times conflict the firm's administration with its creditors and shareholders' – proffer a determining role to the integrated study of the banking relationships and corporate governance so as to understand corporate performance.

The aim of this paper is to systematise at the theoretical level the current state of research with regards to the interdependence of bank relationships, corporate governance and performance, an area of research which is relevant to SMEs.

It is organized as follows. Section 2 characterizes the bank relationship, identifies the benefits and costs involved and analyses its impact on corporate performance. Section 3 reviews the theoretical foundations of corporate governance, highlighting control mechanisms, governance models and their relationship to corporate performance. Section 4 discusses the relations between the previous two dimensions – bank relationships and corporate governance – is analyzed in terms of performance. Finally, section 5 provides concluding remarks.

## 2. BANK RELATIONSHIPS AND PERFORMANCE

The question of the bank relationship is a complex but unavoidable subject when one wants to analyse companies' financial performance insofar as it conditions financing.

The bank relationship is generally associated with the information relationship which is established between bank and customer (especially the credit customer). The relationship influences proposed contractual conditions for various banking products and services obtained or to be obtained by the customer. Boot (2000, p.10) defines the bank relationship as "the supply of banking/financial services rendered to the customer (enterprise) by a bank (financial intermediary) which invests in collecting specific information (private information) to assess its Profitability, taking into consideration multiple interactions held over time". Degryse and Ongena (2007) state that banks as the main creditors reduce information asymmetry, signal the quality of the enterprise to the market, increase availability of credit and exercise a dual role in disciplining managers thereby keeping them from carrying out unviable projects. The information exchange which occurs in the bank relationship has a high degree of privacy, which stems from the trust established (Groessl and Levratto, 2004). This, in turn, results in a learning process which is marked by positive experiences which enable the parties of the credit contract to reduce the uncertainty surrounding the relationship.

The strength of the bank relationship is measured thus: the *duration* of the relationship, *how extensive* the services obtained are, and the *number* of bank relationships.

The *duration* of the relationship, the most widely used measure, is the amount of time from the beginning of the relationship. The importance of this relationship is based on the fact that it reflects accumulated private information over various periods of time by the creditor. This information is very difficult to transfer outside of the relationship. According to Ongena and Smith (2001), as the relationship is established the credit institution may observe, learn and use its customers' private information which is crucial in celebrating new contracts.

For the enterprise, this is synonymous with servicing the debt, the viability of the project and the solvency of its promoter.

The second dimension is the *amplitude* (how extensive the services obtained are). Ongena and Smith (2001, p. 452), define this as the amount of services the bank offers and the enterprise uses. Interaction with the customer on various financial products gives the bank greater accuracy in the information obtained and higher efficiency in obtaining it. The bank's grant of several financial products/services enables the bank to introduce more contractual flexibility, set pricing policies depending on the different services and learn more about the company's capacity for repayment. Extending banking products may condition the concession of credit in distinct ways: i) it increases the information the bank has on the enterprise, ii) the bank may dilute its fixed costs in collecting and treating information through a wider range of products and services (Borneihm and Herbeck, 1998).

Another variable that is used is the *number of simultaneous bank relationships* the enterprise establishes. Bank relationships may be classified in terms of the number of parties involved as bilateral (the enterprise and a bank) and multilateral (the enterprise and several banks). For Diamond (1984), bilateral relationships give the bank a greater incentive as a creditor to supervise the firm's activities and allow it to eliminate the duplication of vigilance and control. Nevertheless, this relationship confers on the bank an informational monopoly which may be used for its own benefit, conditioning the firm's investment decisions (Sharpe, 1990; Rajan, 1992). Firms, in turn, anticipating hold up problems have an incentive to establish multilateral relationships.

The bank relationship fosters the production and sharing of information and lacks, under many circumstances, a previous evaluation of its credibility. The existence of information asymmetry in the bank relationship creates problems, the solution of which entails costs, known as agency costs, particularly felt when the credit is small or with a tendency to be opaque as is the case of SMEs (Psillaki, 1995).

In the credit market, information asymmetries show up when the enterprise has private and exclusive information which is difficult to transfer to the creditor. This situation allows the enterprise to outline its strategies, causing added difficulties for banks to identify different risk levels (Langlais, 1999) among the proponents of credit. The result of this is an adverse selection which keeps banks from practising active differentiated interest rates and credit contracts, which are adjusted to the risk level of the proponents, hinder access to credit for "good" enterprises (Stiglitz and Weiss, 1981).

On the other hand, the creditor bank may find it difficult to control the enterprise's behaviour chancing moral hazard. Under these circumstances, the bank demands *a priori* interest rates and higher collateral, as well as more

restrictive clauses, particularly felt by SMEs leading them to forego good investment opportunities, which compromises their performance (Degryse, Masschelen and Mitchell, 2005).

The bank relationship provides benefits insofar as it develops confidentiality, improves negotiating flexibility, reduces agency problems and allows an image of their reputation to be built and consolidated (Cánovas and Solano, 2006). Nevertheless, there are disadvantages, such as, when the benefits of the relationship are not equally shared. They stem from the appropriation of benefits on the part of the enterprises (the bank has an incentive to concede more credit than the real risk the company can afford – *soft budgeting problem*). They may also stem from on the part of the banks (which take advantage of the fact that the enterprise is “tied up” in terms of information in order to impose higher prices – *hold-up problem*) (Sharpe, 1990; Rajan, 1992).

The capacity for the bank to increase interest rates in the future is conditioned by its ability to create change costs which are high enough to keep the enterprise from seeking another competitor with more tempting offers, a feat achieved by the informational advantage it has, fruit of the relationship (Kim, Kliger and Vale, 2001; Dunkelberg, Leeds and Scoot, 2003). Even for low change costs the possibility of making an adverse selection makes banks, which are external to the relationship, reluctant to propose conditions of credit to customers interested in that transfer (Vesala, 2007).

The availability the creditor bank shows in investing, collecting and treating information is directly linked to the expectation of obtaining benefits. According to Sharpe (1990), the bank relationship creates “internal information” which allows the bank to assess its prospects for its customers’ future businesses more reliably than its competitors. This informational monopoly enables “inside banks” to obtain an extraordinary profit on its best customers, insofar as changing banks becomes burdensome, by the fact that these profits are not readily observable by “outside banks”.

Greenbaum, Kanatas and Venezia, (1989) has a different view. For them, the informational monopoly tends to decrease with the consolidation of the banking relationship contributing towards minimising the “hold up problem,” which provides the bank with an expensive asset of limited duration. Multilateral bank relationships contribute towards resolving the “hold up problem” but, on the other hand, they make access to credit more difficult, insofar as the relationship is undervalued (Besanko and Thakor, 1987). For more opaque enterprises the quantity of information obtained is reduced, information asymmetry is more significant and the benefits obtained in each relationship are less evident (Diamond, 1984; Ongema and Smith, 2000b).

Information asymmetries tend to decrease over time in the relationship with an impact on corporate efficiency, felt through multiple channels. Firstly, a stable

relationship allows long-term credit contracts to be entered into, increasing the value created. This objective is achieved, for example, by decreasing collateral demanded (Berger, Klapper, Peria and Zaidi, 2008), by implementing periodic subvention mechanisms for the cost of the loans (Petersen and Rajan, 1995), as well as through greater flexibility in contractual terms (Boot *et al.*, 1993). Secondly, the information collected by the creditor over time and used later reduces the costs of supervision and accompaniment (Boot, Greembaum and Thakor, 1993). Thirdly, it reduces the *free-rider*<sup>1</sup> problem insofar as the bank internalises the benefits of the investment. Fourthly, bank relationships develop knowledge within specific sectors which reinforces the value of the financed projects. Finally, bank relationships contribute to economic growth by promoting efficient allocation of capital to more profitable projects (Boot and Thakor, 2000).

The bank relationship confers negotiating power on both parties and recent studies are unanimous that close relations provide greater availability of credit. As for the impact of these relationships on contractual conditions, interest rates or collateral demanded, it is more difficult to reach a consensus as the results have been contradictory.

Peterson and Rajan (1994) are the first authors to analyse the impact of bank relationships empirically for a sample of SMEs. They found a reduction in interest rates for companies which maintain relations with a reduced number of institutions even though there is not a significant relationship between duration and cost of the debt. In a study on 436 Portuguese microenterprises Matias, Serrasqueiro and Costa (2009), found that a longer relationship does not translate into better credit conditions. Nevertheless, greater credit concentration accords greater availability of credit and lower interest rates. Bonfim, Dai and Franco (2009) show that when Portuguese enterprises increase their number of bank relationships, cost of financing decreases.

From a different perspective, a set of studies (Hoshi, Kashyap and Scharfstein, 1993; Weinstein and Yafeh, 1998) assess the manner in which financial constraints vary among enterprises in terms of bank relationships. Houston and James (2001) conclude that American companies with a bilateral relationship have a greater sensitivity of investment to cash-flow and that companies with low investment levels are subject to lower financial constraints. In concentrated banking markets, such as Germany, Rauterkus (2009) shows that companies in financial distress are more likely to be liquidated.

<sup>1</sup> The *free-rider* problem occurs because of more than one financial intermediary in situations in which the company finds itself in financial straits. In this case, the entity which concedes additional credit assumes all the additional risk which stems from insolvency, but will possibly enjoy only one part of the profit if there is success. Thus, no entity will risk conceding credit. Another interpretation of the *free-rider* problem is shown by Foglia, Laviola and Marullo (1988), according to whom, the presence of various banks reduces the incentive for supervision, since the respective cost will be assumed by just one of them and the benefit will be shared by all.

Empirical research in this area has underscored, nevertheless, that the benefits outweigh the costs so that bank relationships create value. To the extent that the value generated is shared with the enterprise (through reduced loan costs, more flexible contractual terms, etc.), the relationship is equally important for the company.

Studies on the impact of bank relationships on corporate performance are summarised in Table 1.

TABLE 1

**The impact of bank relationships on performance**

<i>Study</i>	<i>Country</i>	<i>Period of Study</i>	<i>Number Observed</i>	<i>Performance Measure</i>	<i>Results</i>
Weinstein and Yafeh (1998)	Japan	1977-86	6836	Profits, Sales	Not Significant
Kang and Stulz (2000)	Japan	1977-93	154	Investment	Bank relationships facilitate investment and increase value
Agarwall and Elston (2001)	Germany	1970-86	1660	Operational Results/Sales	Not Significant
Degryse and Ongema (2001)	Norway	1979-95	1897	Various Measures (simultaneous equations)	Bilateral relationships increase profitability
Limpaphayom and Polwitoon (2004)	Thailand	1990-96	1340	Tobin's Q	Bank relationships have a positive effect on market value
Castelli, Dwyer and Hasan (2006)	Italy	1998-00	10764	ROA, ROE, Investment / Asset, Sales/ Asset	The increase in bank relationships has a negative impact.
Van Overfelt, Annaert and Deloof (2006)	Belgium	1905-09	569	Market Value, ROA	Not Significant
Chirinko and Elston (2006)	Germany	1965-90	91	EVA	Not Significant

Weinstein and Yafeh (1998) found that a close bank relationship does not have any influence on the company's profitability and growth. The authors consider this type of relationship charges higher interest rates and, because banks are more risk averse than shareholders, they condition the enterprise's capacity for investment. Based on a sample of Japanese enterprises, Kang and Stulz (2000) found that bank relationships facilitate investment and increase shareholder value. These results contradict previous studies of American enterprises. Degryse and Ongema (2001) analysed 235 Norwegian enterprises between 1979 and 1995

and found that enterprises with bilateral relationships are more profitable. Other studies present contrary results. Based on a sample of large German enterprises over the period of 1970-86, Agarwal and Elston (2001) state that the bank's influence is not significant for the enterprises' performance and growth. Chirinco and Elston (2006) studied data from 91 German enterprises and found that bank relationships have no influence in reducing financial costs or in changing profitability.

### 3. CORPORATE GOVERNANCE AND PERFORMANCE

Taking agency theory as a conceptual starting point, the aim of this section is to assess, in the light of existing research, how the various mechanisms of corporate governance and how their interaction condition corporate performance.

The separation between ownership and control causes conflicts of interests between investors (shareholders and creditors) and administrators, therein lies the need to implement internal and external control mechanisms so as to coordinate them as it is impossible to celebrate complete contracts<sup>2</sup> (Baysinger and Hoskissom, 1990). The investors make financial resources available and must be remunerated and the enterprise must implement a set of mechanisms to keep some *stakeholders* from obtaining privileges with regards to others (Prowse, 1995). The dominant view in the literature on this issue focuses on the conflict of interest between investors (owners) and administrators (controllers and users of resources) and the inefficiencies which result as a consequence. The absence of conflict occurs when ownership and the power of decision reside in one and the same person. When that does not happen, the business's governance and its instruments are limited to the relationship which develops between the investors and the administrators whose decisions condition the remunerations of the former (Shleifer and Vishny, 1997). Investors value governance quality in terms of the perception of agency conflicts within the firm (Chi and Lee, 2010).

The impossibility of resolving conflicts of interest through celebrating complete contracts gives rise to the discretionary directive. Agreements established between the administration and the investors generally contemplate the purpose of the enterprise's resources and where the generated returns are to go.

The problems arising from the discretionary directive mean that mechanisms of corporate governance must be established through which investors may guarantee returns. These mechanisms, however, do not always work so as to

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<sup>2</sup> The complete contract collects all the obligations of those who participate in the contractual relationship, under any eventuality that may occur and penalises those who do not comply. Because it is impossible to define all contingencies and the costs of drawing up this type of contract, the result is celebrating incomplete contracts.

satisfy the interests of all of the shareholders or so as to guarantee the company's value is maximized. That is why the corporate government associates itself with legal instruments and effective control mechanisms in order to safeguard the expropriation of minority shareholders (Johnson, Boone, Breach e Friedman, 2000). Granting resources on the part of investors gives them the right to control corporate activities. Nevertheless, the legal protection this gives them is insufficient to guarantee returns. The effectiveness of the rights with which the investor may count on is conditioned by the predisposition and capacity to use it; so that the ownership structure exerts significant influence (Andres, 2008).

It has been difficult to obtain consensus on the concept of "corporate governance," which is probably a symptom of its complexity and scope. Nonetheless, the predominating notion is that there is a sharing of power and results among the various parties, whose interests do not always coincide.

The literature on corporate governance has conferred importance on the contractual problems between the shareholders and the directors and to the study of mechanisms at the disposition of the investors to control their resources and minimize conflicts of interest. Nevertheless, studies carried out on the concentration of ownership have given a new focus to agency theory: it moves the principal/agent relationship to the connection which is established between majority and minority shareholders where the expropriation of "private benefits"<sup>3</sup> takes on an overriding role, which causes a conflict of interests (Gregoric and Vespro, 2003).

Large corporations are the object of these considerations. However, within the framework of corporate finance, SMEs have gained added importance by their specificities. Among these, the family nature of the ownership structure and the control this gives them are such that the contractual relations established within the company, often include family ties. In the first generation, the ownership of these companies is often concentrated in the core of the family and direction usually falls on the founder. This coincidence between ownership and direction reduces agency costs borne by conflicts of interest between the principal and the agent. The relationships which are established are very intense and may cause externalities which are manifested by greater commitment, trust and loyalty among contractual parties. Nevertheless, the relationships become more complex as the enterprise grows and are subjected to processes of succession. In this type of company agency problems are more difficult to resolve, to the extent that the contractual relationships go hand in hand with family relationships (Schulze, Libatkin, Dino e Buchholtz, 2001). The source of power in any enterprise, come from the rights of control over resources or from information asymmetry (Schulze, Libatkin, Dino, 2002). In the family firm there is another source of power which

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<sup>3</sup> The "private benefits" result from the majority shareholder using his controlling power to obtain a fraction of the residual benefits which spill over from the part to which he is entitled by his capital.

comes from the fact that the participant is a member of the family which holds control. This duality confers a privileged position within the organization giving him "private benefits." Therefore, besides the control mechanisms any organization requires, further mechanisms should be implemented so as to regulate family relationships.

The literature also shows that the term corporate governance is understood differently in different countries. It refers to different people or institutions and there are differences in intensity and nature depending on the legal/political system (e.g. the legal protection of the investors) (Goergen and Renneboog, 2008). Despite the differences, there is a consensus in grouping ownership systems and corporate management around two models: i) the Anglo-Saxon model (*outsider system or market oriented*) and ii) the Continental/Japanese (*insider system or bank oriented*). In the latter system, bank market concentration can serve to safeguard creditor rights in the absence of stronger legal protections and in this way decrease agency costs of debt (González and González, 2008).

Developing these models has been conditioned by historical, financial and legal factors which determine its characteristics (Plihon and Zarlowsky, 2002) shown in Table 2.

The resolution of conflicts generated by the various company stakeholders leads to establishing control mechanisms. The most consensual classification allows them to be placed in two groups: one which includes external control mechanisms, where market structures predominate, and another known as internal control, where incentives rest mainly on elements such as the board of directors, ownership structure, indebtedness, dividend policy, *stock options*,....

External mechanisms play an important role in converging managers' and stockholders' interests, namely when the internal mechanisms are shown to be inadequate limiting the opportunistic behaviour of directors that arise from the competition between the different markets in which the enterprise operates (Hoskisson and Turk, 1990). Jensen (1993) identifies them and proposes the following grouping: i) the human capital market – it calls for the hiring of the managers whose value depends on the level of prestige obtained (Fama, 1980); ii) the capital market – the mechanism which sets the company's share price thereby reflecting behaviour (diligent/negligent) of the directors (Demsetz, 1983; Shivdasani, 1993); iii) the goods and services market – the structure where the company fights for survival and satisfies its customers' needs (Demsetz, 1983); iv) the political/legal system – it defines and lays down some of the rules that underscore managers' conduct (Jensen and Meckling, 1976).

The lack of efficiency inherent to the various mechanisms of supervision, their interrelatedness and the absence of a superior mechanism together with the need for various countries to reinforce external and internal control mechanisms has led to the creation of an atmosphere that is auspicious to a variety of codes of conduct

TABLE 2

**Most significant differences between the models of corporate governance**

<i>Designation</i>	<i>Continental Model</i>	<i>Anglo-Saxon Model</i>
<b>Type of control</b>	Referential shareholder. Crossed participation and pyramid structures	Capital Market
<b>Ownership structure and type of shareholder</b>	Concentrated Other companies, families, banks	Dispersed Individual and institutional investors
<b>Use of capital markets</b>	Less developed, lower levels of information and transparency	High liquidity and informational transparency
<b>Incentives and director Remunerations</b>	Remunerations basically fixed and less weight on the variable part, based on accounting indicators or internal indicators	Remunerations fixed and significant weight of the variable connected to the market
<b>Legal environment</b>	Civil Law	Common Law
<b>Level of investor protection</b>	Greater probability of expropriation of the minority shareholder	Greater protection: greater market value; greater number of companies using the market financing
<b>Level of protection of workers' interests</b>	In the German case, control committees are integrated	They are not considered in the relationship

or “good corporate governance.” This need, reinforced by privatization policies and sales of corporations has meant a considerable increase in shareholders with the right to exercise a greater role in the administration of enterprises and in the development of internal control mechanisms.

The importance of internal control mechanisms derives from organizations working in a hierarchical structure or chain of governance, which identifies the groups which have a legitimate influence on the organization’s objectives (Denis and McConnel, 2003). In companies where there is effective separation between ownership and control, the owners delegate to the board of directors the right of control and to take decisions. In turn, the board then grants executives the management of the company so that, later as representatives of the shareholders, they supervise the executive team (Andrés, Azofra e Rodriguez, 2001). Thus, internal mechanisms from which they may limit the discretionary directive are resorted to, such as: the ownership structure in its dual facets – concentration (Shleifer and Vishny, 1986; Demsetz and Len, 1985) and managers’ participation in the capital (Jensen and Meckling, 1976) – the composition of the board of directors (Fama, 1980; Vijay and Subhash, 2007), the use of debt and remuneration systems (Murphy, 1997).

SMEs are primarily owned by families, so that it is particularly relevant to study the role of this ownership structure as a supervisory mechanism (Fernández, Fernández and Gómez-Ansón, 1998). Two features individualize the shareholder

of a family enterprise: i) maintaining family interests in the long term supervision of the company ii) preserving reputation (Anderson and Reeb, 2003). Greater efficiency is guaranteed by family involvement in the ownership and management of the business (Cabrera, Pérez and Garcia, 2001).

The family as a governing structure has advantages both in terms of incentives and supervision (Andres, 2008). In terms of incentives the members of the board are stimulated to recognize the effects of their decisions on the family's wealth, making the survival of the family enterprise particularly relevant. In terms of supervision, the overlap of economic and personal relationships increases the family's efficiency in carrying it out. Wang (2006) highlights that because the incentives for opportunistic behaviour in these companies are reduced; putting into practice policies to preserve the family reputation and performance in the long term is encouraged. However, the family nature of these companies also has disadvantages, leading some authors (Galve, 2002; Andres, 2008) to refer to the limited talent pool the family can offer as well as the expropriation of small shareholders.

With regards to the relationship between the company's governance and performance, this has focused on two great areas of research: i) one concerned with the variables related to ownership structure, and ii) the other highlighting the more institutional aspects, examples of which those connected to the board of directors and to the CEO (Denis and McConnel, 2003).

Work related to ownership structure has focused on analysing concentration of ownership (Parigi and Pelizzon, 2004), the identity of the main shareholder (Sheifer and Vishny, 1986; Franks, Mayer e Rossi, 2006) and the participation of managers in shareholder structure (Demsetz, 1983; Miguel, Pindado, Torre, 2004).

As far as the impact of the concentration of ownership on performance, empirical studies carried out have not given definitive conclusions because there are contradictory effects in this relationship. If on the one hand, concentration of ownership enables greater supervision and an increase in common benefits, on the other hand, it enables a reduced number of shareholders to obtain private benefits (Holderness, 2003).

Regarding the influence of the shareholder's identity on performance, Agrawal and Mandelker (1990) support the idea expounded by Shleifer and Vishny (1986) for whom the prevalence of large shareholders enables greater control of direction and improved performance, especially when the ownership is concentrated in the hands of institutional investors. But this empirical evidence is inconclusive; on the one hand McConnel and Servaes (1990), Prowse (1990) realise the positive effect exercised by institutional control, on the other hand Franks *et al.*, (2006) did not find any significant relationship with the value of the enterprise. Conversely, Rajan (1992), Hoshi, Kashyap e Scharfstein, (1993), Wiblin and Wood (1999) found that institutional concentration effects performance negatively as a result of

private benefits obtained and expropriation of the remaining shareholders' wealth. Moreover, Cucculelli and Micucci (2008) say that maintaining management within the family has a negative impact on performance.

Table 3 summarises some of the studies which assess the impact of corporate governance on corporate performance and the respective findings.

Consider the differences found among the various studies (see, Jensen and Meckling, 1976; Demsetz and Lehn, 1985; Morch *et al.*, 1988, Lee and Ryu, 2003, among others) on the role ownership by managers plays on performance. There is consensus on the idea that the company's value is higher for low levels of internal ownership (market discipline), decreases for intermediate levels (opportunistic behaviour) and finally increases once it achieves a critical level of ownership (convergence of interests).

Research on the board of directors has focused on the composition of the board itself and its impact on corporate results, highlighting size as a variable under study – attested by the number of advisers – and its nature – established by the relationship between internal and external advisers (Gabrielsson and Winlud, 2000, Kanagaretnam, Lobo e Whalen, 2007).

Nevertheless, the studies are not unanimous as to how these variables influence results. If a very significant set of authors (e.g., Eisenberg *et al.*, 1998; Wiblin and Wood, 1999; Andrés *et al.*, 2001; Kim *et al.*, 2001) report a positive relation between size and the finding or the company's value, others report a non-linear relation and mention that the size of the board exerts a positive effect on the findings up to a certain point, after which it has a neutral effect (Yermarck, 1996) or even a negative effect (Fernández *et al.* 1999). As for the nature of the advisers, empirical studies show contradictory findings as for their influence on corporate performance. For example, Rosenstein and Wyatt (1990) show a positive relation between the number of external advisers and the company's market value, whereas others do not find significant relations between the participation of external advisers and profitability or the company's market value.

#### **4. BANK RELATIONSHIPS, CORPORATE GOVERNANCE AND PERFORMANCE**

The relationship between the banking system and corporate governance has been attracting growing interest within the scope of corporate financing as the European institutional context is propitious to financial institutions playing different roles whether as creditors or shareholders, or as active participants in management (Byers *et al.*, 2008).

This diversity of roles and the effect on the company's value may occur for various reasons. Firstly, as holders of ownership and control, financial institutions

TABLE 3

**Impact of corporate governance on performance**

<i>Study</i>	<i>Variable</i>	<i>Findings</i>
Prowse (1990)	Shareholder identity	Institutional control has a positive effect on performance
Rosenstein and Wyatt (1990)	Nature of advisors	There is a positive relation between the number of external advisors and the company's value
Rajan (1992)	Shareholder identity	Institutional concentration has a negative effect on performance
Hoshi et al. (1993)	Shareholder identity	Institutional concentration has a negative effect on performance
Yermarck (1996)	Size of the Board of Directors	Non-linear relation with a positive effect up to a certain value, after which there is a neutral effect
Eisenberg, Sundgreen and Wells, (1998)	Size of the Board of Directors	Positive relation between the size of the board and the company's value
Wiblin and Wood (1999)	Shareholder identity	Institutional concentration has a negative effect on performance
Fernández et al. (1999)	Size of the Board of Directors	Negative relation between the size of the board and the company's value
Kim et al. (2001)	Size of the Board of Directors	Positive relation between the size of the board and the company's value
Bhagat and Black (2002)	Nature of advisors	There is no evidence of a significant relation between the nature of the advisors and the company's value
Lee and Ruy (2003)	Internal ownership	Non-linear relation between internal ownership and performance
Kumar (2004)	Concentration of ownership	Over 15% participation in the company's equity effects performance positively
Bhagat and Bolton (2008)	Internal ownership; Nature of advisors	Positive relation between internal ownership and performance. Negative relation between external advisors and performance
Bries, Brisley and Caboles (2008)	Concentration of ownership	Positive relation between concentration of ownership and the company's value due to shareholder protection
Marynova and Rennebog (2008)	Control Mecanismos	Cross-border mergers and acquisitions generate synergies with a positive impact on performance
Harford, Mansi and Maxwell (2008)	Control Mecanismos	Negative relation between shareholder protection and performance
Omran, Bolbol and Fatheldin (2008)	Concentration of ownership; Nature of advisors	There is no evidence of a significant relation between concentration of ownership the nature of advisors and performance
Lin, Zhang and Zhu (2009)	Shareholder identity	Bank ownership exerts a positive effect on performance
Omran (2009)	Shareholder identity; Concentration of ownership; Nature of advisors	Private property, concentration of ownership and a greater presence of external advisors exert a positive effect on performance
Sueyoshi, Goto and Omi (2010)	Concentration of ownership	Positive relation between concentration of ownership and performance

have strong incentives to exercise greater vigilance over the company's management (Asquith, Gertner e Scharstein, 1994). Operating exclusively as creditor, it ensures that the best practices of corporate governance will contractually guarantee repayment of the capital and the established remuneration.

Secondly, the participation of these institutions in the equity constitutes an important contribution in the creation of long-term value, particularly when the company undergoes financial difficulties (Berlin, John e Saunders, 1996). Its survival may lead financial institutions to renegotiate the debt turning it into capital taking on the role of shareholders. By taking this decision, the financial institution will demand that other creditors, if there are any, renegotiate their debts. This entire reordering process of liabilities happens when the financial institution identifies long-term business opportunities. The combined role of shareholder and creditor reduces the tendency to liquidate companies with a potential to create value.

Thirdly, internal shareholders tend to expropriate external shareholders. The moment the financial institution performs its role as relevant (internal) shareholder and creditor (external), its incentives to expropriate the remaining vested interests decrease.

Participation by the banking institution in the company's equity allows it to defend the credit it has conceded and to intervene in crises. Participation in the company's equity is a result on the part of the bank to reduce or eliminate the problem of replacing assets (Jensen and Meckling, 1976). As for the second point, the preoccupation is to try to protect credit that has been conceded and to guarantee its repayment.

In a market context of information asymmetries, the literature has questioned the role the bank's participation plays in corporate performance. Despite finding broad consensus in theoretical work which underscores improvements to corporate efficiencies, the question of whether this results in greater profitability or it reverts back to the bank through expropriating private benefits remains open (Weinstein and Yafeh, 1998).

The interest shown by banks in acquiring/selling off shares may also be explained by expectations related to the evolution of the company's profitability resulting exclusively from informational aspects. Long-term bank relationships and the position held as a shareholder places the bank in a privileged position in terms of access to information. This allows the bank to assess the quality of the company and to decide when it should buy/sell its shares, thus obtaining capital gains. Studies carried out in the United States prove the benefits for "insiders" when they transact the companies themselves and the positive relationship between purchase of shares and their future profitability ( Iqbal and Stetty, 2002).

As a conclusion we may state that the presence of banks in companies' ownership structure offer a multifaceted reality where the opportunities and

limitations they face are not necessarily symmetric for both sides. The characteristics of each country's legal system, the structure of its financial system, the relative weight of the capital market, norms and good banking practices vary. In each case there may be significant differences in the effects of the relationship between banks and firms.

The shareholding bank embodies the advantages of being an informed investor within the enterprise. It is an active and long-term investment, which makes for more efficient supervision in support of its investment. On the other hand, it acquires as position of power, which it takes advantage of in order to obtain private benefits and extract returns from the enterprise at the expense of the other shareholders.

## 5. CONCLUSION

In contexts marked by the celebration of incomplete contracts, the bank relationship and corporate governance play an important role in corporate performance. The relationship with the credit institution is particularly relevant in banking practices, in which the literature underscores the specificity of the banks in collecting and treating information, the creation of close bonds and in the difficulty in defining optimum contracts in this context. Furthermore, taking agency theory into account it is possible to glimpse the growing importance of the various governance mechanisms, the interconnection between them, the difficulty in arranging them in a hierarchical order. This is an open topic from which we can make multiple recommendations, none of which can be disregarded within the scope of corporate performance.

Consider the broader debate, the findings obtained by existing research are inconclusive and suggest that more research is needed in different institutional contexts. On the one hand, the studies highlight the fact that the bank relationship facilitates access to credit and lowers liquidity constraints. On the other hand, it is difficult to reach a consensus on the costs involved as well as impact on performance. Recommendations regarding good governance, which have been drawn from agency problems and associated costs, are that they should be adjusted according to the context in each country.

Research on the interdependence of the bank relationship, corporate governance and performance has been scarce, focused on large enterprises and markets and without considering SMEs and their specificities. Therefore, this remains an open subject which requires further development in the field of empirical research.

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## Resumo

Este trabalho tem por objectivo rever e sistematizar a literatura relativa ao modo como as relações bancárias, o governo da empresa e a interdependência que se estabelece entre estas, condicionam o desempenho empresarial. Os bancos e as empresas estabelecem relações que permitem superar problemas de assimetria de informação aliviando desse modo as dificuldades sentidas, na obtenção de recursos financeiros. Paralelamente, as especificidades que as PME's encerram, nomeadamente a natureza familiar que a estrutura de propriedade e controlo lhes confere, remetem-nos para o estudo do papel exercido pelo governo da empresa e dos diferentes mecanismos de controlo, no cumprimento dos propósitos empresariais. Estas dimensões reservam às instituições de crédito, um importante papel de supervisão, fruto da informação detida.

**Classificação JEL:** G30, G32 e G34

**Palavras-Chave:** Desempenho, Relação Bancária, Governo da Empresa

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