In this topic, we consider corporate governance in different countries. In particular, we are interested in the way that firms raise capital and how that affects the way that organizations operate.

The agenda for this topic is as follows:

1. Describe the differences in the way that companies raise capital.

2. Describe how corporate governance is likely to be affected by allowing banks to hold stocks.

3. Describe how investment is likely to be affected by allowing banks to hold stocks.
I: Raising Capital.

Let us begin by considering an aggregate measure of the extent to which companies use the stock market as a way of raising money. In particular, consider the ratio of

\[
\frac{\text{Debt}}{\text{Debt + Equity}}.
\]

For 1986, the ratio of debt to [debt plus equity] in the United States was 55%, compared to 60% for Germany and 68% for Japan. This provides some a priori evidence for less reliance on the stock market in Japan than in the United States, with Germany being somewhere in between.

There are, however, a couple of problems in interpreting these data. First, Japanese firms undervalue their equity holdings because (i) they hold a lot of real estate as collateral and (ii) they value this real estate at the cost of purchasing rather than at market value. As a result, given the enormous increase of Japanese real estate, there is significant undervalued equity in the books. (This is also a problem for German companies.)

The second reason to doubt these figures is that many companies borrow and hold cash simultaneously in Japan. This is caused by what are known as ``compensating balances."

\[Q: \text{What are compensating balances?}\]

\[Q: \text{Why are they used?}\]

For both these reasons, the data are a lot more similar than they appear. Probably a better measure of the differences in institutional structure is in the composition of shareholders. Figure 1 below breaks stock holdings in Japan into institutions, corporations, and individuals. Note the large decline in individual holdings as institutional holdings become more important. By 1985, individual holdings were down to 25%, while in the United States, these were 51%.
Figure 1

Distribution of Stockholdings in Japan

by year

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- individuals
- financial institutions
- business corporations
Institutional Investment:

Even more important than this is that within the institutional sector, financial institutions dominate in Japan, while in the United States, almost all the institutional investing is done by insurance companies or pension funds. The data for Germany suggest that banks hold on the order of 12% of equity. However, these figures understate the true power of German banks as many shareholders surrender their votes to banks. It is not unusual to find a bank with about 5% of the shares holding a majority of the votes: they proxy vote for a large proportion of the shareholders. It is reckoned that banks control on the order of 50% of the value of shares. The three largest banks sit on the boards of about half of the 100 largest German companies.

For the US, historically the Glass-Steagall Act, which stopped banks from holding stocks in non-financial companies limited institutional holdings. This was often compared to legislation in Germany and Japan where banks hold stocks in companies, which is typically assumed to improve monitoring.

Since its repeal, the United States has seen a huge change in the importance of institutional investment in the last thirty years. In 1970, less than 30% of stocks were owned by institutions but by 1998 this has passed 50%. By contrast, the share made up of individual ownership has fallen from 70% in 1970 to 46% by 1998. However, most of this increase has been pension funds and mutual funds rather than bank holdings.

The Role of Banks

Banks are often put forward as a solution to the monitoring problem. The significant holdings by financial institutions in Japan is put forward as a reason for perceived enhanced efficiency as they monitor the activities of the senior management.

Q: Why are banks likely to be necessary to monitor companies?
Q: Why can’t insurance companies or pension funds play the role than banks do in Japan, monitoring the operations of the companies?

Q: Why can’t debt holders monitor the company?

A final role for banks: Renegotiation and the threat of liquidation.

II: Corporate Governance

Corporate governance refers to mechanisms that shareholders have for ensuring that the company is likely to be run in their interests. I will begin by considering some general mechanisms that economists have suggested. There are a number of mechanisms for controlling CEO behavior, not all of which involve explicit compensation schemes involving stocks or options or whatever. These include

1. Reputation - we might argue that CEOs care so much about their reputation that they will act in the interests of shareholders.

   Why might this not work?

2. Monitoring by the Directors and Postretirement Events

   It might be possible to induce the CEO to act in the interests of the company by threatening not to put him on the board of directors. This threat does not appear to have much
teeth, however. In particular, we find that over 80% of the CEOs end up on the board, which is pretty high given that many of the CEOs may retire due to illness.

Recent legal changes:

Sarbanes Oxley (2002):

(a) Requires executives to report sales of stocks in two days – previously ten,
(b) Changes in accounting rules to make it harder to misreport earnings,
(c) Audit committees made more independent,
(d) Increases board responsibility for misreporting.

Other changes – (i) board selection is now typically done by the nominating committee, not the CEO, (ii) more equity compensation for directors.

Evidence on the role of boards for the US – look at the effects of (a) board size, and (b) outside directors. Very marked difference between the available evidence and recent legal changes in say the UK.

3. Large Stakeholders

The benefits of stakeholders with more at stake must be traded off against

(a) worse diversification,
(b) lower liquidity
(c) the effects on minority shareholders.

But why should institutional holdings matter?

Evidence from the United States: there is not much evidence that large stakeholders affect performance.

The “curse of liquidity” in the United States.
Despite this, voting stock typically trades for more? Why?

4. The Stock Market

It may be that explicit incentive plans are not necessary, because the stock market provides discipline through takeovers. The idea is that if CEOs shirk or do not act in the interests of shareholders, they are likely to find themselves taken over and replaced.

The stock market preferable to simply using shareholders due to the free-rider problem.

Q: What are the potential problems with using the stock market as a disciplining device?
Common Anti-takeover Defences:

(i) Supermajority Amendments
(ii) Staggered boards
(iii) Poison pills – allows management to issue more shares at a low price to existing shareholders if one owns more than x%.

Why do shareholders agree to these?
(i) Too difficult to coordinate action,
(ii) Monopoly pricing problem.

Empirical evidence on the effect of these on performance and on CEO pay.

5. Explicit Incentives

Here we address the use of explicit compensation plans where we see how sensitive a CEO's compensation is to changes in the stock price of his company. Let us begin by describing results on CEO compensation. Suppose that we look at CEOs of Fortune 500 companies. Next consider the value of the company rising by $1,000.

How much does the CEO's salary increase by?

How much does the CEO's salary + bonus + stock options rise by?

How much does the CEO's salary, bonus, options and stock holding rise by?

Do you think that this provides reasonable incentives for the CEO?
Now let us look at the issue a little closer:

Consider a typical Fortune 500 CEO like CSX. The CEO has an annual salary of about $700,000. His company has sales of about $7bn. Suppose that the stock price changes by 1%. How much does the CEO's compensation change by?

Finally, let me address the issue a slightly different way. Jensen and Murphy look at LBOs. They find that the sensitivity of the executives compensation is about $64 rather than the $3 we saw above. They claim that this must be better as it gives CEOs more incentives. Do you agree? What problems could $64 cause?

Do CEO compensation plans work?

This is a difficult issue to test. Jensen and Murphy look at a subsample of their data and argue that those with sensitive compensation schemes typically have better stock market performance than those which had less sensitive compensation plans. Graef has looked at J&M's full sample and finds that on the whole sample, no such effect can be seen.

Why might this not be a good test of the effect of compensation plans? [Hint: Think of what the Efficient Market Hypothesis in finance tells us.]

Hence an appropriate measure is to look at how stock prices change when a new (sensitive) compensation plan is implemented. Typical finding: stock prices rise.

Q: Are there any problems with concluding that sensitive compensation plans are liked by the stock market?
Q: Are CEO plans designed efficiently?

(a) Rewarding for things beyond their control
(b) Little evidence of "relative performance evaluation"
(c) Few restrictions on hedging out
(d) Boards typically offer insurance against being sued
(e) Why aren't CEOs required to buy stock?

Data for Other Countries

A: Compensation

Let us now consider how CEOs are paid in the US compared to other countries. We do this by considering how much higher the wage for a CEO (in large companies: $30 billion in sales or more) is compared to that of the average worker.

Q: How much higher is the average CEOs wage in Japan? in France and Germany? in the US?

Notice that many of these changes in the US have occurred over the last 15 years. The differences for small companies are smaller; here European or Japanese CEOs earn about a third to two thirds as much as an American CEO.

Where does this difference principally arise? Most actually comes in the form of stock payments or options, which are much rarer in Europe and Japan.

Q: How would we determine what CEOs should be paid?
B: Takeovers

Takeovers in Japan are exceedingly rare. Instead, it is argued, banks will step in to improve the running of a company if there is evidence of the company being run inefficiently. An example that we saw of this arose earlier in the reading "How Lean Production Can Change the World" under Topic 4, where we saw that in 1974, Sumitomo Bank stepped in and provided board members for the Mazda corporation after they hit hard times.

Germany is another country with almost no hostile takeovers, though mergers are quite common. It is commonly felt that takeovers occur in Germany more as a way of benefiting from economies of scale or scope than as a mechanism for controlling management.

In the late 1990s, there was a surge of attempts to carry out hostile takeovers, but there have been only three successful ones in the last thirty years.

There are a number of reasons for the comparative absence of takeovers in Germany. First, ownership of listed companies is very concentrated – most firms have a single majority owner, so very difficult to unseat. Second, 50% of the seats on the board of directors of large companies are held by workers, who may feel that they have little to gain from the takeover. Second, works councils hold considerable rights with respect to employment and dismissal so that the benefits of takeover may be low.

Third, boards of directors can be fired from their jobs only for proven breach of duty, unlike in the United States. As a result, even if a takeover is successful, it may not be possible to make the required restructuring. Another constraint is that the supervisory board, which chooses the board of directors, can be fired only if 75% of the shareholders vote in favor of it.

Another reason for hostile takeovers being rare is that corporations can easily set up their charters in order to limit the power of any one individual. For example, one of the few cases of an attempted hostile takeover in Germany was for Feldmuehle Nobel, where the charter limited the holdings of any one voter to 5%. This is not unusual, as voting caps are in place in the following companies:
BASF – 5%
Bayer – 5%
Volkswagen – 20%

Sometimes these restrictions happen during a takeover attempt – for instance, an attempt to change the charter of Mannesman was made after Vodafone began its to take it over. These voting restrictions are much harder to do now.

In France, the restrictions are not quite as stringent as in Germany. Hostile takeovers are again rare, though there have been a number of recent attempts. Employees and works councils have the right to be consulted but have no veto power over the takeover. Supervisory boards can be fired with 50% of the shareholders' vote, unlike the 75% required in Germany. The major constraint in France appears to be the government, which holds considerable shareholdings in major companies and seems to frown upon hostile takeovers.

Legislation in the United Kingdom is more like the United States than in the two countries mentioned above; the U.K. has on the order of 50% more takeovers, many of which are hostile. In the United Kingdom, employees have few right, not even to be consulted over the proposed changes. Similarly, the CEO can fire the supervisory board if he so feels, and equally the board of directors has few rights to claim unfair dismissal. Finally, the Stock Exchange in London discourages the use of discriminatory voting rights for shares so that it is difficult to restrict voting power of any one shareholder.

C: Pay for Performance and Firings

A recent article by Kaplan looks at the relative efficiency of Japanese and American corporate governance by considering the effect that poor performance has on how likely the CEO and directors are to be fired and how their pay changes.

The main result from the study is that it is important to distinguish between the inside directors and the CEO. If the company does badly in Japan, there is an effect on the CEO's
chances of being removed, but (also) the insider directors face a considerably higher probability of being fired from that job. The only effect on CEOs is that they are a little more likely to be "kicked upstairs."

Kaplan finds that in the United States, the effects on the insider directors are much more muted, but the effect on the CEO exists, where there is a higher probability of the CEO being fired.

Q: Is it necessarily the case that intervention by the banks will increase the likelihood of firing the CEO?

Q: Kaplan argues, on the basis of the figures I have given above, that corporate governance operates a similar way in both countries for CEOs. Would you agree?

Q: Is the different behavior for inside directors consistent with other information we have about how Japanese and American organizations operate?

Caveat: If age is excluded as an explanatory variable predicting the likelihood of a CEO being removed in a given year, the $R^2$ of the regression is about .01. In other words, about 1% of the variation in CEO turnover is explained. If age is included, the $R^2$ goes up to about .15. In other words, the power of this regression is such that if you told me the CEO's age, I could tell you with much more precision whether he is likely to leave than if his company goes down the tubes. As a result, you should take some care in overemphasizing the power of these results.
D: Large Stakeholders

This is the dominant form of corporate governance in continental Europe. As stated above, a majority of German listed firms have a single owner with a voting stake greater than 50%. Often this is done via pyramids.

There is anecdotal evidence of large stakeholder increasing efficiency – eg TIAA-CREF stopping the sale of Telecom in Italy selling wireless at a price that was too low.

Despite this, there is little evidence after 1990 that large stakeholders make much difference to efficiency.

But voting shares have a premium of 50% - suggests a conflict with minority shareholders.

Banks: better evidence that they improve efficiency, but much of this evidence relates to its role as creditor. For instance, for the US, bank loan agreements increase stock prices, something that is not true of public issues or private placements. This is also true for acquisitions. There is also evidence from Germany that the primary role played by banks is as a creditor.

E: Whose objectives should corporate governance maximize?

Typically argued that it should be those of shareholders, but there is widespread disagreement about this in Europe.

III: Investment

Aside from corporate governance issues, it is typically argued that banks may overcome inefficiencies regarding investment opportunities. The argument arises from an idea by Myers and Majluf, which holds that there are reasons why the capital market will be reluctant to fund equity issues as it believes unfavorable information about the company.

Myers and Majluf
The idea here is very simple. Suppose that managers act in the interest of existing shareholders and they have to raise money for a project. If the manager has done research on the project, he may have private information on its value. Assume that this is the case. Then he will issue equity (and share the value with the new investors) only if the company is overvalued. If the company is undervalued, he may decide against issuing equity because he has to give away undervalued equity to outsiders. As a result, conditional on equity being issued, the stock market will assume that the stock is overvalued which may result in an unwillingness of managers to seek financing through the equity market, and hence, to a less efficient stock market. This places added emphasis on the availability of internal funds.

An Example:

Suppose that a manager needs $100 for a new project. The value of the project and of the assets of the company depends on whether the “state of the world” is good or bad as follows:

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<tr>
<th></th>
<th>Good</th>
<th>Bad</th>
<th>Average</th>
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<tr>
<td>Value of Assets</td>
<td>150</td>
<td>50</td>
<td>100</td>
</tr>
<tr>
<td>NPV of project</td>
<td>20</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>Investment</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Value of Company</td>
<td>270</td>
<td>160</td>
<td>215</td>
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Assume first that the manager always funds the project. What is the price of raising 100 in equity through the stock market? (In other words, what percentage of the company must be given up to attract 100 in equity, assuming the stock market is competitive?)

Remember that we talked about the manager operating in the interests of the old
shareholders. How much do they get if the project is funded in each state of nature?

Q: Given this, will they always fund the project?

The reason for this is that they may feel that the company is being given away for a bargain, and hence will eschew the project so as not to give away the company “for a song.”

Q: What is the price of equity?

A diagram will be given in class to illustrate a more general representation of the idea that companies will issue equity only if the company is overvalued.

Empirical evidence shows that equity issues are accompanied by a fall in the stock price, as suggested by this theory here.

Because issuing equity entails a cost, the value of internal funds rises, because they can be sued to finance projects without relying on the equity market. This brings us to the empirical evidence collected by Hoshi, Kashyap and Scharfstein on our reading list. They consider the investment behavior of companies in Japan, where they distinguish between companies that belong to keiretsu groups and those that do not. Their argument is that those in the groups will have better-informed shareholders so that they will not have to rely on internal funds to invest, while those companies which are outside groups will have to rely more on internal funds. The regression they carry out is

\[ l = a + bq + cIF, \]

\[ \rho \]
where \( I \) is investment, \( q \) is the measure of market value to replacement cost (a standard measure of investment opportunities) and \( IF \) is a measure of internal funds.

**Q: Why is it important to include the \( q \) variable?**

They find that the coefficient on \( IF \) is positive for only the non-group firms, so that for group members it doesn't matter whether they have internal funds or not, as they predicted. The authors see this as a benefit of the keiretsu groupings.

The other paper on the reading list by Hoshi, Kashyap and Scharfstein considers the behavior of firms in financial distress. Again, consider the impact of the free rider problem, in an instance where firms are in financial distress. They argue that you would expect there to be a need for a large shareholder to get involved if the problem is going to be sorted out, since small shareholders don't have the incentive to investigate and correct the problem.

They find that (i) firms with bank holdings invest more in financial distress, and (ii) firms with financial holdings sell off more assets in the following years. They actually show something a bit stronger: that companies with large shareholders exhibit these characteristics, rather than just firms with bank holdings.

The authors interpret this result as indicating that bank holdings are useful aids as companies recover from financial distress, which may ultimately make it easier for those companies to hold debt.

**Q: Is there another interpretation of this evidence?**

**IV. Summary**
The jury is still out on this one. Most of the studies that have been done have shown some benefits to the ability of large shareholders to get involved, though the stories are open to alternative interpretations as we have seen. A drawback is that nobody has really studied the costs of allowing banks to buy equity. Is there any evidence of banks propping up companies that they hold stocks in, using depositors' money? The behavior of the S&Ls over the last 20 years would not give much cause for hoping that banks are likely to act in the interests of depositors always. I suspect that the research over the next few years will help illuminate this question considerably.