



International Corporate Governance

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4.1 Introduction

There are many different corporate governance mechanisms used to varying degrees in different countries. For this reason, corporate governance researchers often talk of different corporate governance systems. For example, the United States and the United Kingdom have traditionally relied upon the stock market as an important source of company finance, whereas Germany has relied more upon bank finance, and in Japan the *keiretsu* (i.e. cross-ownership) system is prevalent. There are, as we will document, many important differences and varieties of corporate governance around the globe.

Before we start to analyse them, it is important to note that these differences correspond to broad typologies. The typologies have been constructed by scholars and practitioners to understand the heterogeneous corporate governance arrangements around the world. The broad-brush systems that we describe are, in some sense, fictional, but nevertheless helpful for understanding and classifying complex corporate governance arrangements. For example, not all US firms are listed. In fact, the vast majority of firms in any country are not listed. When we characterize 'systems' we tend to focus on the largest, most visible companies in a nation. But most companies in any nation are small and unlisted and in all nations these small and medium-sized companies account for the bulk of business activity. As far as we know, these small and medium-sized companies tend to be broadly similar in their corporate governance: closely held by founders or by families. Thus we may exaggerate the differences. For example, banks are not active participants in the governance of all German companies, but appear to concentrate on the largest firms.

There are also other substantial parts of corporate governance which are not normally visible in international comparisons; this is the role of not-for-profit firms, government organizations, cooperatives, associations, mutuals and subsidiaries of foreign firms. Some of these entities can be very large and collectively they dwarf the listed companies. We find these organizations in all countries – in the USA as well as in Europe. With the exception of government organizations, we know little about their importance and their relative efficiency. Indeed, the reason scholars now know so much about some of the largest public firms is because of enhanced corporate governance disclosure requirements that have been trending to more openness over the last twenty years or so.

Moreover, the corporate governance systems we describe here change over time. Over the past decade or so, German banks have been tending to reduce their shareholdings in German companies and are no longer the major blockholders they once were. So one might ask whether Germany can still be cited as a case of purely bank governance. France is another example; it used to be well known for government ownership of firms and nationalization. However, many of France's leading firms have now been privatized and in consequence do not look like standard state-controlled firms. This last empirical observation raises an important theoretical and practical question. Are corporate governance arrangements around the globe converging? Is there pressure towards a uniform and universal model of corporate governance? Is there a set of characteristics that seems to resolve the underlying agency problems of moral hazard that we described in previous chapters, or are heterogeneous governance arrangements likely to remain the norm? In short, a central hypothesis to be explored in the international corporate governance literature is whether or not corporate governance systems will tend to converge over time.

4.2 Theoretical context: a taxonomy

We define a country's corporate governance system as a set of governance mechanisms in use in a given country or context. The fact that they are used in combination indicates some degree of consistency and stability. By 'system' we mean a set of practices, mechanisms, institutions and rules that remain stable over sufficiently long periods of time.

It is possible to classify systems along several important dimensions (Aguilera and Jackson, 2010). These features define some of the most salient aspects of the institutional environment. Consider the following possible factors or taxonomies:

- Government vs. private ownership. This was the great distinction between the former communist economies of the USSR and its satellites and the market economies of the United States and open societies. Government ownership and control of economic activity is still extremely important in many companies across the world (e.g. China), and this influences the corporate governance arrangements in place in these economies.
- Market vs. bank-based systems. This is the disintermediation or intermediation of corporate finance arrangements. In some countries, such as Germany or Japan, financial transactions between large companies and banks tend to be based on stable relationships, rather than anonymous trades. There is a close relationship between firms and the suppliers of finance. In other economies, such as the USA or the UK, corporate finance arrangements are more likely to be based on market-based contracting arrangements.
- Dispersed vs. concentrated ownership. Even many countries with well-developed stock markets are controlled or majority-owned by large blockholders such as families or even the state (e.g. Singapore). However, there are some very clear patterns of corporate ownership. In some countries, such as the USA and the UK, firms are owned by many shareholders, each of whom owns a small fraction of the company's shares. In other countries, such as China, there is often a single (or few) very large shareholders who own a large fraction of the firm's shares.
- Stakeholder- vs. shareholder-based systems. In some countries, the legal structure confers rights to stakeholders that are not apparent in other countries. For example, one important issue is whether or not labour is represented on the board of directors and is able to influence companies. This differs substantially across the world. In Germany, for example, there are employee representatives on the board of directors. This is unheard of in the major publicly traded firms of the United States.
- Legal system (common vs. civil law). The legal system is an important institutional feature that varies around the world. There are, broadly speaking, two types of system: common and civil law. Common law countries include the United Kingdom, the United States and countries that use case law as the mechanism to resolve legal disputes and protect shareholder rights. Many countries in the world tend to have various kinds of civil law (e.g. China) which are rule-based systems codified by governments and the state (e.g. France).

4.3 Substitution and complementarity

Corporate governance mechanisms are not independent. There are logical and causal ties between them. In terms of causal structure, macro factors like culture and politics logically precede company law which logically precedes ownership structure. Disentangling these causal relationships is often very difficult. There are quite specific laws which regulate how much a bank or an institutional investor can own, and these laws differ between nations. This is an important cause of the differences in global corporate governance arrangements (Roe, 1994a). For example, a political change will often lead to the creation of new laws, which in turn can influence corporate ownership structure. However, a change in corporate ownership structure will not directly change the law. Board structure is decided by the owners under the limits laid down by law, which are often quite specific. The board decides on management incentives and on a number of other issues, but it delegates significant responsibility to managers, who again delegate to their employees the implementation of their decisions. We have here a series of agency relationships.

Another type of dependency is the degree to which governance arrangements can be considered as complements or substitutes (Holmstrom and Milgrom, 1994). Suppose there are five distinct

governance mechanisms that can be defined and agreed upon: reputation, law, large owners, boards and incentives. One can then ask the question: what are the interdependencies between them? Are they complementary, meaning that an incremental increase in one of the activities increases the (marginal) valuation of one of the others? Alternatively, are they substitutes, meaning that (marginal) increases in one activity reduce the (marginal) benefit to using one of the mechanisms? In short hand, we can simply sign these as positive or negative: complementarity (+) or substitution (-). Complementary governance mechanisms will tend to support and reinforce each other, while substitutes will tend to replace each other, i.e. you will have one or the other. In Table 4.1 we sketch some *hypothetical* relationships concerning these interdependencies. We do not claim to do a complete diagnosis of all the interdependencies, but rather want to stress the idea of governance as an interconnected system. Indeed, it is a useful exercise to think why these mechanisms might be complements or substitutes.

For example, there seems to be some degree of substitutability between formal law and informal governance by reputation. Over time formal law has probably replaced custom law. If laws are well defined there is less of a need to rely on reputation to sanction corporate governance (see Poppo and Zenger, 2002 for a counter argument).

Moreover, law, e.g. investor protection via the legal system in place in a country, enables atomistic share markets and dispersed ownership (i.e. the market model) to function, while strong owners may be necessary to control firms in systems with weak investor protection, so there is substitutability between law and large owners (La Porta et al., 1998). It is also true, however, that it is difficult to have any kind of ownership in the absence of law, so there are also complementarities here.

The link between reputation and ownership is less obvious, since both firms with large owners and firms with diversified ownership are sensitive to their reputation. However, we propose a negative relationship. Large owners (e.g. founding families) appear to rely heavily on reputation, but this is more difficult and less necessary for small investors who can (individually) buy and sell without much of an effect on the firm. Large owners will usually have a longer time horizon since they retain their shares for a longer period of time, sometimes over many generations. This will make the mechanism of building a reputation more attractive. In contrast, firms with atomistic ownership are constantly for sale and may be merged or broken up.

Boards have their key rationale when there is separation of ownership and control with dispersed ownership, whereas large owners do not have to rely on the board to represent them vis-à-vis managers (Pama and Jensen, 1983). Large owners often participate directly in the management of the firm, and in this case it is superfluous for the board to monitor the managers on behalf of the owners. Thus, we propose a substitution effect between board and ownership control.

The relationship between boards and law or reputation is more uncertain. Boards are typically created by law, but we know that they arise spontaneously even in firms which are not required to have them (Bennedson, 2002). It also seems possible to argue that boards need to do less when the governance problem is already addressed by either of the two other mechanisms.

Table 4.1 A hypothetical sketch of substitution (-) and complementarity (+) between governance mechanisms

	Reputation	Law	Large owners	Boards	Incentives
Reputation					
Law	-				
Large owners	+	-			
Boards	-	-	-		
Incentives	-	+	-	-	

Management incentives (performance pay) seem less necessary if there is already a strong ownership incentive. Theoretically, board monitoring to reduce information asymmetries will tend to reduce the need to incentivize. Moreover, by focusing on profit maximization in the short or medium term, management incentives may attenuate reputation building. Put differently, if managers are adequately motivated by reputation concerns, there is no reason to give them more incentives. The direct relationship between law and incentives is more uncertain, but we tentatively hypothesize a positive association because well-developed share markets with a strong legal infrastructure will need additional motivation of managers.

Much more can be said about these interdependencies. We propose the hypotheses in Table 4.2 as a way to illustrate the concept of interaction effects rather than a specific theory of such interactions.

4.4 Why systems?

The dominant streams of research have emphasized the role of formal institutions, for example the legal system and investor protection rules, as determinants of these differences (Shleifer and Vishny, 1997; La Porta et al., 1998, 1999, 2002). The legal systems perspective has led to a growing number of supportive empirical studies (Claessens et al., 2000; Denis and McConnell, 2003; Durney and Kim, 2005; La Porta et al., 1999). The implication here seems to be that countries develop constitutions and basic institutions which have a deep and lasting impact on their corporate governance systems.

This emphasis on formal institutions is also characteristic of the so-called political theory of corporate governance (Roe 1991, 1994b), which emphasizes the regulation of financial institutions as a source of corporate governance differences. The pervasiveness of these differences within systems and the persistence of differences between systems is explained in terms of complementary institutions and rent seeking, which may effectively block changes in corporate governance (Coffee, 1999; North 1991; Roe, 1994b). The argument is that the organizations created in a specific system, e.g. banks or institutional investors, will tend to lobby politicians to protect their own interests including the system which supports them. However, the political theory indicates that corporate governance systems can change when the policies change.

Licht (2001) has proposed a cultural theory of corporate governance. If countries differ systematically in terms of risk aversion, time horizons, obedience to authority, and other cultural factors, this could influence their choice of corporate governance system. It is also possible that the legal origins are related to differences in ideology (e.g. liberalism vs. socialism).

4.5 International systems

Table 4.2 summarizes a large amount of information on corporate governance in six countries. For simplicity we count the three small Scandinavian countries (Norway, Sweden and Denmark) as one. The columns list countries. The rows list corporate governance mechanisms. We label them with tentative titles to identify their governance systems. In Table 4.3 we fill in numbers from various and more or less consistent sources. Since the sources are uneven, and since the data are not collected at different points in time, the numbers must in some cases be regarded as guessimates.

We label the first two countries (the USA and the UK) market-based systems. This is at least partly because they have large stock markets both in terms of the number of listed firms and in terms of stock market capitalization relative to GDP (Table 4.2, bottom rows). Stock market capitalization here is the total value of all listed firms (stock price $\times$ number of shares) divided by the gross domestic product in the country. There were more than 5600 listed firms in the USA. But relative to the size of the population there were even more listed companies in Britain, more than 2400. The German economy is much larger than the UK economy, but the number of listed British firms was almost four times larger than

Table 4.2 Corporate governance systems – qualitative description

	USA	UK	Japan	France	Germany	Scandinavia
	Market governance	Investor governance	Network governance	Public governance	Stakeholder governance	Stakeholder governance
Legal system	Common	Common	Civil	Civil	Civil	Civil
Investor protection	High	High	Low	Medium	Medium	Medium
Ownership concentration	Low	Low	Medium	Medium	Medium	High
Typical owners	Institutions	Institutions	Cross ownership	Cross ownership	Families	Families
Board system	One tier	One tier	One tier	One tier	Two tiers	Two tiers
Managers on board	Yes	Yes	Many	Yes	No	No
Chair = CEO	Yes	No	No	Yes	No	No
Employees on board	No	No	No	No	Yes	Yes
Bank influence	Low	Low	High	High	High	Low
Performance pay	High	Medium	Low	Medium	Medium	Low

Sources: The World Bank (2010), Djankov et al. (2008), Conyon et al. (2011).

Table 4.3 Corporate governance systems – quantitative description

	USA	UK	Japan	France	Germany	Scandinavia
System label	Market governance	Investor governance	Network governance	Public governance	Stakeholder governance	Stakeholder governance
Investor protection 1–5	3	5	4.5	3.5	3.5	3.5
Anti-self-dealing 0–1	0.65	0.95	0.50	0.38	0.28	0.39
Ownership concentration	19	21	10	47	69	25
Board levels	1	1	1	1	2	2
Managers on board %	25%	35%	90%	40%	0%	10%
Chair = CEO	80%	10%	10%	80%	0%	0%
Employees on board %	0%	0%	0%	0%	50%	30%
Bank credit % GDP	223	212	292	126	125	211
Performance pay	70%	50%	30%	40%	40%	30%
Listed firms 2008	5603	2415	3299	966	638	766
Market cap % GDP 2008	83	69	65	52	30	40

Sources: Guestimates based on various sources and years (latest figures), including The World Bank Governance Indicators, Djankov et al. (2008), Conyon et al. (2011), Bebenroth and Donghao (2007), Coles (2008), Jeanjean, Thomas & Siolowy, Hervé (2009), Dahya, Dimitrov, and McConnell (2009).

the German. In this way, we can distinguish between market-based governance systems (in the USA and the UK) and the control- or bank-based systems found in continental Europe and Japan (Bechtuk and Roe, 1999). However, the stock market is not all there is to it. Compared with Europe, the US and the UK rely much more on market mechanisms in terms of a relatively small government sector, a pro-market competition policy and flexible labour markets. In comparison, many European countries have large welfare states, promote or at least accept large national monopolies and have highly unionized labour forces.

We label Germany and Scandinavia 'stakeholder systems' because of the role that employees, banks and other stakeholders play in these systems. For lack of a better word we label the French system 'public governance' because of a high level of government intervention. With regard to legal systems, the two market-based economies are common law systems, and this is perhaps no accident. Some researchers claim that legal systems have important implications for corporate governance (La Porta et al., 1998). In the common law system which is used in the English-speaking world, law is in principle made by the courts based on specific decisions which thus create precedence, and thereby influence future decisions. In short, law is made from the bottom up, and the courts are regarded as private institutions which side with other private institutions against the government in the protection of property rights. In contrast, in the civil law systems of Europe and Japan the law is in principle regarded as an instrument which the government uses to achieve its goals, and it is by nature much less protective of property rights. Law is made top down by politicians, civil servants and law professors. So the theory goes that common law systems are more likely to protect property rights, including the rights of minority investors, and that this is why the stock market is so well developed in common law countries.

In practice, the distinction between common and civil law countries is less clear. Why should lawmakers in continental Europe not be able to adopt the rules which they consider most conducive for stock market development (even to imitate common law countries if necessary)? Moreover, there are many examples of top-down legislation in the USA. Sarbanes-Oxley is a recent example.

However, there is empirical support for the hypothesis that company law in the USA and the UK tends to be more protective of shareholder rights than the law in other countries. One important and widely-used measure is the investor protection index constructed by La Porta et al. (1998) and updated by Pagano and Volpin (2005) – known as the LSSVPV index. The LSSVPV index is correlated with other kinds of minority investor protection: for example the Djanikov et al. (2008) anti-self-dealing index. The anti-self-dealing index measures legal limitations to self-dealing by controlling owners. For example, self-dealing can include transactions with other entities (i.e. those owned by the controlling owner) at inflated or reduced prices which will benefit their own interests and which harm minority investors. These limitations can include mandatory disclosure, a mandatory approval by the minority investor, the ability to challenge such transactions in court, etc.

European (particularly North European) countries score higher on an alternative, broader governance measure: the World Bank governance index, which combines measures of political freedom (e.g. freedom of speech, association, voting), regulatory quality (e.g. costs of regulation, efficient enforcement, presence of generally accepted codes, company law) and quality of the legal system (e.g. quality of contract enforcement and court system). Every second year since 1996 the World Bank has published a set of six different country-level governance indicators for 209 countries (see Kaufmann et al., 2005, 2010). The six governance indicators are: 1) voice and accountability, 2) political instability and violence, 3) government effectiveness, 4) regulatory quality, 5) rule of law, and 6) control of corruption.

Market-based systems are characterized by low ownership concentration. Especially in the largest US companies the largest owner typically holds only a few percent of the stock, in the UK less than 5% (Barca and Becht, 2001), although the percentage tends to decrease with company size. The dispersion of ownership is obviously related to the size of the market. When more small shareholders invest, the size of the market increases and the average ownership share declines. Moreover, the increasing liquidity is attractive both for buyers and sellers of shares, and this leads to even more market participants (investors, companies). Ownership concentration is higher than this in Japan and much higher in the three European systems (France, Germany, and Scandinavia).

The typical shareholders both in the USA and the UK are institutional investors (i.e. pension funds, insurance companies, mutual funds, etc.). While many institutions are also large enough to

take a high share of ownership in individual firms without undue risk to their portfolio, they are prevented from this by legal placement limits (which limit the share ownership of many investors to less than 5% of an individual company) as well as by an obligation to diversify risk (Roe, 1991). In the USA, there are also many individual 'mom and pop' investors, which further disperses the ownership of US companies. In comparison, the control-based systems are characterized by higher levels of ownership concentration by founding families, corporate investors (cross-holdings), banks, and governments (Barca and Becht, 2001).

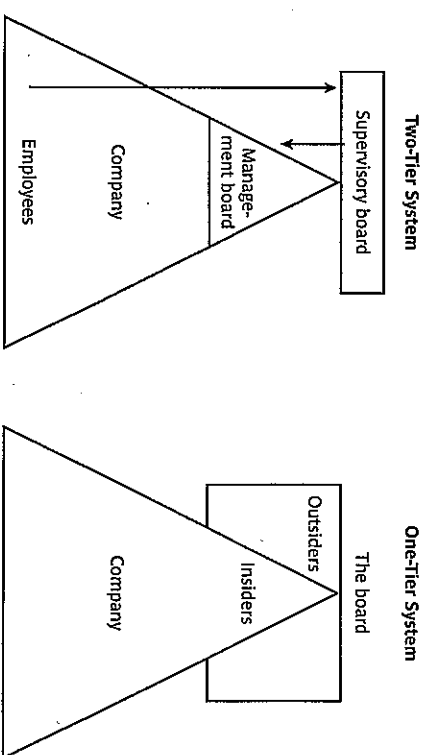
As a result, it is difficult for US and UK managers to have an ongoing dialogue with their shareholders. Instead the price system is the communication mechanism. If the shareholders are not satisfied, they will sell and the stock price will fall. In contrast, in the European system a founder or a founding family will probably be able to express his/her opinion verbally (and probably in no uncertain terms). Management responsibility in the USA and the UK is diffuse (to the public), whereas it is direct and personal in Europe. In the USA and the UK, we find strong managers and weak owners, while the situation in Europe is the opposite (Roe, 1994b).

The dominant owners in Japan and France are other corporations. Japan has the so-called keiretsu system in which members of a company group (a keiretsu) hold shares in each other.

Mitsubishi heavy industry will own shares in Mitsubishi motors. They will both own shares in the Mitsubishi bank, which in turn holds shares in the other two. See Chapter 14 for more on the Japanese model. Although each shareholding is small, when they are summed up, they constitute an effective defence against takeovers.

With regard to board systems, the USA, the UK, and Japan have one-tier systems, while Germany and Scandinavia have two-tier systems.¹ The difference between one and two-tier systems is illustrated in Figure 4.1.

Figure 4.1 Board systems



¹ We define a two-tier system simply as a system in which the law requires companies to have two levels of management. This is the case in both Sweden and Norway, and so we define these countries as two-tier systems. Some people would disagree and claim that for example all decision power in Swedish companies is vested in the board which only delegates some of these functions to the management as a practical issue. We would maintain that Sweden is a two-tier system, although it is different from the German two-tier system. Japan (and China) also refer to a two-tier system with a 'board of statutory auditors' monitoring the management board, but since the auditors audit rather than hire and fire the managers or ratify strategies, we regard them as auditors rather than boards.

In two-tier systems (Germany, Scandinavia, Finland, Austria), shareholders elect supervisory board members, who are part-time non-executive directors, and occasionally also a minority of executive directors to a supervisory board which evaluates company performance, hires and fires the management (the executives), and must approve all major decisions. This is similar to one-tier systems, but unlike one-tier boards, supervisory boards cannot run the company on their own. They must appoint a management board.

In one-tier systems, shareholders elect the board, which then appoints the executives. Executives may or may not be board members, but typically some of them are. In Europe and the USA most of the board members are now non-executive directors (this holds in the USA and Europe, but not in Japan). Non-executive directors are typically part-time, and generally, in accordance with best-practice codes, a majority are independent also in the sense that they have no other material ties with the firm (e.g. the company lawyer, for example, is not an independent board member). Many non-executive directors have demanding jobs as executives, managers in other firms, lawyers or professors.

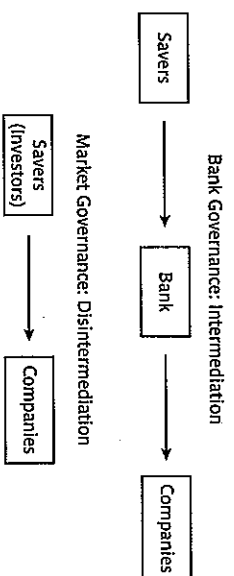
French companies have a choice between one- and two-tier boards, and the vast majority of them have chosen to stay with the traditional one-tier system. This is interesting, since it indicates that the one-tier board structure would win if the choice between one-tier and two-tiers was left to the market participants. It may be that the one-tier model is more effective or it may be that managers dislike the added control. However, it is also possible that many French companies hold on to the old board structure because of conservatism.

Turning to board composition, executives are prohibited from taking a seat on German supervisory boards, but in the USA, the UK and France companies have a fairly large percentage of managers on their board, although not a majority. In Scandinavia, the majority of the supervisory board members must (by law) be non-managers. In Denmark it is now regarded as best practice that managers do not sit on the supervisory board at all. Japan is famous for a very large percentage of insiders on boards. Historically, boards in Japan tended to be quite large (up to 30 or 40 members) which is perhaps too many for the board to make effective decisions. However, they have since shrunk down to an average size of 10. In the USA and France, the chief executive can also be chairman of the board (i.e. duality), but this is prohibited in two-tier systems. The French title is PDG: President + Director General. In the UK, the two positions – chairman and managing director – are now typically separated following corporate governance recommendations (Cadbury, 1992).

In Germany and Scandinavia employees of a company have a right to elect members of the supervisory board: typically 1/3 of the board members (Denmark, Norway, Sweden and Austria). But in some large German companies, up to 50% of the board will be employee representatives. Despite employee representation, the shareholder-elected board members have a majority of the votes (e.g. in Germany the vote of the chairman is decisive in the case of a split). Employee representation is not found on the shareholder-friendly US and UK boards, nor is it found in France. Interestingly, French unions have historically been unwilling to assume responsibility by employee representation. The differences are directly attributable to company law. In some countries, employee representation is mandatory by law and this is where you will find it. In other countries, employee representation is not mandatory, and the result is that most companies choose not to have it.

Banks have little influence in the (stock) market-based systems in the USA and the UK, but they continue to play a role in German corporate governance. Figure 4.2 illustrates the key difference between market-based and bank-based governance systems. In a market-based system, savers invest directly in shares and bonds of listed companies. In a bank-based system, they put their money in the bank which then lends it to the corporations or invests some of it directly in their shares. In the bank-based system, the bank acts as an intermediary and we therefore talk about 'disintermediation'. In the market-based system, or in a transition to a market-based system, we refer to 'disintermediation'. To be sure, even in market-based systems many people prefer to invest in a mutual fund rather than investing directly in stocks, but in this case, the role of the intermediary is much more limited. Banks used to be central actors in most corporate governance systems and may become important again in the future. Growing stock and bond markets shifted the balance towards disintermediation up to the financial crisis in 2008, but this process now seems unlikely to continue.

Figure 4.2 Bank vs. market governance



In Germany the importance of banks for corporate governance is magnified by a number of special characteristics. First, banks are allowed to make large investments in stock even to the point of controlling some of the largest German corporations. Secondly, bankers often act as custodians for German shareholders and they may be entitled to vote on their behalf at shareholder meetings. Thirdly, bankers often sit on the boards of non-financial companies. Legal and other considerations discourage bank managers from sitting on the boards of non-financial companies in the USA or the UK. So, despite a recent trend towards the reduction of their shareholdings in Germany, banks remain powerful actors in the German system. It is interesting, however, that German banks do not appear to provide more credit to the business sector than in the USA, which combines high levels of bank lending and a large number of listed companies. In other words, banks and markets may be complements rather than substitutes. More can be found on the German system in Chapter 13.

Japanese banks are powerful actors in the Japanese corporate governance system since they play a role as 'main banks' at the centre of many keiretsus. As in the USA, Japanese banks cannot hold controlling shares greater than 5% in non-financial companies. This is no accident since the Japanese regulation was written by the Americans during the occupation after the Second World War. However, one interpretation of the keiretsu system is that it is a way to circumvent these rules so that banks can retain control despite the rules.

Again, there are very concrete legal reasons why banks are less powerful in the USA and the UK. Commercial banks are prohibited from taking large positions in non-financial companies in the USA and also (albeit less formally) in the UK. Moreover, traditionally US banks have been kept small by a forced specialization among investment and commercial banks (due to the Glass-Steagall Act). For a long time in the USA banks were prevented from merging across state boundaries (due to the bank holding company act). Only recently, in 1999, some of these restrictions were lifted. Now, with post-crisis financial regulation, they may return.

The extent of performance pay for senior managers differs widely across systems although recently there appears to have been some convergence. Total pay levels for CEOs appear to be much higher in the USA and, to a lesser extent, in the UK than in continental Europe and Japan. Moreover, a much larger percentage (e.g. 70%) of US executive pay depends on performance (in the largest companies). Overall, this means that US and to some extent UK managers have much stronger performance incentives than do European or Japanese managers.

4.6 Country models

Instead of comparing corporate governance mechanisms, it is interesting to examine the individual countries to explain their historical and cultural characteristics (Pedersen and Thomsen, 1997). Charkman (1994) makes an interesting, if somewhat speculative, attempt.

Great Britain was the first nation to industrialize, and funds for large enterprises had to be attracted from a number of individual investors. The fortunes of the landed gentry and the merchant class were to a large extent channelled into manufacturing at arm's length via the City of London. Social prestige dictated that occupations in finance and economics enjoyed a higher status than engineering.

France has a historical tradition for government intervention and centralization which, according to some, can be traced back to Louis XIV (Charkman, 1994). Features of the French system like the almighty chairman-CEO (the PDG combined President and Director General) also fit a hypothesis of centralization. More recently, the large share of government ownership in France which is partly a consequence of nationalization after the Second World War and partly a result of the Mitterrand government intervention is no doubt strengthened by strong personal ties in the elite that graduate from 'grand écoles' and who occupy top jobs in business and government (Charkman 1994).

Another interesting feature of French ownership structure is the role played by holding companies which were originally established by industrial companies to overcome financing constraints (Levy-Leboyer 1980). This helps to explain the frequency of cross-holdings. After privatization there seems to have been a tendency for this system to reappear, as companies join in a hard core of cross-ownership to avoid being taken over by 'Anglo-Saxons'.

In Germany, banks played an active role in the industrialization process and financial institutions continued to exercise dominant minority control over many large companies (Feldentkichen 1988), but have sold out in the past decades. Individual company profiles reveal that bank participation has often come about unintentionally as the result of financial distress (Charkman 1994). In addition, Social Democratic politics have clearly played a role in the emergence of employee representation both in Germany and in Scandinavia. Both countries are characterized by more friendly relations between capital and labour than in the market-based governance systems.

A high frequency of family and cooperative ownership in Scandinavia is partly attributable to the scarcity of large companies and partly to industry effects. Norway has many shipping companies (which tend to be family owned). Denmark has many food producing companies, which are still dominated by co-ops. Foundation ownership is often regarded as a response to high tax pressure.

4.7 Convergence?

Corporate governance systems are quite stable in the short run (e.g. from year to year), but they do sometimes change over longer periods of time (e.g. decades).

A decade ago, a consensus seemed to emerge among academics and executives alike that the Anglo-American corporate governance model had won and that European systems were converging to US/UK standards (e.g. Hansmann and Kraakman, 2000, 2002; Coffee 1999, 2002a, 2002c; Denis and McConnell, 2003). During the 1990s, examples were easy to find. Examples included the growing importance of stock markets in most economies, the increasing importance of institutional investors (Coffee, 1999; van den Bergh, 2002), the increasing number of hostile takeovers (*The Economist*, 2000) and suggestions to open the European markets further by a break-through rule (Bolkestein report, 2001), the spread of stock option-based managerial compensation (Murphy, 1999), or increases in leverage through share buy-backs and higher dividends (Warner, 1998).

However, contrary to general beliefs, it is possible to argue for a mutual convergence hypothesis (Thomsen, 2003). Not only has European corporate governance converged to US standards, US corporate governance has also effectively converged to European standards in several important respects since the 1980s. Comparative research in corporate governance has emphasized that Anglo-American corporate governance is characterized by low ownership concentration, one-tier

boards and shareholder value norms, whereas high levels of insider ownership, two-tier boards and stakeholder concerns are more characteristic features of continental Europe (Baums, 1994; Roe, 1994b; Prowse, 1995; Gugler, 2001; Vives, 2000; Barca and Becht, 2001). But during the 1990s ownership concentration in the USA/UK increased due to growing managerial ownership and institutional investment (Holderness et al., 1999; Meyer, 1998; Investor Relations Business, 2000). Moreover, management and control in the USA/UK have increasingly been separated by the appointment of non-executive directors (Monks and Minow, 2001), subcommittees composed of non-executives (Cadbury Code, NYSE code) and separation of the roles of CEO and board chair (e.g. the Cadbury and Higgs codes in the UK). Furthermore, the stakeholder approach attracted increasing attention in US management research and practice during the 1990s (Clarkson, 1995; Donaldson and Preston, 1995; Jones, 1995; Mitchell et al., 1997; Agle et al., 1999; Jones and Wicks, 1999; Jawahar and McLaughlin, 2001). Finally, financial deregulation has relaxed the separation of investment and commercial banking and has allowed banks to assume a more prominent role in the American economy (Financial Services Modernization Act, 1999; *The Economist*, 1999). That too is a step in a European direction.

The leading convergence theorists, Hansmann and Kraakman (2000), pointed to three mechanisms of governance convergence: logic (persuasive arguments for the superiority of one model), example (of competitive success of one model), and demonstrated competitive advantages. These forces work in the same direction when influential shareholders or company managers adopt international governance structures that are perceived to work better, for example, when European managers adopt US/UK governance principles because comparable companies in the US/UK have higher market value, lower capital costs, or other advantages. In global capital markets this may be the direct result of an attempt to attract capital from the same investors, or it may be a more indirect imitation of new management practices. Studies by van der Elst reported in van den Bergh (2002) document the significant internationalization of European equity markets which implies global competition to attract shareholder funds. Among listed companies international share ownership has increased considerably as a percentage of total ownership in most European countries over the period 1990 to 1998. In rough figures international ownership increased from 12% to 15% in Germany, from 14% to 35% in France, from 8% to 12% in Italy, from 16% to 36% in Spain, and from 12% to 24% in the UK. It also increased significantly by more than 30% in the Nordic countries (Thomsen, 2001), but only marginally in the USA from 7% to 7%+. Likewise, Coffee (2002a, 2002c) documents an increasing tendency for foreign firms to list on the New York Stock Exchange up to 2001 which was significant given the size and importance of the large companies in question (e.g. Daimler Benz) although the numbers (20–50 new firms a year during the 1990s) are probably too small to affect global changes in corporate governance in their own right.

Hansmann and Kraakman (2000) also mention harmonization and changes in corporate law as a weak force towards convergence. Convergence in regulation may come about if politicians initiate the laws and policies of other countries because they are persuaded by logical arguments and/or the desire to improve international competitiveness, economic growth, or employment. For example, a case in point is the proposed EU takeover directive (Bolkestein report, 2001; EU Commission, 2002) which aims to stimulate the market for hostile takeovers in Europe. Alternatively, governance structures may converge if corporate decision makers respond in the same way to similar challenges (e.g. the growing importance of institutional investors).

Clearly, these forces must be weighed against other powerful forces which block convergence or even promote divergence, for example the same factors that created corporate governance differences in the first place. Bebchuk (1999) and Bebchuk and Roe (1999) explain why ownership concentration will not automatically adjust to efficient levels, and particularly why a controlling shareholder structure with high ownership concentration (which we will call a control structure) does not automatically develop into a non-control structure (which we will call a market-based structure), even when the market-based structure maximizes the financial value of the firm.

One important reason is the existence of private benefits to controlling shareholders, which are not shared with minority investors (Bebchuk 1999; Bebchuk and Roe, 1999). When firms have already adopted a mixed ownership structure with some minority investors, prospective gains by selling

² This section draws heavily on 'The Convergence of Corporate Governance Systems to European and Anglo-American Standards', European Business Organization Law Review, 4 (1), 2003.

more shares to the public must be shared by these investors, and this reduces the incentive to give up private control benefits (Bechtuk and Roe, 1999). Bechtuk (1999) therefore predicts that control-based governance systems will emerge when the private benefits of control are large. In market-based systems, managerial control benefits may give rise to persistence of market-based governance structures (dispersed ownership). Because of vested interests in maintaining the status quo, incumbent managers may resist the formation of controlling blocks (Bechtuk and Roe 1999) and fight hostile takeovers. Gains from the formation of large blocks of control will again be shared with the market, reducing the incentive to form such blocks in market-based systems (Shleifer and Vishny, 1986).

Other factors at the system level also create barriers to change of ownership structure (Bechtuk and Roe, 1999). Ceilings and other limitations on ownership by financial institutions, as in the USA, limit their ownership shares of individual firms (Roe, 1991). The existence of complementary institutions in a given system, e.g. a large and well-functioning stock market as in the USA/UK or an active bank sector as in Germany, may influence the ownership and capital structures of firms based in that system (Roe, 1994b). Legal systems may provide varying degrees of protection of minority investors (La Porta et al., 1998). Finally, the incumbent organizations/institutions will lobby for continuation of their own existence (North, 1991).

However, even though the formal governance structure is unchanged, there may be convergence in behaviour. Gilson (2001), and later La Porta et al. (2000), makes the important distinction between formal and functional convergence: companies within a particular institutional framework may change their behaviour in order to succeed or survive in international competition even though the formal structure is unchanged. Coffee (1999) argues that a number of forces pull and push towards convergence: the growth of European stock markets, disclosure harmonization, the growth of institutional investors, harmonization of international accounting standards and the need for global economies of scale. But these forces clash with path dependency, complementarity and other strong forces that block formal changes in the legal system. The outcome of this dilemma, Coffee argues, is that formal governance structures change very little, but that functional convergence in corporate governance takes place as European companies change behaviour to align with American standards.

Theoretically, functional convergence can be seen as a special case of Coasian contracting (Coase, 1960). If there are gains to trade or coordination, market participants have an incentive to contract around the prevailing formal structures of law and ownership to approach a first best allocation of resources. An obvious channel for this type of convergence is the internationalization of equity markets in which profit-seeking investors can strike mutually advantageous deals with companies in other governance systems and thus they may contract around formal barriers. This may, for example, have resulted in a functional reorientation of corporate governance in continental Europe.

More recently, papers by Markarian, Parbonetti and Previti (2007) or Martynova and Renneboog (2010) point to convergence in disclosure and legal system. Papers on the topic surveyed by Yoshikawa and Rasheed (2009) are more ambiguous, but very few find evidence of divergence. Large country differences remain in ownership structure, board systems and incentive pay. The speed of convergence is often found to be slow and to depend on the country context, but there is little doubt about the direction of change. For example some countries adopted corporate governance codes faster than others during past decades, but gradually they have all adopted such codes. It is highly plausible that some of the convergence was superficial and symbolic (and the underlying structure and behaviour remained relatively unchanged), but it is also possible to see convergence as a process in which symbolic adoption gradually becomes better rooted as laws, regulations and attitudes change.

In recent years convergence appears have been strengthened by macro trends. Figures 4.3 and 4.4 show the size of the stock market over time in terms of stock market capitalization to GDP and the number of listed companies. Market capitalization has dropped in all countries from levels of as high as 200% of GDP to below 100% today, first at the bursting of the dot.com bubble (2000–2003) and secondly during the financial crisis (2007–2008). During the same period the number of listed companies fell dramatically in the USA from a peak of 8850 companies in 1997 to 5603 in 2008, while it generally increased or remained roughly constant in Europe and Japan. In effect, US businesses have increasingly opted out of the market model, while Europe and Japan have opted in. The result is that the two continents are slowly converging.

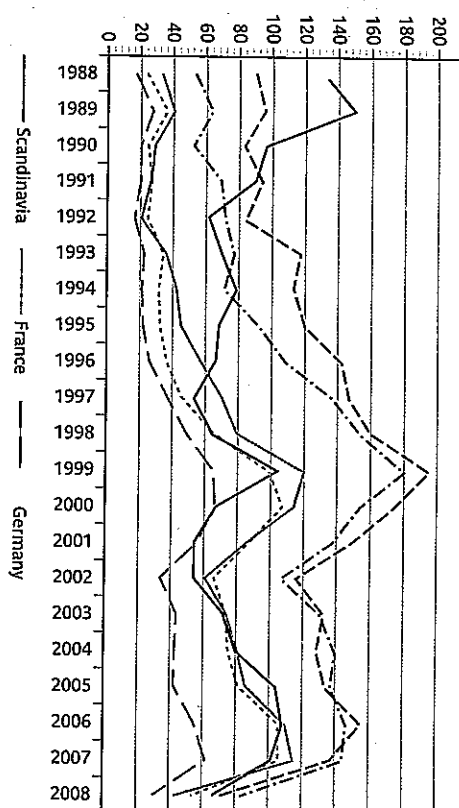


Figure 4.3 Stock market capitalization to GDP %

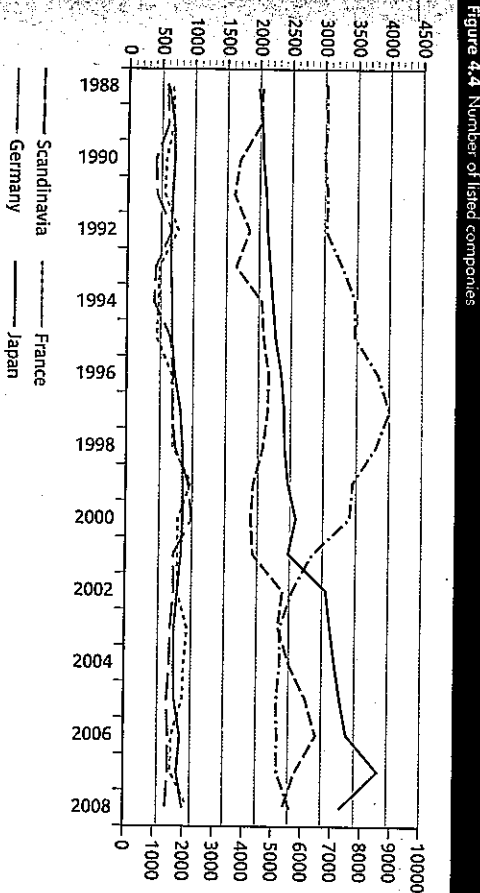


Figure 4.4 Number of listed companies

4.8 Discussion

Corporate governance systems differ because countries use different mechanisms to control and direct companies. Some rely on more markets and price signals, others rely more on large owners such as families, business groups or governments. Some rely on economic incentives such as pay for

performance, others rely more on social sanctions. Some integrate stakeholders such as employees into the formal governance system; others keep them at arm's length distance to companies. Over time the different mechanisms are adjusted to fit into the bundles which identify as corporate governance systems.

These systemic differences shape the way governance is practised and the way companies do business. For better or worse companies in some countries have to listen more to their employees or their banks, while others need to spend time convincing the stock market that they are on the right track. Managers have much more autonomy in market-based systems, while owners are more influential where ownership is concentrated. They are more incentivized to maximize shareholder value in the market-based systems of the USA or the UK, but conform more to social norms in Japan.

The differences may be overstated, however. Small companies around the world tend to have similar (owner-managed) governance. Moreover, governance systems do change over time, and we can see elements of convergence over time. For example, companies around the world have adopted market-based governance mechanisms over the past three decades and now face much more regulation and government interference regardless of system. To some extent companies can now free themselves of their national origins and adopt individual governance models. It is often possible to contract around legal limitations if this is believed to create economic value.

Minicase

A match made in heaven – DaimlerChrysler 1998–2007

On 7 May 1998, Daimler Benz and Chrysler announced a merger – a match made in heaven, it was called. The merger was greeted with enthusiasm. Share prices rose, especially Chrysler's, and the combined value of the two companies increased. The merger was announced as a merger of equals with no need for job cuts since there was little overlap between Chrysler's operations in the USA and Daimler's in Europe. The equality was reflected in the management. There were two CEOs and parallel organizations. At one stroke DaimlerChrysler was the world's third largest car maker.

The governance of the two entities changed as a result of the merger. The ownership structure became more dispersed as Deutsche Bank's share in the combined entity fell and Chrysler's largest shareholder Kirk Gregorian sold out. The supervisory board became quite large with members from both companies. The German employees gracefully allowed United Auto Workers one of their board seats. Management pay for the German executives was adjusted upwards to the US level.

The market optimism did not last. Share prices started dropping on news that Chrysler's earnings had to be revised downwards, that former Chrysler executives were rejoining, that DaimlerChrysler was dropped from the S&P 500 index (no longer being a US company), and that the company was having merger talks with Nissan (shares rose again when the talks were dropped). S&P deregistration alone drove share prices down by 15%. The US managers were replaced by Germans. But change was slow. Share prices took 10 years to recover to the 1998 level and then tumbled in the financial crisis of 2008. Growth slowed and the company eventually began to shrink. Return on net assets dropped to single figures. Credit ratings fell.

Finally, in 2007, Daimler gave up and sold Chrysler to Cerberus, a US private equity fund. Chrysler went bankrupt during the crisis and was taken over by the US government. But the world dream is not forgotten. Chrysler was recently sold to Fiat!

Discussion questions

- 1 What are the key governance differences between US and German firms?
- 2 What problems could this create for the merged company?
- 3 What do you think about 'the merger of equals'?
- 4 Did governance become stronger or weaker after the merger?
- 5 Why do you think share prices fell during the talks with Nissan?
- 6 Was DaimlerChrysler doomed to failure?
- 7 Do you think Fiat-Chrysler will work?

Summary (learning points)

- Countries tend to have distinctive governance systems conditioned by history, politics and interdependencies among governance mechanisms.
- The UK and the USA broadly conform to the market model: they have large liquid stock markets, dispersed ownership, high investor protection, and widespread use of incentive pay and independent one-tier boards.
- Germany, in contrast, has a much smaller stock market, more concentrated ownership, two-tier boards with employee representation and influential banks. The system can be described as a stakeholder model.
- Japan is characterized by powerful banks, ownership ties between business firms, insider-dominated boards and limited use of performance pay. We describe it as a network system.
- France has medium ownership concentration, primarily one-tier boards with a powerful President Directeur General and a tradition for government intervention. We therefore characterize the French model as 'public governance'.
- Scandinavia has strong elements of the stakeholder model, which are taken even further by specific features such as strong welfare states, a gender quota (in Norway) and industrial foundations (in Denmark).
- Governance systems are not constant and we see some signs of convergence over time.

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