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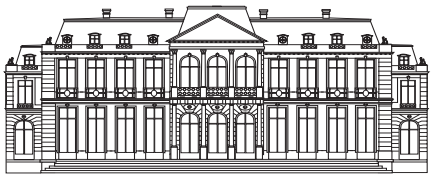

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Conference on

"CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE"

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The UK is quite different from most other Continental European countries in having a large developed stock market. The total market capitalization of firms as a proportion of GDP in the UK averaged 75% over the period 1982 to 1991 in comparison with 19% in France and 20% in Germany (Figure 1).[1] The OECD average was 30% over this period. In contrast, bank lending in the UK is comparatively modest in relation to many other countries. Figure 2 shows that the ratio of credit to GDP averaged 42% over the period 1980 to 1990 as against 82% in France and 86% in Germany. The OECD average was 55%.

On average, British companies go public at much earlier points in their life cycle than their Continental European counterparts. The average (median) age of firms at the time of initial public offerings is 8 years in the UK as against 40 years in Germany. The average size of UK firms coming to the stock market is $16 million in the UK as against $60 million in Germany.[2]

OWNERSHIP

Still more striking are differences in concentration of ownership between the UK and elsewhere in Europe. The European Corporate Governance Network has been undertaking a systematic comparison of ownership and control of corporations in Europe.[3] Its study is based on information which is becoming available in member states of the European Union as a consequence of the Transparency Directive which was passed in 1988 requiring member states to introduce laws forcing disclosure of shareholdings of companies listed on member state exchanges. The Directive requires companies to notify the relevant authorities when voting rights cross certain thresholds of, for example, 10%, 20% etc of total votes. It therefore relates to control rather than ownership of firms.

Figure 3 reports the proportion of votes controlled by investors in seven European countries. It shows that the average of the largest voting block lies between 34% in Spain and 52% in Austria. In contrast, in the UK the median size of the largest block is just 10% and in the US it is below the minimum disclosure level. Concentration of control is appreciably greater on the Continent that it is in the UK or US.

However, Franks, Mayer and Renneboog note that this is not because there are no significant share holdings in the UK. Franks, Mayer and Renneboog report the results of collecting ownership data on shareholdings in 250 randomly selected firms quoted on the London Stock Exchange over the period 1988 to 1993.[4] They classified shareholdings according to type of investor (eg financial institutions, industrial and commercial companies and families) and distinguished between holdings of directors and their families from those of other investors, for example, financial institutions.

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[1] See W. Carlin and C. Mayer (1998), "Finance, investment and growth", Said Business School, mimeo.

[2] Goergen, M. (1998), *Corporate Governance and Financial Performance*, Cheltenham: Edward Elgar.

[3] The European Corporate Governance Network, *Who Controls Corporate Europe?*

[4] J. Franks, C. Mayer and L. Renneboog (1998), "Who disciplines bad management?", mimeo.

Franks, Mayer and Renneboog report that the largest five shareholders accounted for between 30 and 35% of shareholdings depending on the year. The median size of the largest stake was in the range of 5 to 15% but there were a significant number of blocks of at least 25%. Institutional investors held the highest proportion (53%) of the largest shareholdings. Directors and their families are the next most significant holders of the largest stakes and they have larger controlling shareholdings than financial institutions. While ownership concentration is appreciably lower in the UK and US, coalitions of shareholders can control a significant fraction of shares in a company (eg five shareholders can frequently cast 30% of the votes in a firm) so that together they are able to exercise control.

In fact, Mayer (1999) argues that cross-country difference in the size of second, third and smaller shareholdings is as important in understanding variations in corporate control as the largest shareholdings.[5] Drawing on the work of the European Corporate Governance Network, he notes that in most Continental European countries, the average size of the third or fourth voting blocks is negligible from a control perspective (Figure 4). Control is therefore concentrated on the Continent not only because of the existence of large blockholders but also because of the absence of other voting blocks.

The one country where second and third voting blocks are not insignificant and indeed not that much smaller than the largest voting blocks is the UK (Figure 5). Even beyond the tenth largest shareholding, the mean voting block is greater than 3%. "No individual investor therefore exerts dominant control; instead, it can only come from coalitions of investors" (Mayer (1999), p 4).

In the UK, financial institutions, in particular pension funds and life assurance companies (Figure 6) hold a majority of shares. Directors are the next largest shareholding group with individuals and companies having very modest shareholdings in aggregate. While financial institutions in total hold more than 60% of shares, in general no one institution holds a substantial fraction of any one company's shares.

In contrast, on the Continent, individuals and companies hold a majority of the large share blocks reported above. Figure 7 illustrates this for Germany. Inter-corporate holdings are particularly important, frequently taking the form of cross-shareholdings and complex webs of holdings. In the case of Germany and Italy, the shareholdings are often in the form of pyramids or cascades. These allow shareholders at the top of the pyramid to exert control over firms lower down in the pyramid at comparatively low cost.

The central question that these differences raise is how do they relate to differences in corporate control and performance. There is much more evidence on the former than the latter. Relations between ownership and performance are complicated by the numerous other factors that affect performance. Corporate control is established from information on the composition and turnover of boards.

[5] Mayer, C. (1999) "Firm control", mimeo, Said Business School , University of Oxford.

BOARD COMPOSITION

The UK has a unitary board system. There is no separation of executive and non-executive boards and no direct association between non-executives and particular shareholders; instead, non-executives are responsible to shareholders in general. Franks, Mayer and Renneboog report in their study that on average boards comprise just over 9 directors, of whom just under 40% are non-executives. In some companies the roles of chairman and chief executive officer (CEO) are combined: Franks, Mayer and Renneboog report that this is the case in 32% of their sample.

One of the striking developments over the last decade has been the increase in the proportion of non-executives on corporate boards and the number of companies in which the role of chairman and chief executive have been separated. According to Conyon and Mallin, by March 1995 non-executive directors held approximately 50% of the positions on boards of the top 100 companies.[6] They also report that only 14.2% of all quoted companies combined the role of CEO and chairman in 1994 as against 24.5% in 1992. These changes in board composition were in part prompted by publication of the Cadbury Committee Report on Corporate Governance.[7]

BOARD TURNOVER

The question that Franks, Mayer and Renneboog address is how does the UK system of corporate ownership relate to corporate control. They look at how bad management is disciplined in UK firms with different ownership patterns. They examine the relation between board turnover of both executive and non-executive directors and relate this to firm performance, ownership concentration, types of owners and board composition.

They find that the proportion of non-executive directors on the board bears little relation to board turnover in poorly performing companies. Non-executive directors in the UK primarily play an advisory rather than a disciplinary function. This is different from the US where non-executive directors appear to perform an important disciplining function. One of the possible explanations for this difference is the more clearly defined fiduciary responsibilities of non-executive directors in the US than in the UK. In contrast, separation of the roles of chairman and CEO is important in the exercise of corporate governance in the UK: there is evidence of more CEO replacement in poorly performing companies that have separated the functions of CEO and chairman.

Dispersed ownership exploits the benefits of portfolio diversification. Any one investor holds only a small proportion of any one stock and investors can hold a large number of shares in their portfolio. Dispersed ownership also promotes liquidity in stock markets by making a high proportion of shares available for trading. On the other hand, dispersed ownership creates a free rider problem in corporate control. No one investor has much incentive to engage in active corporate governance because they capture a small proportion of the benefits associated with active governance. Incentives

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[6] Conyon, M. and C. Mallin (1997), "A review of compliance with Cadbury", *Journal of General Management*, 2, 24-37.

[7] Cadbury, A. (1992), *Committee on the Financial Aspects of Corporate Governance*, London: Gee.

are greater where shareholdings are concentrated in the hands of a small number of investors, as they are in most Continental European countries.

It is feasible for coalitions of in particular institutional investors to take collective action in the face of poor corporate performance. As noted above,Franks, Mayer and Renneboog record that on average around 5 institutions can command around 30% of shares, enough to be able to force through motions at shareholder meetings. However, these coalitions are infrequent, and institutions in general prefer "exit" to "voice".

There is evidence of more institutional involvement over the last few years, partly in response to pressure from various organizations for institutions to play a more active role. There have been several cases of institutions intervening in the face of poor performance during this decade but the evidence cited in Franks, Mayer and Renneboog suggests that this only comes in response to extremely poor performance. Institutions appear reluctant to intervene unless there is very clear evidence of failure.

MARKET FOR CORPORATE CONTROL

While dispersed ownership creates free rider problems of corporate control, it promotes liquidity, in particular in corporate control. Where a majority of shares of a company are traded on the stock market then it is possible for firms to be subject to takeovers, including hostile bids. In the case of the UK, typically a majority of shares are traded on the stock market within approximately six years of firms coming to the stock market.

The market for corporate control is active in the UK. There are typically around 230 takeovers of publicly listed companies per annum in the UK. The exact number is subject to considerable fluctuation from year to year, and is closely correlated with aggregate share prices. Of these 230 bids are hostile in nature in the sense that they are opposed by the target management.

In theory, takeovers are supposed to discipline poorly performing management. Companies are up for auction to the highest bidder and firms that fail to maximize shareholder value are therefore prone to bids. Good management drives out bad, and the threat of takeovers acts a salutary threat to all management encouraging greater efficiency than would exist in the absence of a market for corporate control.

However the evidence in relation to the UK is that hostile takeovers do not perform this disciplinary function. The targets of hostile bids are not particularly poorly performing firms in the sense that they display significantly worse than average share price or accounting performance. Instead, they appear to be close to averagely performing firms.

While performance of targets of hostile takeovers is not particularly poor, the turnover of management subsequent to a bid going through is extremely high. Within approximately two years of a hostile bid around 90% of the incumbent management of the target firm has been replaced. Even

in unsuccessful hostile bids (in the sense that the bid failed), replacement of target management is high. There are large assets disposals, sales of subsidiaries and break-up of firms. In other words, the market for corporate control appears to be more closely associated with changes in strategies of firms than with corporate governance and the disciplining of bad management.

FINANCIAL FAILURE

This raises a bit of a puzzle. Neither non-executive directors nor institutional investors (the dominant owners of UK corporate equity) appear to perform active governance functions. There is an active market for corporate control but this too does not appear to be associated with the disciplining of bad management. What or who then does discipline bad management?

Franks, Mayer and Renneboog report a high level of new financing associated with poorly performing companies. They have high levels of leverage, low interest coverage and raise substantial amounts of new financing from banks, bond market and stock markets. In particular, the incidence of new equity issues is surprisingly high amongst badly performing firms.

The requirement to raise new finance to be able to continue operations is closely associated with active governance. The provision of new finance is frequently made conditional on changes in management. Financial institutions lay down managerial changes as a requirement for the provision of new finance. The role of underwriters and lead institutions in organizing new finance overcomes the collective action problem. Franks, Mayer and Renneboog note that the requirement that new issues take the form of rights issues, thereby giving existing shareholders the first right to subscribe to new issues, may play an important governance function. In the absence of such a right requirement, management could bribe new investors to subscribe to new issues by underpricing them at the expense of existing shareholders. Rights issues prevent such wealth transfers by giving existing shareholders the first rights to subscribe.

ISSUES RAISED BY CORPORATE GOVERNANCE IN THE UK

The particular features of UK corporate governance raise a number of issues that are pertinent to governance around the world. The first is the question of how the role of non-executive directors can be strengthened. While non-executives may play an important function in assisting and advising management they are not active in disciplining bad management. The more active role of non-executives in the US points to the importance of specifying precisely the fiduciary responsibilities of non-executives to shareholders.

There is also a debate that is emerging about the wider responsibilities of directors to other stakeholders in the firm. The traditional focus of UK corporate law is towards shareholders. However, there is concern that this might have come at the expense of other stakeholders most notably employees and local communities. Consideration is currently being given to extending the remit of director responsibility to include broader stakeholder interests.

Despite repeated exhortations, the role of financial institutions in UK corporate governance remains limited. It is only during periods of financial distress when companies have to seek external financing that the free rider problem of corporate control is overcome. This raises the question of whether it would be possible to identify lead institutions that are supposed to provide more active corporate governance of particular companies. As with syndicated bank finance and domestic banking in many Continental European and Far Eastern economies, financial institutions could be expected to take their turn in acting as a lead institution in monitoring and governing certain firms in return for deriving the benefits of others playing this role elsewhere.

More generally, the problems of UK corporate governance raise questions about the merits of dispersed versus concentrated ownership. Dispersed ownership systems are associated with more transparent and liquid markets than more concentrated ones. There is better protection of minority investors and better functioning of securities markets in providing finance for firms as well secondary trading in securities. However, this may come at the expense of more active corporate governance. What is unclear at present is the balance of advantage between more active governance with concentrated shareholdings and more efficiently functioning securities markets with dispersed shareholdings.

In seeking to expand and internationalize securities markets, there is a natural tendency on the part of regulators to seek to harmonize regulatory standards on those systems which emphasize liquid securities markets. But different types of financial systems may be best suited to different types of corporate activities. While securities markets may be well suited to the financing and control of high tech, speculative investments, more concentrated ownership and the provision of bank finance may be better suited to more traditional manufacturing activities which require active governance by owners and providers of finance. If this is the case then there is no single dominant system and instead of seeking to harmonize on one system, regulators should be encouraging the development of a plurality of systems. This suggests that regulation should be enabling in encouraging the emergence of different types of financial and corporate arrangements rather than being restrictive.