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Class B

Corporate Governance and the EU's Dilemma

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On January 7th 1996 the then leader of the opposition Tony Blair adressed an assembly of businessmen in Singapore and laid out his plans for a stakeholder society in Labour-led Britain. This speech has since become known as the famous *Stakeholder-speech.*

In it Tony Blair explained a vision of a Britain where all the economic agents had a stake: "... it is surely time to assess how we shift the emphasis in corporate ethos - from the company being a mere vehicle for the capital market - to be traded, bought and sold as a commodity; towards a vision of the company as a community of partnership in which each employee has a stake, and where a company's responsibilities are more clearly delineated".

Only a few sentences earlier does Tony Blair mention the concept of *corporate governance* and its relevance to the stakeholder issue.

In this essay I shall attempt to

- explain the concept of corporate governance,
- analyse the way in which it bears fundamentally different relevance in the economies of the UK and Germany respectively,
- explain the connection between different applications of corporate governance and the notions of stakeholder and shareholder societies
- outweigh the relative merits of the two economic systems with respect to their differences in corporate governance
- discuss how harmonisation may be achieved in the EU

What is corporate governance?

Loosely defined, one could say that corporate governance (or *corporate control*) is *the control the owners of a joint-stock company have over its management.* [1]

The reason that owners would want to exert this control is that the goals and actions of a company's managers often conflict with the interests of the shareholders[2]. A manager might for instance not maximise profits by diverting horrendous profits to himself, by making net-deficit investments in order to increase his or her personal power or - at the other end of the egoism/altruism spectrum - by being reluctant to sack workers whose marginal cost is above their marginal productivity (Hart 1995:681).

Managers, Hart argues, can not be committed through contracts, since these are expensive (*contracting costs*), nor through incentive schemes - the manager's pay is dependent on the firm's economic performance - since these are not comprehensive[3](Hart 1995: 679).

It is obvious that there is some need for 'checks and balances' on managerial behaviour. Oliver Hart mentions three ways to keep managers under control:

1. Monitoring by a board of directors or large shareholders.

2. Threat of proxy fights & takeovers.

3. Corporate financial structures[4].

At this point it is worth considering the extent to which corporate governance is prevalent in the economies of the UK and Germany respectively. The two differ enormously in the respect that, very broadly speaking, German companies experience a lot of corporate governance whereas UK companies experience a small degree of corporate governance, but instead stand under the threat of takeovers and are thereby controlled.

I shall now discuss each economy in detail.

Corporate Control in the UK

The UK capital markets are typically defined by a large number of public joint-stock companies, each with a *large* number of *small*[5] shareholders and very few *large* shareholders, if any. This fact is simply an application of the principle of *portfolio diversification.* [6]

This system of large numbers of small shareholders leads to a significant problem in corporate control: usually no one shareholder is big enough to exercise any control. Small shareholders on the other hand have no incentive to monitor management for the following reason: there is a big *free-rider* problem. Any effort on the part of a shareholder would be beneficial not only for himself, but also for all other shareholders, so that the average shareholder hopes that someone else will do the "dirty work". In other words, the social benefit of a shareholder taking measures to exert control would be huge, whereas his or her individual benefit would be minute, and would not do justice to the costs involved, like gathering information, monitoring management etc.[7] (Hart 1995: 681)

Other forms of control remaining are monitoring by independent boards of directors, proxy fights and hostile takeovers.

Independent boards of directors who monitor management bear the same problem as the management itself: who controls them? In other words: who monitors the monitors?

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[1] Owners being the *shareholders* of the respective company

[2] This is often referred to as a *principal-agent* problem, where the owners of the firm are the principals and the managers the agents.

[3] ie a manager might make an investment that pays off a fortune in the short run but ruins the company in the long run, then take the money and run. This again would require contracting and we are faced with the same problem.

[4] Since I won't come back to this topic later, I shall briefly explain this issue. Hart argues that if companies decreased their level of gearing and made managers liable to the amount of debt outstanding, then managers wouldn't want to misbehave. Liability laws would have to be altered in most countries to make such a system effective, though.

[5] small shareholders = shareholders owning an insignificant proportion of the total of shares, eg 0% to 5%.

[6] This implies that mean returns are maximised and risk is minimised simultaneously by spreading ones portfolio of shares over a large number of companies with different risk-return characteristics. Note that there is a trade-off between risk and return, implying that with perfectly diversified portfolios one cannot increase average returns without increasing risk and that, conversely, one cannot decrease risk without decreasing average returns.

[7] Oliver Hart also argues that large shareholders will not take full measures to ensure control if they don't own a 100% of the shares. There seems to be a fallacy in Hart's reasoning, however, since active control may be beneficial long before the owner owns 100%, namely at the point where his marginal cost of monitoring management equals his individual marginal benefit. This may theoretically already be the case where an owner only owns say 10% of all the company's shares, if the dividends are very high.

Proxy fights - a shareholders tool which allows him or her to propose a new, alternative set of non-executive directors at shareholder's meetings - bear in them the same free-rider problem as individual control: the marginal cost of leading a proxy fight is enormous compared to the marginal benefit of the individual shareholder. (Hart 1995: 682)

The only method left in a UK-style economy to control management seems to be *takeovers.* [8]

Jenkinson and Mayer identify two roles of hostile takeovers:

- The *threat* of a hostile takeover will lead incumbent management to change the way it behaves and drive it to being as efficient as possible
- Hostile takeovers that actually take place allow poor management to be replaced with better management.

Jenkinson & Mayer indeed report that 90% of incumbent management can expect to be sacked in the first two years after a hostile takeover.

There are, however, a number of problems with hostile takeovers:

- Free-rider problem: shareholders see potential increas in share value and therefore hang on to their shares, making a takeover bid impossible.
- Bidding companies may face competition from other companies
- Incumbent management may pose a problem to hostile bidders, eg through employing a white knight[9] (Hart 1995: 684)
- Hostile takeovers are expensive
- Hostile takeovers do not always discern poorly managed firms from well managed ones
- Evidence on the performance of a company after a a takeover is very mixed and rarely shows much improvement of an incumbent company. (Jenkinson & Mayer 1992:3)

Nonetheless hostile takeovers seem to be a common feature of the UK's economy. Jenkinson & Mayer argue that this is due to a *corporate strategy* of acquiring companies rather than to any form of management-arbitrage. They argue that the replacement of managers is more *ex ante,* ie to ensure better management in the future, rather than *ex post,* ie to get rid of managers because of their actions in the past (Jenkinson & Mayer 1992:3).

Erik Berglöf also argues that the whole mechanism described above is strongly linked to Britain's *common law* framework, with its *company-based* legal system, which focuses on the *firm* as a legal entity and the relationship between the firm and its investors. (Berglöf 1997: 106)

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[8] Indeed Franks & Mayer report that the level of takeover activity is twice as high in the UK as in France or Germany, and Jenkinson & Mayer report that 1/4 of all takeovers in the UK since 1970 were hostile[8] in nature, whereas Germany has only experienced four hostile takeovers in its whole post-war era. (Jenkinson & Mayer 1992:3).

[9] white knight = third company that bids in order to save incumbent company from hostile bidding company.

Corporate Governance in Germany

As I have noted above, takeover activity in Germany is very low and hostile takeovers are virtually inexistent. How then are managers of German companies kept at bay?

Jenkinson and Mayer suggest that there are two fundamental factors accounting for the large degree of corporate governance in Germany:
1. Ownership of the corporate sector
2. Structure of the corporate sector

I shall take a look at both in closer detail:

Corporate sector ownership

The big contrast in corporate ownership to the UK economy is the fact that Germany has a system of *concentrated shareholdings*. [10]

A second contrast is the fact that a large proportion of all shares is held by non-financial companies[11], which indicates a large degree of *participation* and *holdings*. (Scneider-Lenné 1992:14).

A third factor is the strong participation of banks in the German economy. I shall discuss the role of banks in more detail further down.

Jenkinson & Mayer argue that the purpose of these share-groupings is the fact that they allow *implicit contracts* to be sustained between different parties to a production process, ie that large ownership and cross-participation allow *informal arrangements* to be done where contracting costs would be far too high. (Jenkinson & Mayer 1992:6)

Corporate sector boards

Schneider-Lenné points out that there is a strict[12] threefold division of the head of German companies into:

- Vorstand[13]
- Aufsichtsrat[14]
- Hauptversammlung[15]

In addition German law requires the Aufsichtsrat to include 50% *employee representation* [16] and it by default usually includes major *suppliers* and *purchasers* - ie other *stakeholders* in the firm. (Schneider-Lenné 1992:15)

The role of banks

Banks play a very important role in the German economy for the following reasons (Schneider-Lenné 1992:17ff):

- Relations between banks and companies are traditionally closer that in the UK. [17]
- German Banks have large industrial holdings.
- Many supervisory boards of companies have one or more representatives from a major German bank.
- German Banks are often given proxy voting rights by shareholders which enable far greater vote-representation at shareholder meetings.

Far from being the vicious owners they are often made out to be, banks find that they cannot do justice to the great amount of demand they face to be on supervisory boards of companies.

Net effects on corporate governance

The three factors mentioned above, concentrated shareholdings, strict division of boards and the large role of the banks can explain why there is a great degree of corporate control in Germany. Large shareholders now have an incentive to monitor their firms, this is supported by the division of boards, and the banks, as major financig instruments, have an additional vested interest in the governance of the companies.

[10] Franks & Mayer report that of the 200 largest German firms, 90% have at least one owner with more than 25% of all shares. This is rarely the case in the UK, since it goes against the principle of portfolio diversification.
[11] in 1990 non-financial companies accounted for 42% of all shareholdings.
[12] Berglöf (1997) argues that German corporate legal system enforcing this strict division, based on its civil or Roman law roots, is *enterprise-based* and thus places emphasis on the broader view of the stakeholders.
[13] managing board
[14] supervisory board
[15] shareholders' general meeting
[16] Note however that in the case of a draw the president's vote counts twice, so that owners potentially have the saying.
[17] Companies usually bank with one bank for most of the time, which leads to the German concept of *Hausbank*. Companies see their fidelity in their house-bank as a form of insurance, and many German companies have been saved from financial distress by their banks (Allen & Gale 1995)

The effects of this system are manifold:

- German firms usually have a very long life-span. Close cooperation between suppliers, purchasers and employees ensures continuity.
- Stakeholders at large - and not just shareholders - have a large part in the decision-making of a firm. Allen & Gale point out that many German banks do not necessarily seek to maximise profits. Schneider-Lenné indicates that the German constitution holds down that 'ownership entails obligation' and that traditionally boards pass all decisions unanimously in order to ensure weighted decisions. The German model is therefore often called the *consensus model*.

Comparative Merits

Comparing both systems we can see that both have their advantages and disadvantages. The obvious advantages of the German system are the longevity of individual companies coupled with long-term investment in both human and physical capital. The resulting stakeholder system also accounts for greater social cohesion.

The UK System on the other hand has its obvious advantages in risk diversification. Furthermore, small companies at the beginning of their lives which are comparatively risky and speculative find easier entrance to capital markets than equivalent firms in Germany (Jenkinson & Mayer 1992:8). On the other hand one can complain that - as Tony Blair does - the emphasis on profit maximisation leads to only respecting a shareholding minority as opposed to a stakeholding whole.

The EU's dilemma: regulation or competition, stakeholder or shareholder?

In view of the unification of countries with systems as diverse as the UK and Germany within the European Union, the obvious questions arise:

- In what direction should harmonisation of systems move? The German system or the UK system?
- How should this harmonisation take place? Should competition decide or should regulation lead the way?

The first question is indeed very hard to answer, since on the one hand there is very little empirical study on the correlation between corporate governance and economic performance (Berglöf 1997) and since on the other hand economic performance may not be the only criterion of relative merits[18]

The second question is no easier, but considering the fact that there is a lack of profound empirical study on the subject, one might conclude that artificial harmonization in the form of regulation is unwise, since this could lead to very fragile circumstances (Jenkinson & Mayer 1992; Berglöf 1997; Blair 1996[19]).

It would in this case seem better to let competitive forces decide what the natural outcome of the coexistence of two systems will be.

The Economist[20] argues that deregulation should pave the way, but this is self-defeating since both the UK and the German systems are backed by regulation (Berglöf 1997). [21] Tony Blair does not seem to give us any practical solutions to the problem and the Economist criticises him for adopting a system which has proved to lead to slower economic growth. This again seems to be self-defeating in as far as the statement is tautologous: the systems are radically different in as far as they adopt different *values*: the UK wants profit-maximization and Germany wants stability and social cohesion. One could argue that the quest for sustained growth is a value that goes hand-in-hand with profit maximisation, but not necessarily with social cohesion.

To end with a note from Jenkinson & Mayer: " It is quite conceivable that increasing internationalization of capital markets will cause a breakdown of quite fragile collaborative arrangements that exist in these[22] countries. The important point to bear in mind, however, is that if this happens it will say *nothing* about the relative merits of the different systems. It will merely be a reflection of the asymmetries in moving from one system to another." (Jenkinson & Mayer 1992:10)

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[18] One might argue that there is a trade-off between economic growth and social cohesion, but that it is worth the economy growing at a slower rate for the sake of equality or whatever.

[19] "We cannot by legislation guarantee that a company will behave in a way conducive to truth and long term commitment."

[20] Issue of February 10th 1996

[21] In the UK regulation ensures that insider dealings is strictly forbidden and thereby makes takeovers easier.

[22] Continental Europe