

# **Corporate Governance and European Financial Markets<sup>1</sup>**

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## **1 Investor protection and economic performance**

The dominant paradigm amongst law and finance academics and the most influential policy prescription is that investor protection is key to financial development and economic growth. This policy has risen to the fore in international agencies such as the OECD and the World Bank as well as amongst governments around the world.

The basis for this assertion is that investor protection is critical to the willingness of minority investors to participate in the financing of corporations. In the absence of adequate protection, minority investors are exposed to self-interest of large shareholders and markets are dominated by these shareholdings. Participation by outside investors is then discouraged, and the development of financial systems is restricted. Furthermore, investment in some companies and industries is particularly dependent on external finance. The growth of these firms and industries is impeded and economic development suffers.

The policy prescription is therefore straightforward. Strengthen investor protection and financial development will follow. This will promote external finance, which will accelerate economic growth.

This emphasis on investor protection takes several different forms. It stresses the importance of bank regulation and the protection of depositors through prudential supervision. It points to sound regulation of non-bank financial institutions, such as pension funds, life assurance firms and mutual funds. It takes the form of creditor protection and the establishment of insolvency procedures that preserve creditor rights and priorities. And it concerns the rights of shareholders to vote on corporate policies, to dismiss management and to litigate against injustices.

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<sup>1</sup> This paper has been prepared for a meeting of the Euro 50 Group in Luxembourg on 10 July, 2003. Colin Mayer is Peter Moores Professor of Management Studies at the Saïd Business School, University of Oxford and a Fellow of the European Corporate Governance Institute (ECGI).

It is not difficult to see failures in financial markets that justify regulation. At the very least, they are prone to imperfect information that makes investors exposed to incompetence and bad management. More seriously, investors are at risk of fraud, which afflicts financial markets more than any other because of the ease of perpetrating it, the difficulties of detecting it and the frequent impossibility of prosecuting for it successfully even when disclosed. Regulation can also readily be justified by threats to financial systems as well to individual investors and poor corporate governance has been blamed for systemic failures in the Far East, Japan and Russia.

The pre-eminence of investor protection pervades most current financial market policy proposals. For example, the response in the US to financial irregularities is to introduce legislation that strengthens accounting standards, increases directors' fiduciary responsibilities, imposes larger penalties for corporate governance failures and encourages whistle-blowing by insiders. Conflicts of interest are to be discouraged by raising barriers between different institutional activities, such as analysis and broking.

The main source of regulation is scandals. Regulatory inaction in the face of fraud or deception is impossible. In so far as audit failures reflect not only on the auditing companies but also on the standard setters and enforcers, it affects investors' views about the reliability of accountancy firms in general and their regulators.

The best example of this is the greatest scandal and corporate governance failure that the world has ever seen. This was of course the South Sea Bubble. The Bubble not only consumed the South Sea Trading Company itself but also "a company for carrying on an undertaking of great advantage, but nobody to know what it is." and petitions for charters to "extract silver from lead". The response was the Bubble Act, which set back the development of incorporation in the UK for 100 years.

The latest examples are Enron and Worldcom in the US. These failures are perceived to be indicative of underlying deficiencies of the US system in corporate governance, accounting and auditing. They are therefore systemic in nature and have prompted

responses in the form of the Sarbanes-Oxley Act, as well as those from the New York Stock Exchange and NASDAQ.

In Europe over the past few years, there has been the Bouton report in France, the Baum Commission and the Cromme code in Germany, the Swiss Stock Exchange, SWX, code and the Higgs committee in the UK. These have proposed a variety of reforms primarily focusing on the composition and role of boards, and the independence and responsibilities of directors.

This paper explores some of the questions raised by regulatory proposals on corporate governance, their relations to European financial markets and their effects on corporate performance.

## **2 The Costs of Regulation**

There are many objections that are raised against regulation, relating in particular to the accountability of regulators, the direct and indirect costs of regulation and the moral hazard problem associated with the provision of public insurance. However, there is a further concern that is particularly applicable to corporate governance.

The costs of regulation are not only borne by savers and financial institutions but also by the users of capital, namely firms. One of the most pronounced differences in corporate sectors across countries concerns the ownership and control of firms. Levels of concentration of ownership differ appreciably from the highly dispersed systems of the UK and US to the highly concentrated of Continental Europe, Japan and the Far East.

Figure 1 shows the percentage of listed companies in different countries that have a single shareholder or voting block that commands a majority of votes in a company. It shows that in majority of listed companies in Austria, Belgium, Germany and Italy there is a single voting block commanding more than 50% of votes. In the Netherlands, Spain and Sweden it is between 25% and 40%. In contrast in the UK and US it is around 2%. Figure 2 shows that the difference is even more pronounced in relation to the percentage of companies in which there is a single voting block with a blocking minority, i.e. more than 25% of the votes in a firm.

## INSERT FIGURES 1 AND 2

Figure 3 illustrates another feature of many Continental European companies that is largely absent from large listed firms in the UK and US and that is the dominance of family ownership. The Porsche family controls all of the voting shares in their firm even though they only have a small percentage of cash flows. Finally Figure 4 is an example of the way in which management can protect itself against the discipline of markets in corporate control. Ownership in ING is widely dispersed through the Administratie Kantoor but the holders of the share certificates have no voting rights.

## INSERT FIGURES 3 AND 4

Principal-agent theories tell us that the corporate governance problems associated with dispersed ownership are quite different from those of concentrated ownership. As guardians of investors' savings, the role that financial institutions should perform in monitoring their corporate investments should therefore vary appreciably across countries.

Nowhere is this more in evidence than in the differences between developed, emerging and transition economies. The financial and corporate governance needs of enterprises in developing and transition economies are quite different from those in developed economies. For example, the significance of bank versus market finance varies appreciably across economies.

Similarly, within particular economies, the financing and governance requirements of small firms are quite different from those of large and those of high tech industries quite different from those of more traditional manufacturing and service firms. For example, venture capital emerged to meet a specific financing and governance requirement of start-up and developing corporations. Venture capital funds work in very different ways from other mutual funds, and banks and business angels work in quite different ways from venture capital funds. Furthermore, the funding of venture capital firms in Japan is quite different from that in the UK and US - primarily through banks rather than pension funds and life assurance firms as in the UK and US.

What this points to is a considerable variety in the needs of firms across countries, time and activities. The heterogeneity of financial institutions and financial systems is a reflection of those needs. But still more significantly, those needs change in unpredictable ways. Few would have predicted the remarkable growth in venture capital or the use of derivatives in corporate activities even thirty years ago. The relevance of securitization to corporate finance is only just beginning to be appreciated.

In the context of the importance of diversity and innovation in corporate finance, the concern that regulation raises is its inevitable tendency to homogenize. Corporate governance rules prescribe the structure of boards, the way in which they operate, the way in which executives can be remunerated, the employment and rotation of auditors, the separation of functions between different types of activities. To avoid accusations of arbitrary or unfair conduct, regulators have to operate according to well-defined, pre-specified rules. Only a very modest amount of variation can be permitted before regulation becomes unworkable or unenforceable.

According to this view, possibly the most serious risk of financial regulation and corporate governance rules is not the cost that it imposes on investors and financial institutions but its effect on corporations and the rest of the economy. Regulation threatens diversity and innovation in financial institutions and systems. This is a particular concern in relation to regulation at an international level. There is a natural inclination for regulators to favour harmonization. Not only is it tidier and avoids “runs to the bottom” but it also allows best practice from one regime to be imposed elsewhere.

And therein is the heart of the debate. There is a presumption not only in harmonization but in regulation more generally of best practice. There are best ways of running businesses and organizing corporate governance. Adopting these best practices improves corporate performance and financial systems. But there is another view and that is best practice varies across countries, time and activities. What is suited to one economy is quite different from another. What is suited to one firm is quite different from another.

According to this view, regulation should not be picking winners. It should encourage the market to identify winners and push out the frontier of best practice. It should be minimizing interference in the operation of financial institutions. It should not be substituting for markets but promoting them. There should be competition between financial systems and companies should be free to choose their system of incorporation. In this respect the European Court of Justice's ruling in favour of Centros in its dispute with the Danish Companies Registry over its right to choose its country of incorporation is very significant.

Is diversity in financial systems beneficial or detrimental to the corporate sector? Is harmonization of regulation desirable? Should regulation be seeking to harmonize or promote diversity in systems? Does competition promote diversity or runs to the bottom? Should the Centros judgement regarding freedom to incorporate be welcomed or regretted?

### **3 Forms of Corporate Governance**

There is a commonly held view that the culture of British business makes it unlikely that Enron could happen in Britain. Less use of stock options as a form of executive remuneration and a more substance based system of accounting mean that US style accounting scandals could not happen there. For example, directors of British companies have had to sign off their accounts as being a true and fair representation of the financial condition of their firms for a long time. The implication of this is that the British system of corporate governance, of accounting, regulation and doing business is inherently superior to that in the US.

This is the latest twist in a debate that has been raging for decades if not the best part of a century about the comparative merits of different financial systems and forms of corporate governance. One officer of a German Great Bank observed in the early part of the last century that, "in Germany our banks are largely responsible for the development of the Empire, having fostered and built up its industries. ... To them, more than any other agency may be credited the splendid results thus far realized".

Twelve years ago, the Japanese system was regarded as the model and Japanese firms were posed to take over US industry. Then as the Japanese bubble burst and the economy went into recession the only model that the Japanese economy seemed to exemplify was that of crony capitalism.

As the bubble drifted from Japan to the US, Japan was replaced as the role model by the US. Up until a few years ago US GAAP was regarded as the global standard. The US was viewed as the engine of entrepreneurship and the new economy and Europe was plagued by sclerosis. But as its high-tech, internet bubble turned to bust, the US was regarded as exemplifying the excesses of capitalism, the problems of paying executives with options, the home of accounting manipulations and the breeding ground of conflicts of interests between auditors, managers, credit rating agencies, analysts, brokers, investment banks, not to mention between government and business.

That is how the UK rose to the fore. It has come to be seen as providing an appropriate balance between unrestrained capitalism of the US and the private benefit systems of Continental Europe and the Far East. It supposedly has good accounting standards, it has led the way through the Cadbury Committee of establishing codes of good corporate governance conduct and it has well functioning markets in corporate control.

Is there a preferred system of corporate governance? Is there a model that all countries should be adopting and, if so, what is it?

#### **4 Takeovers**

The European Commission has proposed a new takeover directive. The absence of a market for corporate control has been regarded as a serious deficiency of European capital markets and a reflection of the antiquated systems of ownership and control that pervade European corporate systems. The absence of a level playing field has been viewed as an impediment to the restructuring of European enterprises. The European Commission believes that the breakdown of barriers to a market in corporate control is a fundamental requirement for the establishment of an integrated European financial market.

Europe is littered with impediments to takeovers: voting right restrictions, dual class shares, pyramid structures of ownership, cross-shareholdings and staggered boards are just a few of the methods that management employ to avoid the discipline of the takeover market. The way in which the Winter Committee report on takeovers recommended that this should be corrected was by providing predators with the right to break through at least some of these barriers, in particular voting right restrictions and dual class shares. This provoked an outcry from countries that routinely employ these devices and the complaint that if some but not all barriers are penetrated then far from creating a level playing field in takeovers, a still more uneven terrain will result. The debate is still raging but, if a break-through provision results, it will fundamentally alter the structure of corporate ownership and control in Europe.

Is a break-through provision required to create a market in corporate control? Will it be beneficial?

## **5 Information and Disclosure**

Critical to the promotion of markets is the provision of information. The one failure that we know pervades financial markets is asymmetries of information. Investors need to know the basis on which they are investing. They need to know the systems of protection that they provide. They need to be able to price the risks that they incur.

US financial regulation has traditionally placed greater emphasis on “private contracting” than the public contracting system of European financial markets and the Far East. Private contracting emphasizes disclosure, private insurance and auditing rather than conduct of business rules and compensation funds. It promotes rather than substitutes for markets. Recent experience has demonstrated the potential vulnerability of private contracting. It relies not only on *caveat emptor* but also on the accuracy of information and the integrity of auditors. It is particularly vulnerable to the failures that we have witnessed over the past year. Superficially at least, public contracting offers greater investor protection. But an alternative policy is to strengthen disclosure, auditing and private insurance rather than impose the uniformity of public contracting.

Is an emphasis on disclosure desirable? Is it adequate? How far should regulation be prescribing best practice?

## **6 The Role of Non-Executive Directors**

There are two areas of corporate governance that have received particular attention. The first is in relation to the board. Non-executives are in a unique position to gather information about the company from within, to evaluate the performance and integrity of executive management and to inform investors. But several conditions need to be fulfilled for this to happen. Firstly, investors need to be able to rely on the agents they appoint to perform this function. Non-executives need to be good, independent and highly motivated. This means that they should be properly remunerated, well trained, appropriately appointed and effectively sanctioned when they fail to perform.

Secondly, investors need to have access to relevant information. Some of this relates to strategy and is appropriately communicated by executive directors. But other information concerns management competence, integrity and process for which independent assessments are required. For non-executives to be able to evaluate these, they need to have access to similar information and personnel to executives.

According to this view non-executives should not be seen as external part-timers who turn up for board meetings, and are fed information and good lunches by executives. They should be able, and expected, to move freely through the firm, accessing information as required. They should be given the resources (personnel, data, data systems etc) that allow them to evaluate performance, to uncover failures and in particular to evaluate corporate and managerial performance against appropriate benchmarks.

Defining the independence, appointment, remuneration and role of non-executive directors and auditors are key determinants of good corporate governance. Some of these could be set out in articles of association or contractually specified as part of the duty of care of non-executive directors and auditors.

But while independence is critical for non-executives to perform whistle-blowing functions, some companies look to non-executives to provide advice and experience.

For them, independence is unduly restrictive. The role of non-executives should therefore be precise but not uniform. Some may be appointed for their knowledge of the industry and others for their ability to monitor. On this basis, self-regulation is preferable to statutory intervention, perhaps backed up by the threat of statute if institutions and companies fail to adopt adequate standards of care.

Should the role of non-executives be strengthened? Should they be independent? Should there be diversity in the functions performed by different non-executives?

## **7 The Role of Institutions**

Institutions like pension funds, life assurance funds and mutual funds hold significant blocks of shares in companies and are in a strong position to solicit and evaluate information about the performance of their management. Individual investors delegate authority and pay substantial fees for the management of their portfolios to these institutions. Despite this, institutions have played a very modest role in corporate governance. This has been variously attributed to free rider problems, preference for exit over voice, and an unwillingness to be in the position of insiders when it comes to intervening in the management of firms. None of these are very compelling arguments given that an intermediary should be the medium for collecting and communicating the views of its investor clientele.

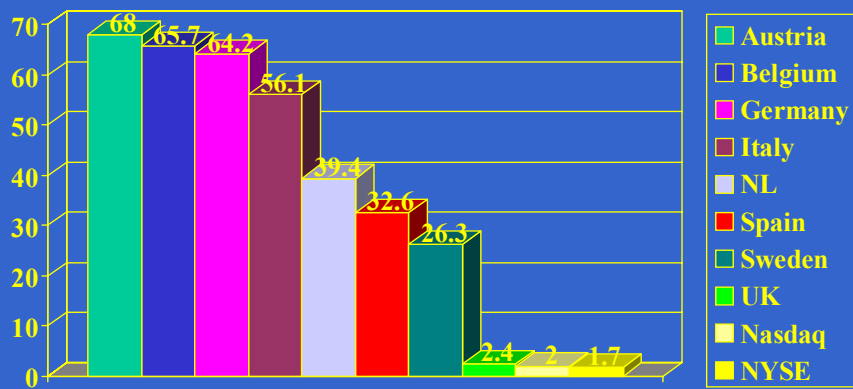
But at present, investors are provided with no information about the resources that institutions devote to corporate governance, the degree to which they exercise their voting rights, and the extent to which they interact with board members. Again the presumption should not be that there are uniform codes by which institutions operate but investors should have the right to know what institutions are doing on their behalf and how they are solving the collective action problem of representing individual investor views.

Should the role of institutions in corporate governance be strengthened? How can this be best achieved?

## **8 Summary of Issues**

Should diversity of corporate governance systems be viewed as a strength or weakness of the European financial systems? Should regulation promote diversity or discourage it? Should competition between systems and freedom of companies to choose their country of incorporation be encouraged? Is there a best system of corporate governance, and if so what is it? Should there be a break-through provision in the takeover directive? What emphasis should be placed on disclosure? Is disclosure sufficient and to what extent does it have to be supplemented by rules relating to best practice? Should the role of boards and, in particular non-executive directors be strengthened and, if so, how? What obligations should be placed on institutional investors to perform a governance function?

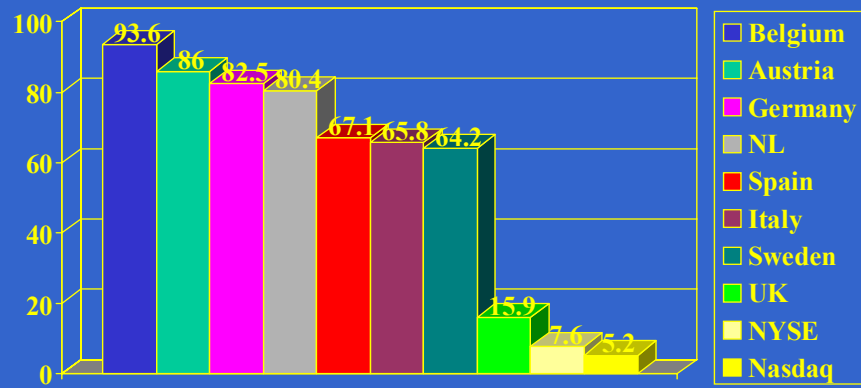
## Percentage of listed companies under majority control



Source : country chapters in Barca and Becht (2001)

Figure 1

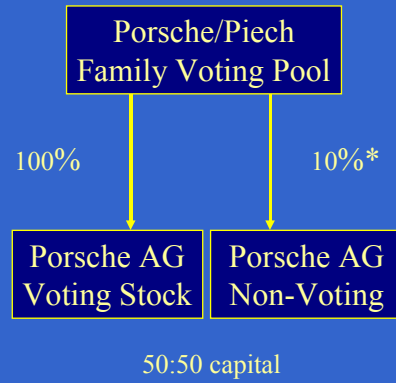
## Percentage of listed companies with a blocking minority of at least 25%



Source : country chapters in Barca and Becht (2001)

Figure 2

# Porsche AG



Source : Hoppenstedt Guide 1999; \* estimate

Figure 3



Figure 4