Corporate Governance

Economic, Financing and Governance Models

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LSE & CBS

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Why Governance?

The protection of suppliers of capital (equity & debt)

- **Lowers cost of capital**
- Optimal allocation (better use) of resources in society

Cost of Capital

Key Determinant for Wealth of Nations

- “Productivity isn’t everything, but in the long run it is almost everything” (Krugman, 1994)
- Wealth is created by substituting labour with capital, hence automation
- Degree of automation is defined by the cost of capital, and the availability of human capital
- Cost of capital for firms is defined by the governance system → governance codes and legal framework

Corporate Governance issues cannot be solved, only mitigated

It’s all about institutions
(and institutional consistency)

Today’s Journey

Overview over this session

- Motivation, mechanisms, and interactions (myself)
- Legal governance framework, and the danger of copying someone else's (Carsten)
- Board diversity, and the importance of widening the human capital pool (Renee)
- On SOEs, and independent directors in Asia (Dan)

The Impact of Governance on Firms

CAPITAL STRUCTURE COMPARISON

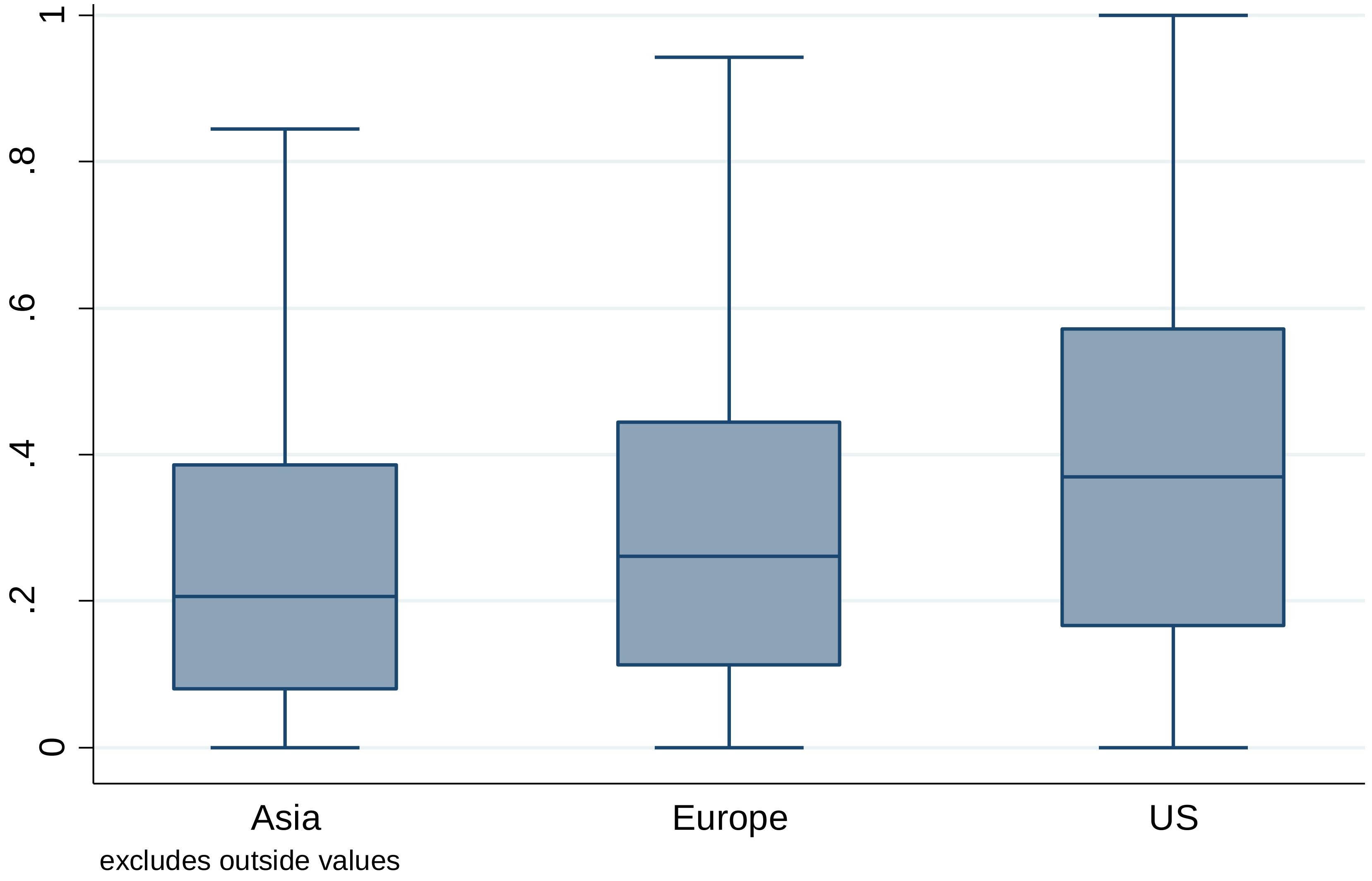
Our Sample

Companies: 33,059
Countries: 120
Observations: 327,144

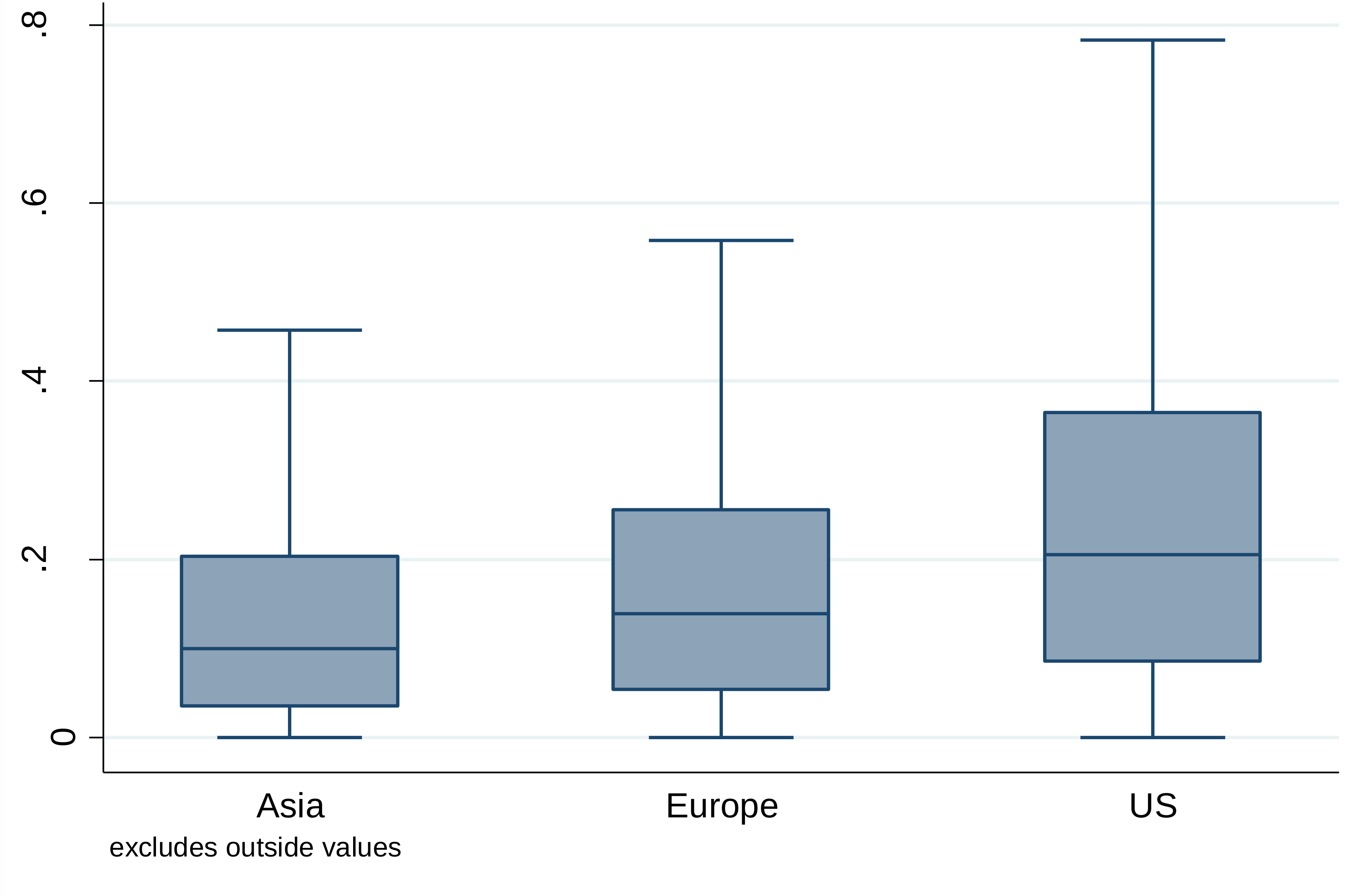
Continent	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Africa	457	457	457	457	456	456	456	456	456	456
Asia	11,045	11,045	11,045	11,045	11,043	11,043	11,043	11,043	11,043	11,043
Europe	5,185	5,185	5,185	5,185	5,169	5,170	5,169	5,169	5,169	5,169
Latin America	370	370	370	370	369	369	369	369	369	369
US	8,894	8,894	8,894	8,894	8,834	8,834	8,834	8,834	8,834	8,834

Source: Capital IQ. Warning: Survivor bias!

Long-term Debt / Total Debt

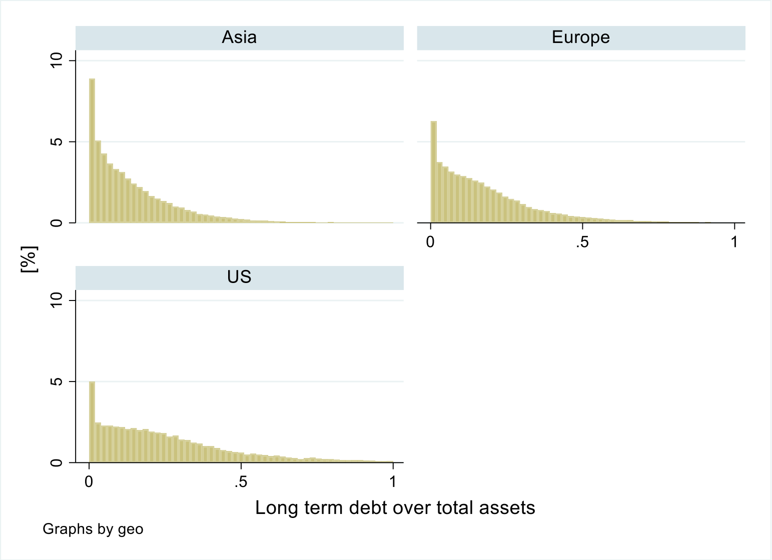


Long-term Debt / Assets

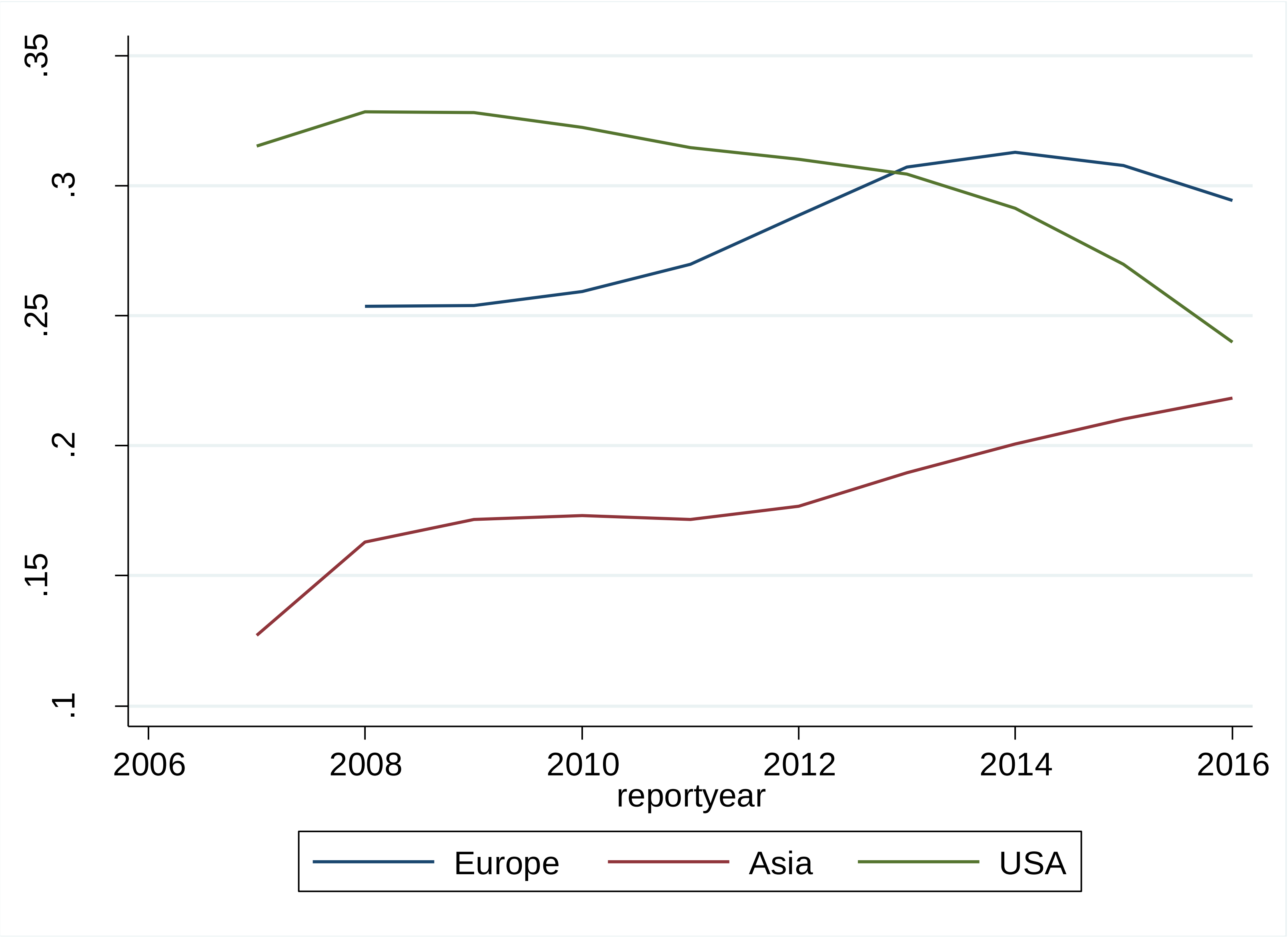


Long-term Debt / Assets

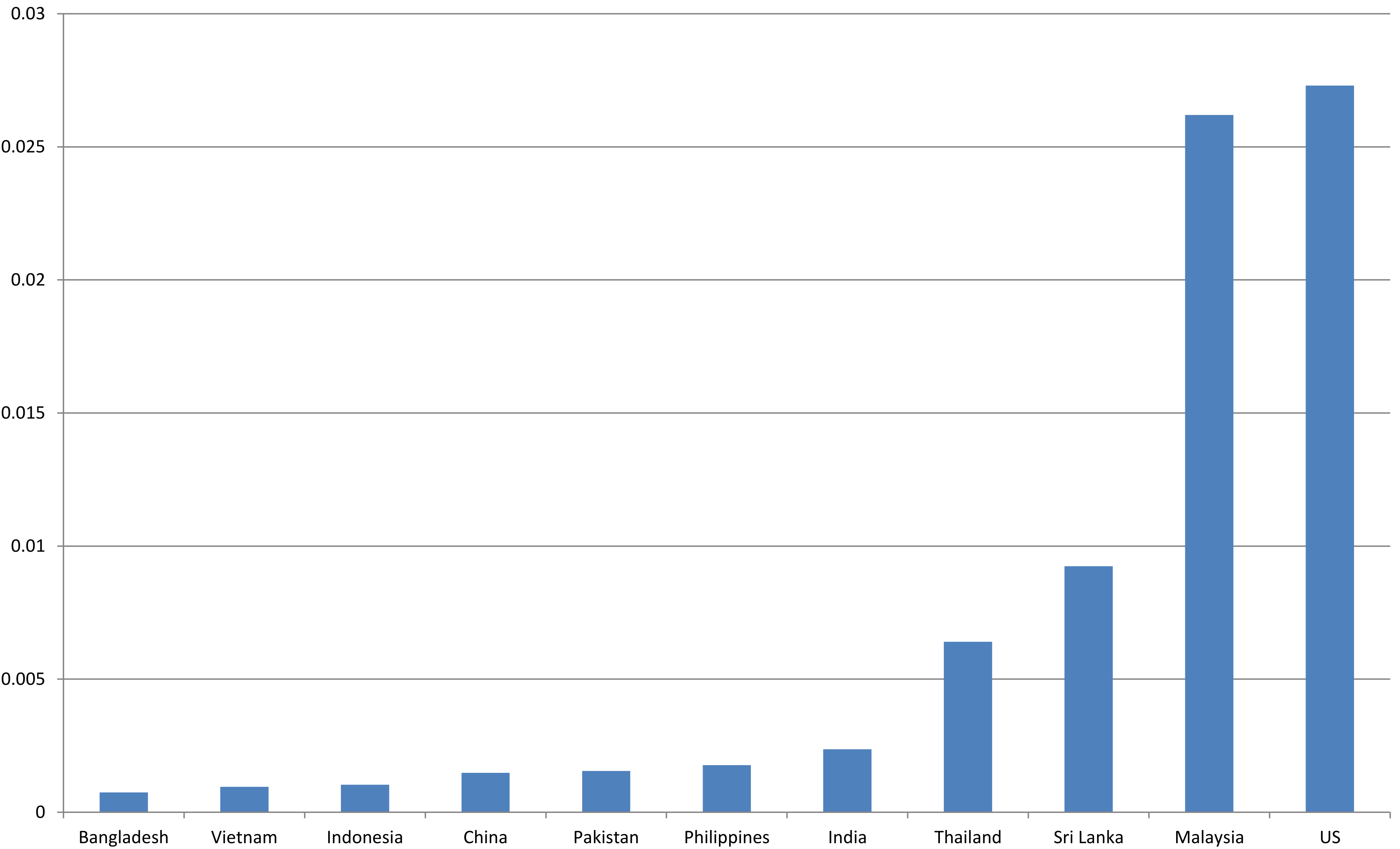
Distribution

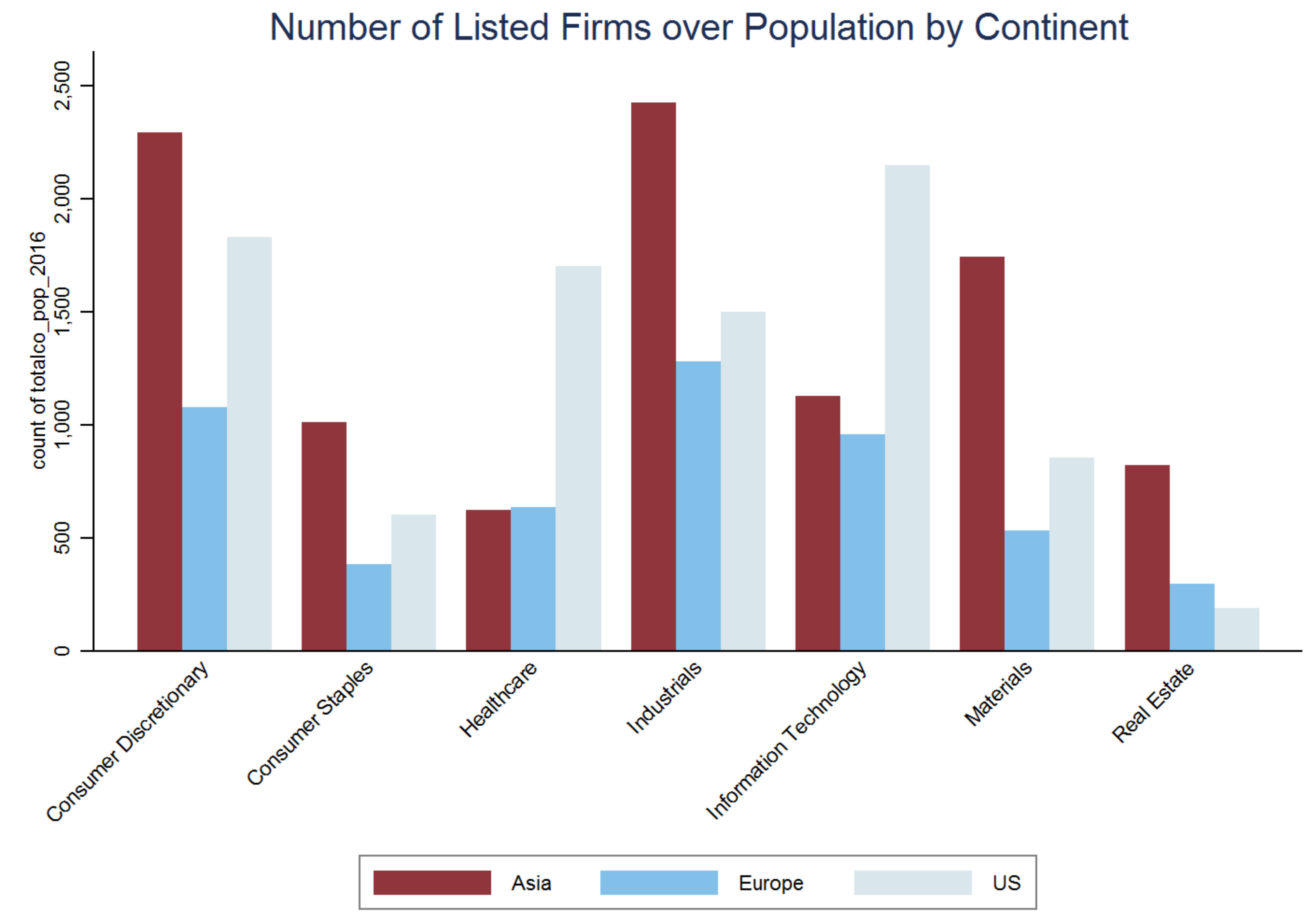


Fraction of Lossmaking Listed Firms



Listed Companies / Population ('000)





Number of Listed Firms over Population by Continent
count of totalco_pop_2016
0
500
1,000
1,500
2,000
2,500
Consumer Discretionary
Consumer Staples
Healthcare
Industrials
Information Technology
Materials
Real Estate
Asia
Europe
US

Capital & Firm Structure

- Developing Countries
  - The need to rely on internal capital markets requires firms to adapt a conglomerate structure
  - Conglomerates a suboptimal organisational form, as it forces inconsistent coordination, control and incentive structures upon an organisation
  - The case of the US in the 1970s
- Developed Countries
  - Specialised production, sold on world markets (maximise economies)
  - Access to capital markets at very competitive rates
  - Requires reliable institutional structures
  - The German case

Corporate Governance

Set of Internal and External Institutions & Mechanisms

- Internal
  - Board of Directors
  - Incentive Structures
  - Block holder

- External
  - Legal System
  - Market for Corporate Control
  - Shareholder Activism

Other Governance Mechanisms

- **Product Market Competition** - complement to good corporate governance, but not a substitute. Enforces the most efficient use of capital within the firm, but not the return of capital or profit to investors.
- **Poor Governance Discount** – investors will anticipate manager's non-value maximising behaviour and purchase shares at a discount. Requires significant insight and judgement of future conditions. Does nothing to allocate societies' resources to highest value added usage.
- **Media Scrutiny** – varies between countries and depends on the stage of the economic cycle.

The Natural Corrective

MODELS

Banks vs. Markets

Modes of Finance

Insider Systems (relationship based): Germany, Japan, Italy etc.

- Main supplier of finance is the house bank - exercise control, represented on advisory board and other companies (through cross-holdings, pyramidal ownership structures)
- Performs better where markets and firms are smaller, legal protection of shareholders is weaker, relationships are long-term
- Lack of transparency to outsiders
- Technological innovation is incremental rather than revolutionary
- Often reliant on explicit or implicit government guarantees

Banks vs. Markets

Modes of Finance

Outsider Systems (arms length): US and UK etc.

- Main supplier of finance are the financial markets (Equity and Tradable Debt)
- Performs better where markets and firms are larger, legal protection of shareholders is stronger
- Greater transparency and reporting requirements
- Technological innovation is revolutionary (Silicon Valley)
- Less stability
- No explicit or implicit government guarantees (although too big too fail?)
- Increases access to financing and future opportunities.
- Market oriented, dispersed ownership, institutional investors

Shareholder vs. Stakeholder Model

or

Anglo-American vs.
Continental European Model
vs. future Asian Model (?)

Stakeholder Model

- Management, board and corporate governance should be concerned about the well-being of all stakeholders in an enterprise (e.g. employees, suppliers, …)
- Long-term large investor model -
- In the 1980s it was considered to be the superior CG model.
- Provided capital cheaper, and allowed a higher gearing (debt/equity ratio).
- Associated mainly with Japan and Germany.

Stakeholder Model

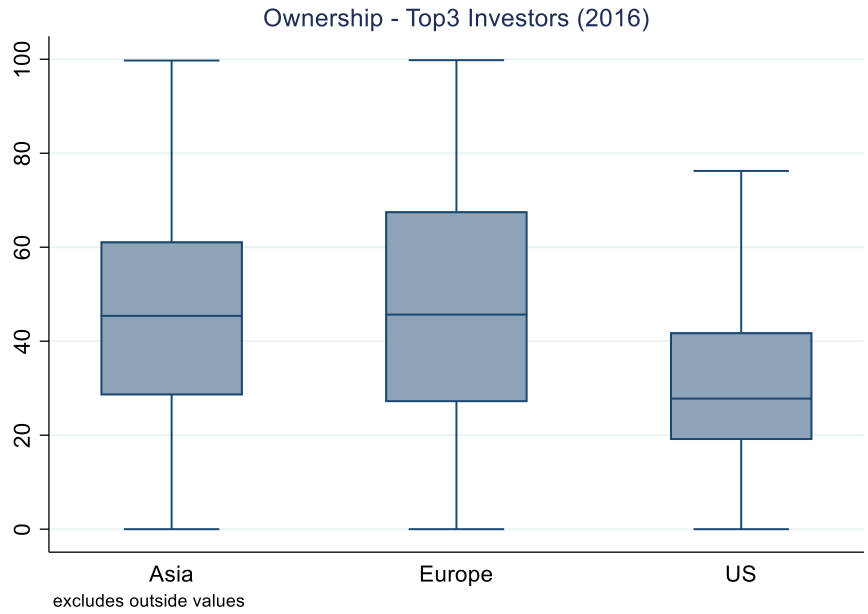
- Often based on an economic system of capital intensive industries producing high value-added goods
- Stability is important for these industries
- Large fixed-asset base => strong creditor rights to help in the recovery of assets
- Reform is difficult to achieve, as the various constituents can voice their concerns and block decisions. Hold-up problem.
- Was it the industrial performance that was superior, or the economic model?

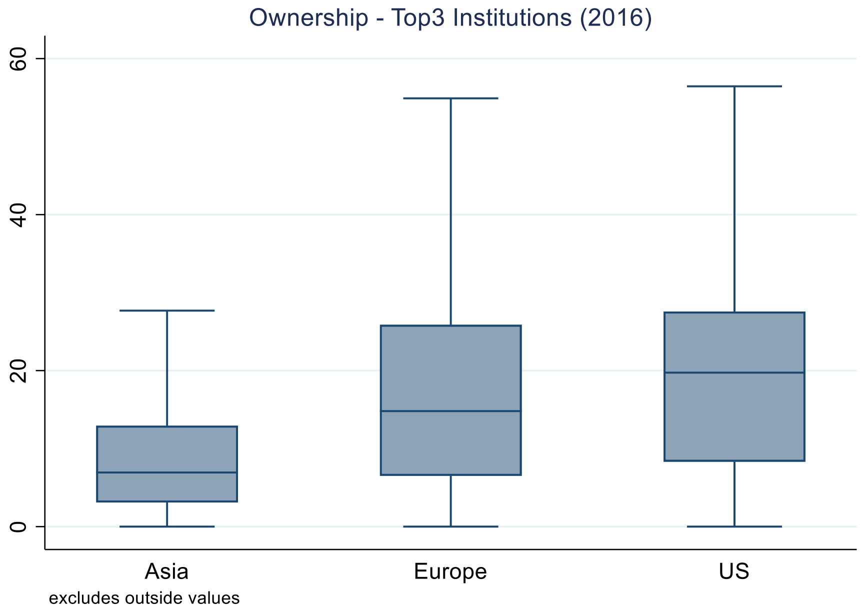
Shareholder Model

- Corporate governance is concerned primarily with capital.
- Considered to be the superior CG model in the 1990s, associated mainly with the US (and Britain).
- Based on an economic system of highly innovative, fast changing and service driven “industries”.
- Change is easily facilitated.
- Critics argue that US managers are myopically ‘short-termist’ in their outlook and investment decision.
- Is it the superior model? Time will tell.

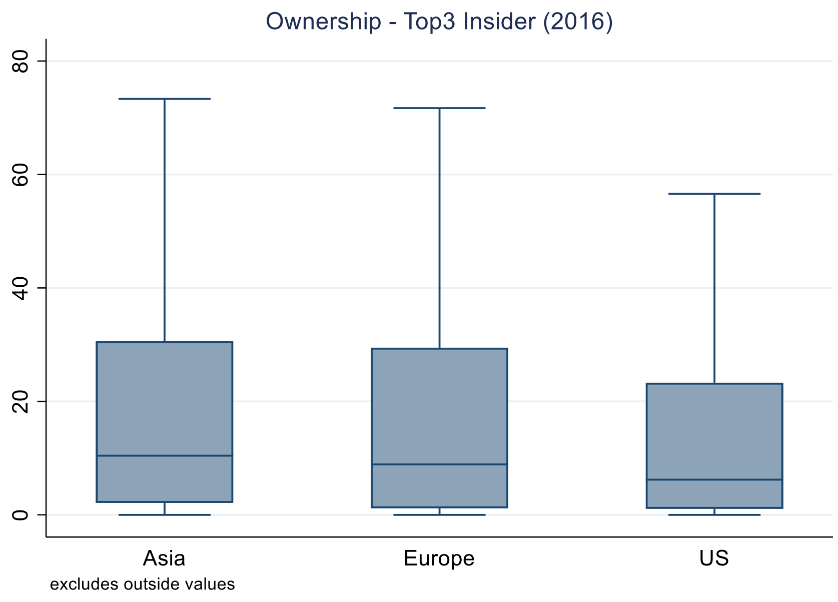
The Natural Corrective

OWNERSHIP STRUCTURE


Ownership - Top3 Investors (2016)
100
80
60
40
20
0
Asia
Europe
US
excludes outside values



Ownership - Top3 Institutions (2016)
60
40
20
0
Asia
Europe
US
excludes outside values


Ownership - Top3 Insider (2016)
80
60
40
20
0
Asia
Europe
US
excludes outside values

Control by Type

Europe 2002

	Largest Shareholder			Closely Held Shares		
	Widely Held	De Facto Control	Legal Control	Widely Held	De Facto Control	Legal Control
France	49.0%	16.3%	34.7%	35.8%	13.7%	50.5%
Germany	46.5%	15.8%	37.6%	30.7%	11.9%	57.4%
Italy	30.9%	22.3%	46.8%	16.5%	18.6%	64.9%
Spain	48.9%	23.9%	27.5%	30.7%	21.6%	47.7%
UK	93.1%	5.0%	2.0%	91.1%	5.9%	3.0%