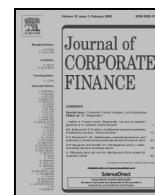




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journal homepage: www.elsevier.com/locate/jcorpfinTrust, family businesses and financial intermediation[☆]Massimiliano Stacchini^{*}, Petra Degasperì*Bank of Italy*

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ABSTRACT

This paper analyzes whether interpersonal trust affects the agency costs of family-controlled firms' debt. Our results are threefold. First, we find that banks apply a discount to the interest rates charged to family firms, whose size decreases considerably for contracts stipulated in high-trust areas. Second, as a response to the (unexpected) liquidity shock affecting the interbank market in August 2007, banks further increased the discount associated with family control. Third, we have no evidence of lender-corruption effects since the ex-post performance of the (cheaper) loans extended to the family firms is superior to that of their peers. These results suggest that banks deem the incentive structures prevailing in family firms to be able to attenuate the higher risks of expropriation run by lenders in areas where agency conflicts are greater, due to lack of interpersonal trust. Our findings are robust to the self-selection and omitted local variable problems as well as to credit demand-side effects. We model family control as an endogenous choice, introduce local-level fixed effects and use the heterogeneous exposure of Italian banks to the 2007–09 financial crisis – and the fact that Italian firms have more than one lender – to fully absorb changes in credit demand schedules.

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1. Introduction

The literature on the link between family businesses and financial intermediation is scant and does not reach clear conclusions (Anderson et al., 2003; Bennedsen et al., 2010; La Porta et al., 1997; Villalonga and Amit, 2006).

According to some authors, the incentives of family block-holders and their lending banks tend to be more closely aligned than those of lenders and other firms' large shareholders – such as banks, investment funds and widely held companies – and result in lower monitoring costs for banks. Banks evaluate family firms as borrowers having lower repayment problems, due to their stable and long-term oriented business model, which arises from the connections existing between the firm prospects and the family prosperity, the desire of family owners to preserve the family's reputation and to transmit the firm's wealth to descendants (Anderson et al., 2003).

By contrast, other scholars point out that large family shareholders may have an incentive and the power to expropriate minority shareholders by favoring family members in the selection of managers or imposing altruistic values in the conduct of business, i.e. by following practices that reduce efficiency and the ability to service debt (Caselli and Gennaioli, 2013; Pinheiro and Yung, 2014;

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Villalonga and Amit, 2006). Moreover, Ellul et al. (2007) argue that a family block-holder's power to extract private benefits of control depends on the enforceability of contracts in the country where the firm operates.

This study empirically analyzes the link between family businesses and financial intermediation, by focusing on interpersonal trust¹ and its heterogeneous distribution across Italian regions, as the key factor for discriminating between the two competing views. The role played by trust in financial intermediation is well known in the literature. Whether individuals are willing to sign financial contracts as well as their propensity to buy stock depends not only on the enforceability of contracts, but also on the extent to which they trust the counterparty (Guiso et al., 2004).

We test the idea that the value of family businesses in reducing the agency costs of debt is higher in low-trust environments, i.e. where individuals are more inclined to behave opportunistically – as the tendency to cooperate is weaker – and borrowers are more prone to invest in risky projects without bearing the costs of downside failure. We verify the implications of Putnam (1993) and Fukuyama's (1995) thesis that where cooperation mechanisms are weaker due to the lack of social capital, delegation problems and other agency conflicts tend to be mitigated by personal relationships, such as those existing within family members.

As for firms located in low-trust areas, our findings show that family controlled borrowers benefit from a loan interest-rate discount compared with non-family firms, suggesting that banks deem the incentive structures of family firms to be less likely to cause expropriation of lenders. By contrast, in trust-intensive areas, family firms lose the discount advantage with respect to their peers, suggesting that where opportunistic behavior and delegation problems are less likely to occur, banks reduce the importance they attribute to family firms when they evaluate borrower risk.

We also show that the (unexpected) shock caused on the interbank market by the failure of Lehman Brothers increased the discount that banks applied to family firms operating in low-trust areas. These results are in line with the existing literature showing that family firms suffered relatively less than their peers from the credit tightening that occurred during the 2007–09 financial crisis (D'Aurizio et al., in this issue). We contribute to this strand of the literature by showing that (mainly) in low-trust areas, lenders perceive the rise of bankruptcy risks for family firms to be less intense than for similar firms not controlled by families. When economic conditions worsen, the temptation to respond to business difficulties by engaging in increasingly risky activities (gambling for resurrection) might be stronger where opportunistic behavior is more likely to occur and less intense for borrowers having higher reputation concerns.

Furthermore this paper does not find evidence of corruption effects on loan interest-rate discounts granted to family-owned firms by their lenders. Econometric tests show that the lower rates applied ex-ante on loans to family firms are justified ex-post by the objective creditworthiness of these borrowers, highlighted by their loans' better performance.

Three factors make Italy an ideal environment for this study. First, it is a paradigmatic case of asymmetric distribution of trust within a country (Banfield, 1958; Putnam, 1993). Such asymmetry, which is one of the drivers of the heterogeneity in the development of the Italian regions, provides the source of variability needed in the data to investigate the trust effects. Second, the significant presence of family firms in the Italian economy – they account for almost 80% of the business – makes it worth studying the financial conditions of these enterprises. Third, the narrowness of the Italian bond and equity markets makes Italian firms highly dependent on bank debt for their external finance; which makes the analysis of loan pricing highly representative of the agency costs of debt sustained by entrepreneurs in Italy.

The results presented in this paper are based on a unique loan-level longitudinal dataset made up of more than 107,000 financial contracts signed or renewed in Italy from 2005Q1 to 2011Q4. The performance of these loans has been observed until 2013Q3.

Our empirical strategy tackles several issues potentially biasing our estimates: i) the omission of variables that are important at a local level and that might overestimate the role played by local trust; ii) the possibility that the variable indicating whether a firm is owned by a family is endogenous to the firm's prospective earnings and credit conditions; iii) the possibility of the credit demand of family and non-family firms changing over time and confounding the supply-side effects of the shock caused by the failure of Lehman Brothers; and iv) the fact that the explicit components of loan contracts, i.e. the interest rates, are likely to be determined jointly with the implicit ones, i.e. the posting of collateral, so that simultaneity bias may affect loan interest-rate regressions.

The first problem is tackled by an empirical strategy exploiting a result of the literature on the determinants of trust. Being social capital a resource of individuals that emerges from social ties, the source of this capital lies with the people (and the environment) a person is related to (Guiso et al., 2004, 2008). The level of social capital prevailing in the area where an individual live affects its propensity to cooperate and generates most of the subjective trusting attitudes needed for financial transactions (Guiso et al., 2004). We move from these arguments to derive our empirical strategy. We focus on contracts stipulated between a bank and a firm located in non-coincident regions. According to the results we mentioned before, the level of social capital prevailing in the region where the bank branch granting the loan is based is expected to influence the loan officers' trusting attitudes as well as their evaluations of the risks of moral hazard that may occur with borrowers (affecting the price of credit risk, in turn). We estimate the effect that the social capital prevailing in the areas where the bank branches granting the loans are based plays on contracts stipulated with borrowers located in different regions. In these regressions it is possible to insert local-level fixed effects, associated with the region where the borrower is based, which absorb any other unobservable factor potentially relevant at the local level. In this way, and similarly to the strategy adopted by Guiso et al. (2004), we can address the critiques based on the omission of local variables.

The second problem arises from the fact that expectations of firm performance, incorporated in financial outcomes, might influence family members' decision whether or not to keep control of the firm (Bennedsen et al., 2010; Miller et al., 2007). This point is addressed through Heckman's (1979) two-step regression framework, where family control is determined endogenously in the model.

¹ Trust has been defined as an environmental characteristic which facilitates transactions in markets exposed to agency costs (Guiso et al., 2004).

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