

What is Corporate Governance?

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Corporate governance problems are not new. Economists have long recognized that conflicts of interest can arise in the direction and control of companies. Adam Smith (1776) in the *Wealth of Nations* knew all too well the central governance problem and wrote: 'The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily

give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.¹

The basic problem of corporate governance, from a theoretical perspective, then, is the so-called 'agency problem' which occurs because of the separation between ownership and management. This is termed 'the separation of ownership and control' by Berle and Means (1932).

The idea is that owners (shareholders) hire executives to manage companies on their behalf. In agency theory, we say that the agent (i.e. managers) acts on behalf of the principal (i.e. shareholders). The shareholders leave their money and other assets in the custody of the managers. The basic question to address is how to ensure that managers will manage the assets well. For example, what keeps them from taking the money and running away with it? Clearly, the law has some bearing on this and is, therefore, perhaps the most fundamental governance mechanism. It is worth noting however that stock markets have historically been able to flourish with little legal support. Thus informal mechanisms like reputation and trust may be even more basic control factors. Vigilant owners, for example owner-managers or large shareholders, represent another powerful control mechanism; self-interested owners will monitor what goes on in the firm and replace bad or opportunistic managers. Managers may be motivated to create more value for the shareholders through incentive systems (i.e. bonuses or stock options). The threat of being fired by an alert board could also be enough to make them work hard. Agency theory, by far the most important approach to corporate governance, is specifically concerned with devising efficient solutions to the agency problem when both owners and managers are rational and self-interested.

There are more theories about corporate governance than agency theory, of course. As previously mentioned, corporate governance is a multidisciplinary subject which draws on economics, law, sociology, psychology and political science. Within business studies it draws on management and organizational behaviour, finance, accounting, international business, and other topics. Economic theories of corporate governance include agency, transaction cost and incomplete contract theory. The focus within these economic theories is, likewise, on relatively rational, selfish and sometimes opportunistic decision makers who interact with and create organizational mechanisms to further their own interests. This 'model of man' has been challenged by sociologists and psychologists who emphasize that human beings are not always rational and may not be motivated by self-interest.

In this book we subscribe to what we call 'enlightened agency theory', which takes agency theory as a starting point, but borrows from psychology, sociology, political science, law and other fields where appropriate. This creates a more complicated but richer understanding of governance issues without losing track of the central governance issues. For example, not all managers or shareholders are selfishly rational, but this does not mean that we can forget incentive problems. Agency problems are shaped by regulation and social context, but they do not become irrelevant.

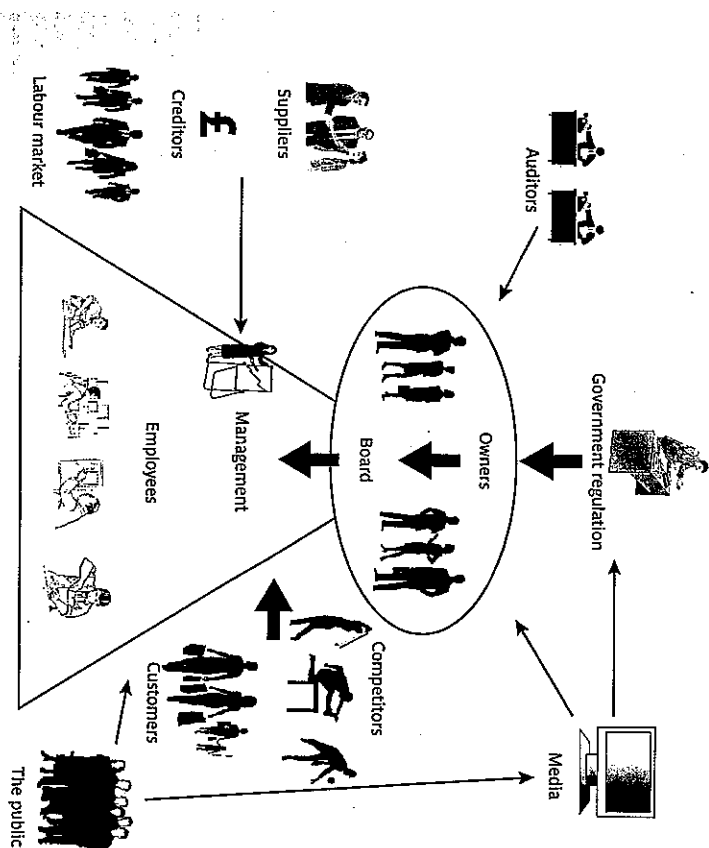
1.4 The extended agency problem

In the real world, of course, there are more than two actors (principal and agent), so the picture becomes much more complicated (Figure 1.1).

Between owners and managers there is a board elected by the owners. Not all types of firms are required to have a board, but for most large firms this is a legal requirement. Boards are the straightforward solution to the corporate governance problem. A group of people are elected to the board to sanction major decisions and to monitor that managers are doing their jobs well. Boards usually meet regularly (e.g. five times a year, sometimes as often as 10 times a year).

The owners of a firm do not necessarily comprise a homogeneous group. There may be many or few owners. Some owners may be private individuals (i.e. 'mom and pop' investors). Some may be founders or members of the founding family. Owners may be institutional investors, mutual funds or hedge funds. There might be some owners who are actively concerned with corporate governance

Figure 1.1 The extended agency problem



Others may be passive investors who never vote and who mechanically match their portfolio to an index and choose to leave it to others to be active owners.

Moreover, most firms have stakeholders with whom they do business and who can directly and indirectly influence their corporate governance.

Banks and other creditors can play a powerful role in corporate governance for firms in need of external finance because they can sanction or veto investment projects, make demands on the composition of the board, and write debt contracts that include conditions (covenants) about what the firm should and should not do. In some countries, banks are so powerful that we talk about a bank-based corporate governance model. Banks may own large stakes in companies if the law permits.

Employees can also play a role in corporate governance. In some countries, employees are entitled to elect board members (e.g. Germany, Austria, and in Scandinavia). If labour unions are strong, they influence the strategic direction of the company since many decisions must be negotiated with them. Employees can also be owners: in owner-managed firms or in professional partnerships, for example, which are common structures for law firms, accounting firms and management consulting firms. Employees may acquire shares as part of employee-ownership policies.

¹ Adam Smith, 1776, Book V, Part III article 1: http://www.econlib.org/library/Smith/sanWN20.html#anchor_165

Suppliers can play a role in corporate governance as owners of firms: for example in cooperatives, where farmers jointly own the slaughterhouses or dairies to which they sell their product. A subsidiary relationship is another structure: for example, as when IBM USA owns a sales subsidiary in France. In joint ventures, the participating companies will often share ownership and will appoint their own representatives to the board.

Customers can also own the companies from which they buy (e.g. retail cooperatives; investment funds) or they can influence them in other ways. The futurist Alvin Toffler once suggested that companies should appoint advisory boards composed partly of customers and through which the customers could get a formal channel of communication to the company. Many companies work hard to build customer relationships and to endorse the marketing concept according to which the customers should have priority over other stakeholder groups.

The most direct way in which customers exercise their influence, however, is through competition. In very competitive markets the job of controlling managers is effectively 'taken over' by the competition since the managers must continuously work hard to stay ahead of their competition. If there are many competitors in a market, shareholders can more easily evaluate the performance of their managers. They can compare their performance with other firms and owners can more easily replace their managers with those from competing firms.

Governments influence corporate governance by making the rules (i.e. laws and regulation). For example, should banks be allowed to own firms? How much should family ownership be taxed by inheritance and wealth taxes? Should pension fund ownership be subsidized by tax benefits? Governments in different parts of the world address these questions in different ways.

Governments can also play a direct role as owners of business enterprises. This used to be quite common, particularly in the former socialist countries, but until recently the trend was to privatize. However, with the financial crisis the pendulum swung back. Banks, insurance companies and even automakers were nationalized.

In addition to the direct stakeholders, the media and various kinds of special interest organizations (NGOs, etc.) can influence corporate governance. Managers and shareholders fear public exposure and act to avoid scandal, sometimes by changing their policies to accommodate grassroots organizations like Greenpeace.

There are several other actors. Auditors, analysts and stock exchanges play a special role by providing information to shareholders and to other stakeholders. Lawyers, stockbrokers, consultants, insurance companies and others also have their role to play.

In all this complexity, the primary focal point in corporate governance is the relationship between owners and companies, with particular focus on the board.

1.5 Why governance?

A third approach to the definition of the subject is to examine why people are interested in it.

At the most general level, good management is obviously crucial to economic efficiency, productivity, firm performance and social welfare. According to Bengt Holmström, 'corporate governance is about mechanisms by which scarce decision making resources are allocated in society'. Corporate governance aims to ensure good decision making – meaning hiring the right managers, motivating them well through reward systems, giving them sufficient freedom to act and combining this freedom with a system of checks and balances to prevent the abuse of power. In this sense, good corporate governance has always been essential for good economic performance.

It is not difficult to find examples of good and bad corporate governance at many levels. Many boards are known to rubber stamp proposals put forward by the executives and so fail to take their control role seriously. Others act in time and replace the CEO or veto dubious acquisitions. Many owners do not take their ownership seriously and do not even bother to show up at shareholder meetings. Others actively seek to influence the direction of companies through dialogue or board representation. The executives of some banks now in government custody live well because they

casted in their stock options in time. Others co-invest in their companies and align their future with the stockholders.

One way of thinking about governance is that it has the same functions as a safety switch which will turn off your electricity or gas before the accident happens. Some people even compare it to a national defence which is intended to avoid war. Hopefully you will not need it at all. In normal times you will not be able to see any benefits from it, but it can still be a good idea to have one. The safety belt metaphor captures some of the same ideas but ideally we want it to work before the accident happens!

But there is another, more obvious, reason which can explain why corporate governance has become such a fashionable topic in the past few decades. An unprecedented amount of savings is currently flowing from pension schemes into the global economy. This money must be used as well as possible since its investment will directly influence the living standards of future pensioners. In 1936, Keynes declared the coordination of savings and investment to be the Achilles heel of the capitalist economies. Keynes was concerned with the short-term macroeconomic impact of these imbalances. But there are also important microeconomic problems associated with them. How can we make sure that our pension money is put to good use? It is therefore no coincidence that pension funds have led the corporate governance debate around the world.

Recent scandals – such as Madoff or Lehman in 2008 or before that Enron, WorldCom, Tyco, Parmalat after the dot.com bubble or before that Maxwell and BCCI – are vivid examples that our pension money is not always being put to good use. Shareholders and debt holders suddenly realized they had lost a significant amount of money, in some cases because they had been deliberately misled by fraudulent managers. Stunning examples of mismanagement often inspire action: for example, the implementation of new laws or codes of best practice to prevent a repeat of these errors.

Long before Keynes, another economist, Adam Smith (1776), discovered that government intervention is not always the best way to create wealth. For example, corporate governance structures that invite scandals may, over time, be replaced by more efficient structures, if the rules and regulations allow it. Although most corporate governance regulation is based on the 'latest' scandal, it is doubtful whether the avoidance of scandals should be the overriding goal of corporate governance. Other famous economists, Frank Knight and Joseph Schumpeter, for example, have discovered that economic growth is to a large extent created by risk taking. Thus there are serious costs to regulation which makes firms more bureaucratic and more risk averse. It may be better, in fact, it probably is better, to tolerate a few scandals now and again than to slow down the capitalist engine of innovation and growth.

It is therefore important to find governance structures which on the one hand allow managers and entrepreneurs to do what they do best and on the other hand hold them accountable to investors if they also invest other people's money. Avoiding overregulation is another good reason to be interested in corporate governance.

1.6 Discussion

At the most general level corporate governance is concerned with how to devise institutions (i.e. governance mechanisms) that lead to wealth-creating decisions in businesses. It should come as no surprise that there are different opinions about what mechanisms are most effective and about how to define wealth generation. This diversity of views may in itself be productive, since it allows for various solutions to compete in the marketplace. In many other business disciplines – including business strategy, innovation studies and marketing – differentiation is considered to be an asset. Thus, it could also be argued that differentiation in corporate governance mechanisms at the firm level can be a source of advantage, since this enlarges the menu of choices available to investors and to other stakeholders.

However, it is important to remember that some of the most pertinent problems of corporate governance are associated with finance: in particular with how best to utilize the huge savings which are currently being accumulated in pension funds around the world.

Minicase

The financial crisis: A wake-up call for corporate governance

The financial crisis of 2007–2009 was an economic disaster. It was the world's longest economic crisis since the great depression began in 1929. Warren Buffet called it an 'economic Pearl Harbor'. Even today few people realize how close the world was to economic meltdown – to a situation when ATMs would stop working, shops would close and economic activity would cease. The financial system was saved by quick, strong and unconventional countermeasures by central bankers and governments. Nevertheless, the crisis has left lasting scars in the form of an overwhelming debt burden, mass unemployment and a heavy burden of regulation.

How could this happen? While monetary and financial regulations were obviously part of the picture, the current consensus view is that the crisis was at least partly attributable to bad corporate governance. For example, the OECD Steering Committee on Corporate Governance argued that 'the financial crisis can to an important extent be attributed to failures and weaknesses in corporate governance' (Kirkpatrick, 2009). If you consider that the global stock MSCI index fell by more than 50% during the crisis and conservatively estimate that perhaps 1% of this was attributable to bad corporate governance, bad corporate governance cost the world \$200–300 billion!

Most commentators focus on failing incentive systems. For example Barack Obama (2009) announced: 'We're going to examine the ways in which the means and manner of executive compensation have contributed to a reckless culture and quarter-by-quarter mentality that in turn have wrought havoc in our financial system.' A common theme is that short-term incentives like bonuses induced managers to take more and more risks. Given the familiar trade-off between risk and returns, managers can increase returns by taking on more risks, and this is what the bankers did. So it is suggested that bonuses should be stretched over longer periods of time, e.g. 3–5 years, so that they capture potential negative effects of risk taking. Instead of a 'bonus' (good) there may in some years be a 'malus' (bad), which is deducted from your bonus account. Another idea is to risk-adjust management compensation, for example by letting it depend on spreads which reveal the market's risk assessment. A third suggested solution is to rely more on share ownership and less on stock options, because shares are more sensitive to downside risk.

Some also direct attention to the role of boards, for example board competencies. After all, boards were responsible for hiring bank managers and negotiating their pay. So boards must take responsibility for incentive failures. One idea is that bank boards were not sufficiently competent in modern finance, and the recommended cure is then to upgrade competencies. For example the economist Willem Buiter (2009) suggested that 'All new board members should take a written test, set by the regulator and marked by independent experts, on the products, services and instruments traded and managed by their financial institutions. Existing board members should be tested every other year. Unless a passing grade is achieved, the would-be board member cannot serve. The graded test will be in the public domain.' With the recommendations of the UK Walker review, practice has actually moved in that direction. Another idea is that boards were insufficiently informed, and this has led to rules demanding that a much wider set of issues in risk management and management pay are put to bank boards.

It is possible to probe even deeper. Boards are elected by the shareholders, so where were the shareholders? If risk taking was excessive, management pay was over-incentivized and boards were too incompetent to do anything about it, why didn't the shareholders revolt? After all, it was their money which was first to go during the crisis. One answer is that many banks had highly diversified ownership without majority owners. This gives rise to free-rider problems and passivity among the shareholders who do little to control the agency problems between shareholders and managers. Many banks reinforced their managerial hegemony by voting caps and other takeover defences. It is interesting that the most leveraged financial institutions – the US investment banks

which formed the vanguard of the financial crisis – were historically organized as partnerships where partners had equity at stake and therefore some in-built aversion to downside risk. Converting them to ordinary joint stock companies may have shifted their preferences towards risk taking. It is also interesting that many financially conservative institutions like mutuals were converted to stock companies before the crisis.

It is even possible that the crisis was ultimately attributable to culture. There have been numerous popular references to a culture of greed, perhaps spreading from Wall Street to the rest of the world. For example, Dr Rowan Williams, the Archbishop of Canterbury, has blamed the financial crisis on human greed (*The Telegraph*, 2011). Investment bankers and house owners got used to rising assets prices during the boom years preceding the crisis and expected prices to continue to rise in the future. This may have encouraged them to borrow and invest, thus blowing the bubble.

Sorting out these issues is a monumental task for corporate governance. Certainly the times have changed, and many practices are being changed. There is much more willingness to regulate, for example.

The crisis ended with a massive global bailout. Governments took over failing banks and businesses, and provided guarantees and rescue packages as well as volumes of credit at historically low interest rates. Ultimately, taxpayers had to pick up the bill. Many observers see this as an extreme case of 'moral hazard'. If banks and financial institutions know that they will be bailed out by the government, should they fail, they have much more of an incentive to take excessive risk. The knowledge that governments would save them may have contributed to the build up to the current crisis. With unchanged incentive structure the same could happen again in the not too distant future. Already in 2011 it was rumoured that bank bonuses were back to their pre-crisis levels. Thus the relevant agency problem may no longer be between owners and managers, but between managers and taxpayers.

Whatever the outcome of all these discussions, corporate governance has never been so topical as it is today, and it has never been more necessary to understand it in order to manoeuvre in today's business environment.

Discussion questions

- 1 In rough terms the value of global stocks fell from US\$60 trillion to US\$30 trillion from top 28 September 2007 to bottom 27 February 2009. Global unemployment hit record levels (6.6%). Do you think this crisis could have been avoided if corporate governance had been optimal around the world?
- 2 How do you see the links between corporate governance and the crisis?
- 3 Is it correct to lay most responsibility on banks?
- 4 What do you think of the popular notion that the financial crisis was caused by greed? Does it contain a grain of truth? Does greed have anything to do with corporate governance?

Summary (learning points)

- We define corporate governance as 'the control and direction of companies'.
- Corporate governance is not company management – and not a religion!
- The basic governance problem is the agency problem: how do owners control managers?

- The extended agency problem includes governments, banks, employees and other stakeholders, who also influence corporate governance.
- One good reason to care about corporate governance is that it will influence the value of your future pension.
- The financial crisis has been (at least partly) attributed to bad corporate governance.



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Theories of Corporate Governance

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