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BANKS AND CORPORATE GOVERNANCE IN CANADA

Randall Morck*

and

Masao Nakamura#

Stephen A. Jarislowsky Professor of Finance, Faculty of Business, University of Alberta, Edmonton, Canada T6G 2R6.

Professor, Faculty of Commerce and Japan Research Chair Professor, Institute of Asian Research, University of British Columbia, Vancouver, Canada V6T 1Z2.

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I. Introduction

In Germany and Japan, and also other countries such as Switzerland and Korea, banks play a pivotal role in corporate governance. Banks in these countries typically own, both directly and indirectly, large blocks of stock in nonfinancial firms. Banks can be represented on boards and can have strong influence upon managements' decisions. The term "universal bank" is used to describe these financial institutions that engage in some or all of deposit taking, lending, trust services, underwriting, merchant banking, insurance, or equity investment.

It is equity investment by banks that concerns us here. Criticisms of the corporate governance of U.S. firms, such as Mace (1986) and Jensen and Meckling (1976), and subsequent analogous criticism of Canadian corporate governance, eg. Leighton and Thain (199), has been biting. These and other critics view boards of directors as cosy reunions of old boys that are generally impotent to prevent, or even recognize, potentially disastrous corporate policies. Managers, the critics argue, are self-interested and, unhindered by effective board oversight, run corporations to suit themselves. Empirical evidence such as Morck *et al*. (1988, 1989, 1990) and Jensen and Murphy (1988) provide econometric support for the existence of corporate governance problems in many large U.S. firms. Given all of this, reformers have begun to speculate about alternative institutional frameworks that might improve the situation.

Shleifer and Vishny (1986) argue that even one large, sophisticated shareholder might provide a valuable counterweight to management, and McConnell and Servaes (1990) report that the existence of such a shareholder does enhance firm value. In Canada, financial deregulation has opened the way for large chartered banks to become equity investors in non-financial firms. Should public policy encourage banks to become large shareholders in Canadian firms as a means to improve overall corporate governance?

To answer this question, we begin with an examination of why the financial systems of countries that have bank ownership of non-financial firms developed as they did. We then consider the nature of corporate governance problems in large Canadian firms, and argue that bank ownership of equity is unlikely to provide the sort of benefits its supporters envision.

II. The History of Universal Banking

The structure of financial institutions is increasingly seen by economists as "path dependent" - that is, history matters! We therefore examine the origins of bank ownership of equity in European industrialization, and then turn to the two banking systems that are often held up as examples of the constructive role of equity ownership: German and Japanese banking.

a. Origins

The first universal bank was the Société Générale du Crédit Mobilier, established in November 1852 by Emile and Isaac Péreire, who were followers of the utopian socialist Claude-Henri, Comte de Saint-Simon.[1] The Saint-Simonians saw banks as an irrigation system for flooding parched areas of the economy with capital. To achieve this, the Péreire brothers

[1] Much of the historical discussion here closely follows Kleeberg (1987), who gives a fascinating description of the history of universal banking in Europe, focusing on Germany. His

employed what we would now call "securitization" -they repackaged their bank's loans to industries as short-term bonds called *valeurs omnium*, which they sold to the public. The reputation of the bank was to have enabled it to raise funds more cheaply than the uncertain credit of individual industrialists would permit. Unfortunately, securitization was not a big success for the Crédit Mobilier, and it ultimately relied more on deposits and its own capital as well as straight-forward underwriting. To retain the confidence of depositors and investors, the Crédit Mobilier felt it essential to maintain its shares' value, and so engaged in heavy purchases of its own stock whenever the price waned. Companies for which the Crédit Mobilier underwrote securities had to maintain current accounts with the bank. Unprofitable investments in the North of Spain railway, a real estate firm, and reverses on the stock market caused the collapse of Crédit Mobilier in 1867.

Numerous replicas of Crédit Mobilier were set up throughout German speaking Europe. The Bank für Handel und Industrie was established in Darmstadt in 1853. The Rothschilds founded the Kaiserlich-Königliche Privilegirte Österreichische Credit-Anstalt für Handel und Gewerbe in 1855. Others include the Schweizerische Credit-Anstalt in Zurich (now one of the three main Swiss banks), the Allgemeine Deutsche Credit-Anstalt in Leipzig, the Vereinsbank in Hamburg, the Norddeutsche Bank in Hamburg, the Mitteldeutsche Credit-Bank in Meiningen, the Schlesischer Bank-Verein in Breslau, the Dessauer Credit-Anstalt, the Coburg-Gothaische Credit-Anstalt, the Preussiche Handelsgesellschaft in Königsberg and the Magdeburger Handelscompagnie.

Replicas of the Crédit Mobilier were also established by the Crédit Mobilier itself in

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work is not well known to economists, but should be.

Amsterdam, Turin, and London. Rival replicas were also established in London, the General Credit and Finance Company; and in Paris, the Société Générale pour Favoriser le développement du Commerce et de l'Industrie en France and the Crédit Lyonnais. Heavy losses in equity investments by these banks (including Société Générale's "guano affair" debacle in Peruvian bonds) and the spectacular collapse of the Crédit Mobilier convinced French bankers of the wisdom of separating commercial banking from equity investment, and gave rise to the present division between banques de dépôts such as the Crédit Lyonnais, and banques d'affaires. In England, the General Credit and Finance Company was liquidated after 90% of its capital was wiped out in the panic of 1866. Its managers renounced all "financing" and transferred its commercial banking activities to the General Credit and Discount Company of London, which was merged into the Union Discount Company. The meteoric fate of General Credit confirmed an informal separation of commercial banking from equity investments that still characterizes British banking. In Italy, universal banking existed until the banking crisis of April 1931, when the government intervened, imposing a legal separation of commercial and investment banking, and took over banks' holdings of non-financial firms' shares. These were placed in a state-owned holding company, the Istituto per la Ricostruzione Italiana or I.R.I., one of the largest conglomerates in Europe. Similar legislation was imposed in Belgium.

Germany's financial history in the late 19th century was turbulent. Kleeberg (1995) counts 20 bank collapses, 15 bank liquidations, one forced merger, and 10 narrowly averted bank collapses in Germany between 1850 and 1910. Germany also had a severe banking crisis in 1931. German banks had made large loans in the 1920's to highly levered industrial firms, especially those controlled by the industrialist heir Hugo Stinnes. As these companies failed, German banks accumulated their equity, which had been pledged as collateral. German banks also spent large amounts of their depositors' money buying their own shares to maintain their stock prices in the later 1920's. Since the share prices being maintained were artificially high, this probably contributed to their later insolvency. By 1931, when all the major German banks were recognized as clearly insolvent, the Deutsche Bank und Disconto-Gesellchaft owned 27% of its own shares, the Dresdner Bank owned 34%, the Commerz und Privatbank 50%, and the Darmstädter-Nationalbank owned 60% of its own shares. To bail them out, the Weimar government took over these blocks, effectively partially nationalizing the banks.

Several proposals to reconstruct German banks along the lines of other European countries were aired. However, a committee established in 1933 to consider banking reform quickly recommended against any changes when the National Socialist Party came to power. Hitler toyed with the idea of fully nationalizing the banks, but never implemented such plans. Following the war, banks in the Soviet occupation zone were "temporarily" closed in 1946 (Kleeberg, 1987), while those in West Germany reattained their prewar structures by 1957.

Banking reform was also on the back burner in smaller European countries like Switzerland, Holland and the Scandinavian countries. The trade war that followed the Smoot-Hawley tariff, passed by the U.S. congress in 1930, virtually shut these small nations out of international trade.[2] Given the economic devastation wrought in these countries by the cessation of international trade, public policy attention was centred on trade initiatives like the Oslo Agreement; banking reform was of negligible importance. Thus, various aspects of universal

[2] The "beggar thy neighbour" devaluations following the September 1931 collapse of Sterling and the adoption of Imperial preferences at the Ottawa conference were also key events.

banking survive in these countries as well. In Switzerland especially, cosy cartels were established to protect the stability of the system. When barriers to entry were relaxed in 1990, 130 out of the then existing 625 either lost their independence or disappeared.

In summary, universal banks were established throughout Europe, but did not survive in France, England or Italy. The Canadian system followed the French and English models. Reform of the banking system in the early 1930's was preempted in Germany by the rise of National Socialism (Kleeberg, 1986).

b. The German banking system.

Heavy bank involvement in industrial firms in Germany is thought by economic historians (see eg. Calomiris, 1992) to have played a key role in that country's rapid industrialization between 1870 and 1914. Citing the German electrical industry as an example, Calomiris (1992) argues that universal banks helped "coordinate decision making among firms" , but that banks "did not encourage the development of cartels to impede entry or stunt technological innovativeness at the crucial early stage of industrial development" although he does not deny that cartels may have arisen later. Calomiris (1992) also argues that Germany's cost of capital during industrialization was both lower and more geographically equalized than was America's, at least in part because bank financing was more difficult in the U.S. Typical underwriting spreads in the U.S. were about 20%, as compared to about 4% in Germany. This, he continues, led to a more capital intensive industrialization in Germany. Benston (1995) argues that the traditional arguments used in the U.S. to justify separating commercial from investment banking are bogus creations of populist politicians. He points out that banks with securities operations had lower failure rates, did not push stocks they were underwriting, etc.

Even if Germany's banking system did provide cheaper capital than was available in the United States, it is not clear how this should be interpreted. The U.S. banking system is an outlier in almost every dimension. Was Germany's cost of capital lower because of greater economies of scale implicit in nationwide multi-branch banking, or was bank involvement in corporate governance through equity ownership the critical factor? Kleeberg (1987) presents a host of evidence that it was not the latter, arguing that German universal banks were remarkably poor at "picking winners" during that country's industrialization, invested in a depressing series of financial debacles, and may actually have impeded Germany's development by sustaining poorly run firms.

Germany industrialized rapidly because it was a latecomer and the path it had to follow was clear, not because of its universal banks. Of course, other factors were also important, but these were often specific to individual industries. The good fortune of having mineral deposits led to coal, zinc and potash industries. It is arguable that the social benefits provided by collieries meant Rurhr miners rarely went on strike, unlike British miners. However, Germany's latecomer advantage may have helped here too - the problems in Britain were clearly something to avoid. A good education system was an undeniable advantage for Germany. Well educated workers helped the Saxon and Franconian printing industries grow to become world leaders in colour printing before 1914. Endowing universities became fashionable for German aristocrats, and a dense network of institutions of higher learning provided personnel for the chemicals industry. Germany's latecomer advantage and these other factors were clearly much more important than universal banks, which Kleeberg would argue were more a hinderance than a help.

Figure 1 illustrates the structure of a German bank's equity holdings under the present rules.[2] The universal bank may own a direct controlling stake in some firms, but more often its shareholdings are held through an investment company. These investment company subsidiaries are analogous to mutual funds in that they pool small investors' funds together to form large portfolios. A critical difference between a German investment company and a North American mutual fund is that investors in the German variant are not shareholders and have no voting rights. Investors sign a contract with the bank's investment company that specifies management fees, etc. German investments law allows the investment company to alter these contracts provided the Federal Banking Supervisory Authority approves the changes. The bank is the controlling shareholder of the investment company and it exercises voting rights in the stocks the investment company owns.

This results in banks controlling majority stakes in most large German companies, as illustrated in Table I. This means that corporate governance power in Germany is effectively concentrated in the hands of the top managers of the major banks. Shareholders are to all effect irrelevant. There are no pension funds in Germany, as pensions are organized on a "pay-as-you-go" basis and are guaranteed by the federal government. Insurance companies are generally affiliated with banks. Thus, institutional investors other than banks and their subsidiaries are not a force. Finally, German law allows management to disfranchise dissident shareholders at annual meetings, so criticism of corporate policy is somewhat muted. Such criticism is, in any case, usually about "politically correct" issues like South Africa or the environment, not the competence or track record of management.

[2] The next paragraphs draw heavily on Baums (1995).

Table I. Voting rights exercised by banks in general meetings of the largest non-bank widely held German corporation in 1992

firm	*banks' direct stake*	*subsidiary investment funds' stake*	*proxy votes controlled by banks*	*total bank control*
Siemens		9.87	85.81	95.48
Volkswagen		8.89	35.16	44.05
Hoechst		10.74	87.72	98.46
BASF	0.09	13.81	81.01	94.71
Bayer		11.23	80.09	91.32
Thyssen	6.77	3.82	34.98	45.37
VEBA		12.82	78.23	90.85
Mannesmann		7.78	90.35	98.11
MAN	8.67	12.69	28.84	48.20
Preussag	40.65	4.51	54.30	99.48
VIAG	10.92	7.43	30.75	49.10
Degussa	13.65	8.65	38.35	60.65
AGIV	61.19	15.80	22.10	99.09
Linde	33.29	14.68	51.10	99.07
Deutsche Babcock	3.22	11.27	76.09	90.58
Schering		19.71	74.79	94.50
KHD	59.56	3.37	35.03	97.96
Bremer Vulkan		4.43	57.10	61.53
Strabag	74.45	3.62	21.21	99.28
average	13.02	10.11	60.95	84.09

Includes shares on own account, depositary voting rights as proxies and shares held by subsidiary investment funds/% of all shares represented at the meeting.
Source: Baums (1995).

It is arguable that Germany has also both actively and passively suppressed financial markets, banks' main competitors in other countries. The active suppression is in the form of punitively high capital gains taxes that both lock banks into their equity positions and discourage the development of active securities markets. The passive suppression takes the form of lax disclosure standards and a tolerant attitude toward insider trading. Thus, relatively primitive financial markets in Germany, by default, leave banks with immense power.

The scope for banks to abuse their positions is immense. Product market competition among banks and their investment company subsidiaries is not intense. No reliable comparison of the performance of German investment companies is made available to the public. The reputation of the bank is considered a guarantee against incompetence or fraud. However, there are surely instances where a bank's interests as a creditor conflict with its investors' interests. Since banks' dividends from their investment companies can be enhanced by churning, etc. there would seem to be another potential conflict of interest here. Banks and their investment companies can also sell blocks of equity to each other in private transactions. Also, investment companies' fees paid to their banks for miscellaneous services are only loosely regulated and are thus another possibility for non-arms-length transactions harming small investors. Baums (1995) points out that German banks' investment companies frequently buy blocks of shares their parents are underwriting, and raises the possibility that German banks may be "dumping the trash" on small investors. He argues that German law is not effective at preventing such "dumping".

German corporate governance, then, is entirely overseen by the country's large banks. How well does this system work? Kaplan (1993) finds that German directors have much more job security than their American peers. He finds that Aufsichtsrat or supervisory board turnover is uncorrelated with firm performance, but that turnover on the Vorstand or management board is related sliding stock prices and especially to very poor earnings. This suggests that if banks do play a role in disciplining managers of nonfinancial firms, they do so from the perspective of creditors - not shareholders.

Even assuming no conflicts of interests between banks and investors, this system depends on the top management at Germany's banks. Incompetence at the helm of a great bank could lead to a domino effect of mismanagement. Unfortunately, bank managers themselves are utterly protected from oversight. Together, the largest German banks control majorities of their own shares, as shown in Table II.

Table II. Voting rights of the five largest stock corporation banks at their own shareholders' meetings in 1992

bank	*Deutsche Bank*	*Dresdner Bank*	*Commerz-bank*	*Bay. Vereinsb.*	*Bay Hypo*	*all banks*
Deutsche Bank	32.07	14.14	3.03	2.75	2.83	54.82
Dresdner Bank	4.72	44.19	4.75	5.45	5.04	64.15
Commerzbank	13.43	16.35	18.49	3.78	3.65	55.70
Bayr. Vereinsb.	8.80	10.28	3.42	32.19	3.42	58.11
Bayr. Hypo	5.90	10.19	5.72	23.87	10.74	56.42

Includes depositary voting rights and shares held by subsidiary investment funds. Figures are percent of all shares represented at the meeting.
Source: Baums (1995).

Overall, the German banking appears singularly poorly suited to provide corporate governance. Germany's large firms have prospered under the system in the post-war period, but signs of strain are beginning to show. In 1982 the Schröder Münchmeyer Hengst bank collapsed because of its heavy exposure to the machinery firm IBH-Holdings, which was heavily levered and failed when the market for construction and farming machinery dried up. The recent financial debacles involving the gigantic German property development firm Jürgen Schneider and the metals giant Metallgesellschaft AG, which threatened the gigantic Deutsche Bank, have raised concerns in Germany that German banks are not able to keep up with the doings of corporate management. Reflecting this, the popular book *Nieten in Nudelstreifen* by the financial journalist Günther Ogger, about the incompetence of German bankers, has been a best-seller there for two years. In response to public concerns, in 1994 the Social Democrats proposed Bundestagsdrucksache 13/367 calls for a 5% limit on the stakes banks could hold in non-financial companies, and a requirement that stakes above 3% be disclosed (down from the current 20%).

c. The Japanese banking system.

Following the 1868 *Meiji* restoration in Japan, that country imitated what it saw as the best features of different Western countries, and chose Germany's banking system as its model, despite the collapse the previous year of the Crédit Mobilier, the template with which that system had been made. The feature of the German system that made it attractive to the Japanese was the same feature that appealed to Bismarck: bank control of capital allocation kept economic power out of the hands of political enemies. Both Germany and Japan were modernizing in the face of concerted opposition from previously entrenched aristocratic classes. Of course, the banks were not always ideological allies either. The Deutsche Bank was also known as *die rote Bank*, and David Hausemann, founder of the Diskonto-Gesellschaft, was a left-wing leader in 1848. Bismarck certainly cared more about controlling the army than the banks. *Gegen Demokraten helfen nur Soldaten!* (Against democrats, only soldiers help.)

Prior to 1945, the Japanese economy was characterized by groups of industrial companies called *zaibatsu*, often organized around a bank, and controlled by a powerful *Meiji* family.[3]

When the family corporate group was highly profitable, their bank invested excess cash flow elsewhere in the economy. These banks, which we shall call *zaibatsu* banks, include the Mitsubishi, Mitsui, and Sumitomo Banks, lent only 10% to 20% of their loans to related firms. They were well diversified and survived the financially troubled 1920's and 1930's.

Other Japanese corporate groups had greater need for outside capital, and so used their banks to raise money for themselves. These captive banks, called "organ" banks, were poorly diversified. For example, 94% of the Nakazawa Bank's loans were to insiders, as were 75% of the Watanabe Bank's loans. Prior to their collapses in 1927, 72% of Suzuki's captive bank, the Taiwan Bank were to Suzuki companies and 75% of Matsukata's Jugo Bank's loans were to Matsukata family firms. In the crisis of 1927, triggered by the financial frauds of Mme. Ione Suzki and the closure of the Tokyo Watanabe Bank, 37 banks failed. All were "organ" banks. It is of note that organ banks typically held less equity (about 15% of the value of their loans) than did the highly diversified *zaibatsu* banks (about 21%).

Another wave of bank failures occurred as the great depression took hold in Japan. In 1930, 19 banks failed; 33 closed their doors in 1931; and 13 more failed in 1932. Again, large diversified *zaibatsu* banks survived, and organ banks failed. Equity ownership was again lower in banks that failed.

Following World War II, the U.S. occupation force in Japan oversaw a full scale revamping of Japan's financial system. Banks were forbidden from underwriting securities issues. Although the U.S. government exerted considerable pressure for a complete ban on bank ownership of

[3] The discussion of the prewar Japanese banking system follows Hoshi (1995).

nonfinancial firms' stock along the lines of U.S. practice, the Allied Forces ultimately decided against this. Banks' share ownership in other companies was limited to a 10% stake, and *zaibatsu* firms were ordered to disgorge their share holdings in each other. (A further reduction to 5% was implemented between 1977 and 1987.) As a result, large Japanese companies were mostly widely held in the immediate postwar period. Reconstruction following the war also entailed high interest rates and low equity prices. Sheard (1991) documents a series of hostile takeover bids during this period. Immediately before the end of U.S. occupation in 1952, Japanese firms began buying up each others' shares again with the explicit purpose of preventing hostile takeovers (Sheard, 1991). This resulted in a considerable increase in intercorporate share ownership between the former Mitsubishi, Mitsui and Sumitomo *zaibatsu* firms between 1949 and 1951. A renewed spate of takeover bids and greenmail payments in the late 1960's accelerated Japanese firms' intercorporate stock purchases, particularly between firms in the newly emerging Sanwa, Fuji, Daiichi, and Kangyo bank groups. The result is the current grouping of Japanese firms into *keiretsu*, groups of firms that, together, own controlling blocks of each others' shares. Corporate groups that contain a large bank as a key member are called *financial keiretsu*. Morck and Nakamura (1994) argue that keiretsu arose primarily as anti-takeover barriers.

The potency of *keiretsu* as anti-takeover defences is illustrated by the American financier T. Boone Pickens' bid for the Japanese firm *Koito* in 1990. Pickens accumulated stock on the open market until he was by far the largest single shareholder, yet he was unable even to gain a seat on the board. Together, other firms in the *keiretsu* owned a majority of *Koito* stock and, acting in concert, they blocked Pickens' every move.

Banks do serve a corporate governance role in contemporary Japan. Morck and Nakamura

(1994) show that new bank representatives are appointed to the boards of Japanese companies when their financial performance lags. Kaplan and Minton (1994) confirm this, and also show that these banker appointments are accompanied by increased turnover of top managers. This is confirmed by Kang and Shrivdasani (1995). This is consistent with banks exercising a greater governance role in troubled firms. However, both Morck and Nakamura (1994) and Kaplan and Minton (1994) find that indicators of possible loan repayment problems, rather than more general indicators of financial health, are the strongest predictors of increased bank attention. Banks appear relatively unconcerned with the welfare of small shareholders or the decisions of management under most circumstances.

Moreover, the globalization and deregulation of securities markets appears to be undermining what governance roles Japanese banks do play. Hoshi *et al*. (1993) argue, in recent years, the most profitable of Japan's large firms seem to be reducing their dependence on banks and turning to financial markets to raise capital. This is consistent with the view that Japanese financial regulations simultaneously protected banks and constrained the capital market activities of other firms.

Japanese banks themselves, like German banks, cannot be taken over. They are protected by the same web of intercorporate ownership that shields industrial companies. Also, the largest shareholders of Major Japanese banks are affiliated life insurance firms. Since these firms have "mutual" ownership structure (i.e. the policyholders are owners) they are unlisted and essentially are management controlled.

III. Banks and Corporate Governance in Canada

Canadian banks are among the largest corporations in the world.[4] Because of their vast systems of branches, they have attained a degree of economic importance that far surpasses that of U.S. commercial banks. According to Breckenridge (1910), the Canadian nationwide branch banking system was a deliberate adoption of Alexander Hamilton's vision of a banking system for the U.S. However, the free banking philosophy current in the U.S. did not take root here. (A brief experiment with free banking in Ontario was not seen as a great success.) The parliamentary charters granted to form Canada's first banks in the early 1800's limited banks' activities to issuing notes and lending for commercial purposes at multiple branches, and required periodic reports to the government. After confederation, their activity was governed by the Bank Act of 1871 and its subsequent revisions every ten years. The general trend of these revisions has been to broaden steadily the scope of banks' businesses.

A financial crisis in 1907, in which crop failures by indebted farmers threatened banks' stability, brought an injection of credit by the federal government, and a new government concern with the stability of the system. The early 1920's were a period of recession in Canada. The 1923 failure of the Home Bank led to increased oversight. Many other banks became unprofitable and were merged into other banks. The number of chartered banks was reduced by two thirds to only ten during the 1920's. Well known names like the Bank of Hamilton, the Bank of Ottawa and Molson's Bank vanished.

Although 27 banks failed in Canada between 1867 and 1940 (Kryzanowski and Roberts, 1994), none failed during the great depression. This latter fact has perhaps given Canada's banking

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[4] The historical description of the Canadian financial and banking systems draws from Siklos (1994) and Freedman (1986).

system an exaggerated reputation for stability. Kryzanowski and Roberts (1994) describe archival evidence that the Canadian government gave a 100% implicit guarantee to all banks following the 1923 Home Bank failure. They further show that all but one bank were technically insolvent in the 1930's and survived only because of forbearance by government regulators. Thus, Canadian banks are a poor example for supporters of multibranch banking to point to when they list greater stability as that system's virtue.

Canadian banks were very conservative about expanding the definition of "banking" in the immediate postwar period. In 1944, they were offered the mortgage business, but collectively turned it down. Only in 1954 did they begin handling N.H.A. mortgages. General mortgages were not part of "banking" until 1967.

In the 1960's and 1970's the Canadian financial system was compartmentalized by function into five groups, known as the "four pillars" of the financial system: chartered banks, trust and mortgage companies, cooperative credit movements, life insurance companies, and securities firms (see Freedman, 1986). This division was underscored by federal regulation of chartered banks and provincial regulation of securities firms. These distinctions became steadily fuzzier over time as innovations by the various institutions encroached on each others' territory. For example, chartered banks increased their mortgage lending while trust companies and credit unions moved into commercial banking and life insurance policies came increasingly to resemble fixed term deposits.

Nonetheless, the introduction of deposit insurance in 1967 created a fundamental difference between banking and other financial businesses that is now politically impossible to undo. The same year, a 10% limit was imposed on bank ownership of nonfinancial firms' voting stock, except for very small companies and for equity obtained as collateral. Prior to this, there was apparently no rule explicitly barring banks from being equity block-holders, but banks' seem not to have taken advantage of this. Even now, the 10% limit in Canada is generous compared to that of 5% in Japan. Yet Canadian banks collectively hold only very little equity, about $10.4 billion out of total assets of $800 billion.[5] The reason we have been given by practitioners and by the Bank of Canada is that "equity ownership is not part of banking".

In the 1980's it became apparent that changing demographics might soon begin eroding banks' lending opportunities as baby boomers age and become net savers. Bankers have a legitimate fear that mortgage lending and other traditional bank activities are likely to be low growth industries. Also, the admission of subsidiaries of foreign banks (schedule II banks) into Canada in the 1981 revision of the Bank Act increased competition in commercial banking as the number of chartered banks rose to 66 by 1991. So do the U.S. Canada Free Trade Treaty and NAFTA mandates that new federal regulations must give "national treatment" to financial institutions.

In addition, inflation and interest rate volatility made banks' traditional business of taking deposits and making loans more risky. New financial products were developed to manage this risk, but these sorts of innovations were part of the traditionally business of securities firms, not banks. Indeed, the global trend towards securitization is undermining banks' traditional financial intermediation business (i.e. taking deposits and making loans). Mortgages, student loans, and perhaps soon small business loans too, are being repackaged into securities and sold to investors. This trend is likely to accelerate following this years introduction of a tax on bank capital in

[5] *Bank of Canada Gazette*, fall 1994.

Canada. Overall, these movements point to a long term decline in conventional banking. Thus, strong pressures arose in the 1980's, mainly from the chartered banks, for financial deregulation. Other financial institutions, especially insurance companies, fearing bank dominance, opposed deregulation.

Various interim measures were introduced in the late 1980's that let banks buy securities firms, trust companies, and enter real estate development. These were consolidated in the Bank Act revisions in 1991 along with an elimination of reserve requirements. The "four pillars" approach is gone. All financial institutions are free to enter all financial businesses, with the sole exception of insurance, which because of intense lobbying, is protected by rules that bar banks from selling insurance in branches and from using information about their customers to target their insurance sales. Banks were also kept out of the car leasing business. All Canada's major securities firms are now subsidiaries of chartered banks, as are any large trust companies.

Canadian chartered banks are currently well represented on the boards of the country's largest nonfinancial firms.[6] Of the 1994 Financial Post 500 firms, 37 have executives from the major chartered banks on their boards. Table III shows some rough measures of growth, profitability, labour force utilization, size, and ownership for Canadian firms without and with bankers on their boards. Firms with bankers are growing more slowly and are less profitable, their workers generate less sales each and they are less capital intensive, they are much larger in terms of sales, employees and assets, and they are less closely held.[7] From this, it is not clear whether

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[6]Romano (1993) reports that bankers are also well represented on the boards of top U.S. companies.

[7] Nakatani (1984) finds that Japanese firms in financial *keiretsu* also grow more slowly and are less profitable than firms with weaker link to these banks.

bankers are appointed to boards in response to declines in firm performance, as in Japan, or whether they are simply more likely to accept honorific board positions from large, slow growing, less profitable firms. In any case, bankers on boards are not *prima facie* correlated with superior overall performance. A more technical research paper in this area is in progress.

Table III. Financial performance and Firm Characteristics of Canadian Firms with and without Bank Executives on their Boards of Directors

	full sample	*no banker on board*	*banker on board*	*t-test probability level*
sales growth	11.4% (492)	11.7% (455)	7.07% (37)	.19
assets growth	10.4% (460)	11.0% (423)	3.41% (37)	.01***
income growth	141% (256)	131% (247)	275% (18)	.52
five year income growth	180% (254)	197% (234)	-17.6% (20)	.01***
return on investments	13.7% (334)	14.0% (306)	10.7% (28)	.05**
return on equity	11.4% (293)	11.7% (269)	9.04% (24)	.04**
income/assets	3.06% (399)	3.11% (365)	2.55% (34)	.37
income/sales	2.97% (404)	2.99% (370)	2.78% (34)	.80
income/worker	$39.4 (391)	$41.62 (357)	$15.6 (34)	.23
sales/worker	$2,158 (485)	$2,305 (448)	$389 (37)	.03**
assets/worker	$2,709 (454)	$2,895 (417)	$601 (37)	.07*
sales	1079 (500)	$922 (463)	$3,042 (37)	.01***
$ employment	4,710 (485)	3,981 (448)	13,543 (37)	.01***
assets	1,547 (466)	$1,393 (429)	$3,343 (37)	.01***
foreign ownership	34.6% (500)	34.2% (500)	38.9% (37)	.53
insider ownership	67.7% (499)	69.3% (462)	48.8% (37)	.01***

Data are for fiscal years ending in 1994. Growth rates are from 1993 to 1994. Five year income growth in 1989 to 1994.

All Canada's chartered banks have long been widely held. This status is preserved by legislated voting caps that prevent any shareholder from acquiring more than a 10% stake. Thus, Canadian chartered banks, like their German and Japanese counterparts, cannot be taken over. Other financial institutions in Canada can be closely-held, so financial deregulation, in establishing equal treatment of all financial institutions, would seem to call for the elimination of these voting caps. It did not. Instead, all federal financial institutions with capital greater than C$750,000,000 were required to have at least 35% of their stock widely held by 1996 and to be fully widely held by 2001. Only banks that are controlled by widely-held financial companies can be closely-held. Smaller institutions and provincially incorporated institutions can come under Schedule II, and thus be exempt from being widely-held.

These ownership rules are reasonable in that they prevent the formation of the sorts of "organ" bank subsidiaries of nonfinancial firms that proved so disastrous in prewar Japan. However, by insulating Schedule I banks' top managers from both the market for corporate control and from oversight by a large shareholder, the current Bank Act almost guarantees that these Canadian banks will suffer from the sorts of governance problems that plague large widely-held U.S. firms. While improved audits and outsiders on bank boards provide some check on managers, the overall ability of the system to discipline bank managers is questionable.

Indeed, banks current rush to diversify into insurance, leasing, securities, etc. is itself disturbing. In other industries, diversification is now almost a dirty word. Morck, Shleifer and Vishny (1990) show that when industrial firms launch diversifying takeovers, their share prices promptly fall. Elsewhere in the economy, firms are returning to their "core businesses" and shedding unrelated operations. Diversified companies are now viewed as expensive failures in corporate governance, and are being broken up. Much of the takeover activity in North America in recent years has actually been the transfers of assets from these diversified firms to firms that specialize in particular industries. Why, then, are banks setting up conglomerates when every other industry is getting back to basics?

A likely answer is that traditional banking produces substantial cash flows (barring Latin American debt disasters, etc.), but offers few growth prospects. Banks are thus following tobacco and steel companies by trying to diversify into growth. When firms in a declining industry try to buy growth by acquiring firms with better prospects than their own, their share prices fall (see Morck, Shleifer and Vishny, 1990). Indeed, this sort of behaviour in other industries would doubtless lead to calls for better corporate governance to force firms to disgorge their cash as dividends to shareholders.

Colossal losses from investments in Latin American debt, London real estate, or New York office buildings have not led to the sacking of senior bankers. Indeed, Canadian banks seem to have adopted a collective "herd" mentality. As long as all the banks make the same investments at the same time, no individual banker can be blamed if money is lost. This sort of logic would do little to convince angry shareholders not to tender in a takeover bid. Canadian pension fund manager Stephen Jarislowsky (1994) reports the following interchange: "After the annual meeting of Canada's largest bank, The Royal Bank of Canada, I quipped to the C.E.O. Mr. Rowland Frazee, "What does it take to get fired as C.E.O. of a Canadian bank?" He responded, "What do you mean, Stephen?" I said, "Rolly, you lost $1.5 billion this year." His answer: "I see what you mean!""

IV. Should Public Policy Push Canadian Banks Toward a Corporate Governance Role?

Canada's financial system is at a unique point in history. Recent financial deregulation has removed most constraints on banks, and a spate of takeovers of other financial firms has greatly broadened banks' economic role. At this same time, corporate governance is becoming a major public policy issue. Pension fund managers are increasingly critical of poor corporate performance. Shareholder advocates such as Fairvest are increasingly vocal. Is there a solution to our corporate governance problems that involves a further expansion of banks' functions in the Canadian economy along the lines of Germany or Japan?

We argue that the answer to this is no for three reasons. First, as we showed in section II, the German and Japanese systems have serious problems of their own. Even if we could switch immediately and costlessly to their models, it is far from clear that this would be an improvement. Second, as we showed in section III, Canadian banks are required by law to be widely-held. Thus, almost alone among major Canadian firms, they are likely to be subject to the same serious corporate governance problems that plague large widely-held U.S. firms. Putting banks in charge of corporate governance is uncomfortably like putting the fox in charge of the hen-house. And thirdly, there are several facts of political and economic life in Canada that make German or Japanese style bank oversight less attractive here. We now turn to these.

A political fact any expanded role for banks must deal with is deposit insurance. Some economists, in recent years, have deplored the apparent political impossibility of downgrading or eliminating deposit insurance. In our view, this popularity should be taken as revealing a strong public preference for the existence of a readily accessible, minimally risky asset. Certainly, standard portfolio theory is consistent with such an asset being welfare enhancing. If, to create such an asset, the government is guaranteeing large swaths of banks' debts (i.e. their deposits), then a case can be made that banks' assets (i.e. their mortgages, loans and other investments) ought to be limited to investments that can be effectively monitored by government supervisors. One straightforward demarcation line might be that investments where tangible assets are put up as collateral are acceptable, but others are not. This clearly excludes equity investments by banks.

A second fact that distinguishes corporate governance issues in Canada from those in the United States is that most Canadian firms are closely held, not widely held. Morck and Stangeland

(1994) show that the poorest performers among Canadian firms are not those with diffuse ownership, but those with entrenched family control. Shleifer and Vishny (1986) demonstrate that a stake by a large outside investor (such as a bank) might improve the performance of a widely held firm. However, large U.S. institutional investors such as CALPERS avoid closely-held firms. Presumably this is because institutional investors are less able to mitigate problems associated with entrenched management than those associated with diffuse ownership.

Related to this, a third fact that distinguishes the Canadian situation from Germany and Japan is the existence of large institutional investors here. Institutional investors like the $35 billion Ontario Teachers' Pension Plan, because of legal limits on the foreign investments they can make, are forced to take large stakes in Canadian firms' equity. Increasingly, Canadian pension funds are working to improve the governance of firms in which they invest, since the alternative of selling their large blocks of equity onto the open market pushes the price down before the sale is complete. Both private sector and public sector pension funds are exerting steadily increasing pressure on corporate managers to improve performance. In both Germany and Japan, pension plans are managed on a pay-as-you-go basis, so there are no pension "funds". Other financial institutions in Canada, like venture capital funds also play governance roles in other sections of the economy. Kroszner (1995) argues that in the U.S., given the existence of these substitutes, letting banks holding equity stakes would add little. The same argument applies here. Indeed, given the potential problems in the governance of Canadian banks themselves, other institutional investors might be preferable as checks on management in the 16% of large Canadian firms that are widely-held.[8]

A fourth fact is that Canada does have active financial markets and a market for corporate control. While hostile takeovers are rare, they do happen. Nova's takeover of Polysar via a hostile proxy fight is a good example. The recent $1.2 billion L.B.O. of Maple Leaf Foods Inc. by the ousted McCain Foods C.E.O. Wallace McCain and backed by the Ontario Teachers' Pension Plan is an example of the market for corporate control in action. Hees International Bankcorp's equity workouts in the 1980's are another. Most Canadian takeovers are friendly since they are aimed at closely-held firms, but these are still ways of replacing top management.

A fifth fact of contemporary Canada is the existence of active and sophisticated financial markets and investors. Organizations like Fairvest Securities Corp. and the Canadian Shareholders' Association lobby for shareholders' rights and against the poison pills that widely-held Canadian companies are increasingly adopting. In contrast, especially in Germany, financial markets are relatively primitive.

Sixth, Canada's banks do not seem terribly interested in being equity block-holders. They seem more intent on diversifying out of their low growth core business and into possibly higher growth lines of business like securitization - in imitation of the financial conglomerates that exist in Britain.

A final political fact is the already considerable public anxiety about concentration of economic power in too few hands in Canada. In Germany, because of their intercorporate ownership stakes and trusteeship role, the large banks indirectly control a majority of their own

[8] Morck and Stangeland (1995) report that only 16% of the largest 550 firms in Canadian 1989 had no single shareholder controlling more that 20% of their votes.

voting stock. In Japan, bankers are protected by networks of intercorporate equity holdings that exclude outsiders from exerting any control. In Canada, banks are insulated from corporate governance challenges by government mandated voting caps. The banks may watch other firms, but who watches the watchers? Encouraging bank ownership of blocks of equity might very well only further entrench Canadian managers and exacerbate the political problems that flow from overly concentrated economic power.

V. Conclusions and Public Policy Options

Historical studies and econometric analyses of banking in both Germany and Japan suggest that the concept of banks as guarantors of good corporate governance owes more to wishful thinking by economic theoreticians than to hard evidence. Both the German and Japanese systems have serious shortcomings of their own.

The Canadian banking system evolved in a different direction, and Canadian banks are now poorly equipped to perform a monitoring role over the managers of other firms. Indeed, Canadian banks arguably show signs of serious corporate governance problems themselves. Any role for banks in improving the corporate governance of other firms must be predicated on improving corporate governance in banks first.

One easy way to do this would be to relax banks voting caps for investments by *independent* pension funds to, say, 20% while keeping the caps at 10%, or perhaps even lowering them to 5%, for all other investors. Pension funds managed by corporations, or even provincial governments, might also be bound by the lower limit. This would allow hardnosed institutional investors to oversee bank managers, but would prevent the formation of "organ" banks.

Another would be to further open up the Canadian banking system to (possibly foreign) competition. Scholnick (1994) reports that the average spread between mortgage rates and G.I.C. rates in Canada has risen from one to two percent in the 1980's to two to three percent in the 1990's, while the overall costs of commercial banking have declined slightly. This should not be possible in a competitive industry. If banks can use their market power to pass on the costs of mistakes in corporate governance to depositors, pressure from shareholders can be deflected. Heightened competition for depositors' dollars in commercial banking would make shifting costs to depositors less viable and would force banks to confront their own corporate governance issues.

If bank ownership of nonfinancial firms' equity does take hold in Canada, regulators should be on the alert to protect both depositors and taxpayers. The "liabilities" on a bank's balance sheet that correspond to the debt of an industrial company are largely its deposits. Financial economists theorize that the industrial firms' bondholders perform a sophisticated monitoring function. It is unrealistic to ascribe a similar role to banks' depositors, who are the quintessential unsophisticated investors. Through their political support for deposit insurance, they have made it clear that they want a maximally safe asset in bank accounts. While it is certainly true that many stocks are much less risky than Brazilian bonds or New York real estate, equity is an investment without collateral. In light of this, a policy option that deserves consideration is amending bankruptcy laws to give depositors absolute priority in all the companies a bank controls. Even if this is unlikely to improve corporate governance, it would at least protect the taxpayers from footing the bill *via* the C.D.I.C. for banks' possible equity misadventures.

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