Topic 7: Corporate Governance and Financial Structures

*We consider financial structures and corporate governance in different countries. How firms raise capital and how that affects the way that organizations operate.

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.

* Reasons to doubt these numbers
* 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.

Figure 1

**Distribution of Stockholdings in Japan**

by year

![Graph showing distribution of stockholdings by year and type of shareholder (individuals, financial institutions, business corporations)]
• 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.

• For the US, historically the Glass-Steagall Act, which stopped banks from holding stocks in non-financial companies limited institutional holdings.

• 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.

• Most of this increase has been pension funds and mutual funds rather than bank holdings.
The Role of Banks

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

1. Reputation - we might argue that CEOs care so much about their reputation that they will act in the interests of shareholders.
2. Monitoring by the Directors and Postretirement Events

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) *Effects on minority shareholders.*

But why should institutional holdings matter?

Evidence from the United States:

*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**

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**

Let us begin by describing 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?
Do CEO compensation plans work?

Jensen & Murphy and Graef

* Why might this not be a good test of the effect of compensation plans?

* 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?
**B: Takeovers**

* Hostile takeovers in Japan and Germany are exceedingly rare.

- There are a number of reasons for the comparative absence of takeovers in Germany.

- Ownership of listed companies is very concentrated – most firms have a single majority owner, so very difficult to unseat.

- 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.

- Boards of directors can be fired from their jobs only for proven breach of duty, unlike in the United States.

- 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.

- Voting caps are in place in the following companies:
  
  BASF – 5%
  
  Bayer – 5%
  
  Volkswagen – 20%.

These voting restrictions are much harder to do now.
France:

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.
C: Pay for Performance and Firings

The relationship between poor performance has on how likely the CEO and directors are to be fired and how their pay changes.
**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 in the US that it should be those of shareholders, but there is widespread disagreement about this in Europe.
III: Investment

* 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.

* 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.
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:

<table>
<thead>
<tr>
<th></th>
<th>Good</th>
<th>Bad</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<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>
</tr>
</tbody>
</table>
More General Representation of Myers-Majluf
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.

Hoshi, Kashyap, and Scharfstein.

They consider the investment behavior of companies in Japan, where they distinguish between companies that belong to keiretsu groups and those that do not.

The regression they carry out is

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

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.
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 firms with bank holdings invest more in financial distress.

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?