

AN ANALYTIC FRAMEWORK OF CORPORATE GOVERNANCE AND FINANCE

2.1 The Issue of Corporate Governance

The issue of corporate governance arises because of the separation of ownership from control in modern corporations. When salaried managers run companies on behalf of dispersed shareholders, they may not act in shareholders' best interests. This agency or moral hazard problem could exist not just between shareholders and managers, but also between controlling and minority shareholders, between shareholders and creditors and between controlling shareholders and other stakeholders, including suppliers and workers.² A sound corporate governance system should provide effective protection for shareholders and creditors such that they are not denied the return on their investment.

The Asian financial crisis suggests that the issue of corporate governance is important not only for protecting investors' interests, but also for reducing systemic market risks and maintaining financial stability. A sound corporate governance system should therefore also help to create an environment conducive to the efficient and sustainable growth of the corporate sector.

A corporate governance system consists of (i) a set of rules that define the relationships between shareholders, managers, creditors, the government and other stakeholders (i.e., their respective rights and responsibilities) and (ii) a set of mechanisms that help directly or indirectly to enforce these rules. Rules and the effectiveness of mechanisms that enforce them can vary greatly across countries. The variations arise from the interplay of political, economic, legal, cultural, and historical factors. Most discussions on corporate governance and finance have focused on ownership structure, shareholder control and protection,

² Shleifer and Vishny (1997) pose the governance question as one of how investors could ensure that the manager would provide them with ample return and would not expropriate money or use the capital provided to finance poor projects. Prowse (1998) argues that an efficient corporate governance mechanism depends upon the right mix of the competitive environment, the legal protection available to outside financiers, ownership structure and the strength of contractual mechanisms in financial contracts.

creditor monitoring and protection, the market for corporate control and the role of market competition.

2.2 Ownership Structure

Ownership structure is the most important factor in shaping the corporate governance system of any country. In particular, it determines the nature of the agency problem, that is, whether the dominant conflict is between managers and shareholders, or between controlling and minority shareholders. Two key aspects of corporate ownership structure are concentration and composition.

Ownership Concentration. The degree of ownership concentration in a company determines the distribution of power between its managers and shareholders. When ownership is dispersed, shareholder control tends to be weak because of poor shareholder monitoring. The inadequacy of shareholder monitoring is due to the so-called free-rider problem. A small shareholder would not be interested in monitoring because he or she would bear all the monitoring costs, but only share a small proportion of the benefit. If all small shareholders behave in a similar way, no monitoring of managerial efforts would take place. In the United States (US) and the United Kingdom (UK), where corporate ownership is relatively dispersed, the major mechanisms for shielding shareholders from the expropriation by incumbent managers are legal protection and the market for corporate control.

When ownership is concentrated, large shareholders could play an important role in monitoring management. In fact, in Continental Europe and East Asian countries as well as in Latin America and Africa where corporate ownership is concentrated, corporate management is usually in the hands of controlling shareholders. A fundamental problem in corporate governance under concentrated ownership is how to protect minority shareholders from the expropriation by controlling shareholders. Controlling shareholders may act in their own interests at the expense of minority shareholders and other investors. This could take the form of paying themselves special dividends, committing the company into disadvantageous business relationships with other companies they control, and taking on excessively risky projects inasmuch as they share in the upside while the other investors, who might be creditors, bear the cost of failures.

Empirical studies have found an inverted “U-shaped” relationship between the degree of ownership concentration and corporate profitability.³ A possible interpretation of this relationship is that as ownership concentration rises from a very low level, agency costs decrease due to increased shareholder monitoring and hence profitability rises; but when ownership concentration rises to a certain limit, its costs may outweigh its benefits, leading to a fall in profitability.

Ownership Composition. A second key aspect of corporate ownership structure is its composition, namely, who the shareholders are and, more important, who among them belong to the controlling group(s). A shareholder can be an individual, a family or family group, a holding company, a bank, an institutional investor (such as a finance company, an insurance company, an investment company, a pension fund, or a mutual fund), or a non-financial corporation. A family or family group, if it were a significant shareholder, would be more likely interested in control benefits as well as profits. On the other hand, an institutional investor who is a significant shareholder is more likely interested only in profits. A problem associated with banks being significant shareholders of non-financial corporations is that they may become soft in granting loans, terminating bad investment projects and pushing for liquidation. This derives from the conflict of interest that may arise when banks are both owner and creditor.

2.3 Shareholder Control and Protection

When ownership is separated from management, a basic question for shareholders is how they can effectively monitor managers and exercise control so that the managers will act in the shareholders’ best interest. A number of mechanisms exist for shareholder monitoring and control. The most important are the system of the board of directors, shareholder participation through voting during shareholder meetings, performance-related executive compensation, legal protection of shareholder rights, and transparency and disclosure requirements. These mechanisms are mostly embedded in corporate laws and other legislation.

³ See Morck, Shleifer and Vishny (1989).

Boards of Directors and Their Fiduciary Responsibilities.

Boards of directors monitor managers and control companies on behalf of all shareholders. Boards are expected to formulate corporate policy, approve strategic plans, authorize major transactions, declare dividends, and authorize the sale of additional securities. They are also expected to hire, advise, compensate and, if necessary, remove management; arrange for succession; and determine the size of boards and nominate new members, subject to approval by shareholders. The effectiveness of boards of directors in monitoring managers and exercising control on behalf of shareholders depends on a number of factors. A widely held view is that (i) the representation of independent or non-executive directors on boards, (ii) independent board committees for remuneration, nomination and auditing, and (iii) splitting the role of the chief executive officer (CEO) from that of chairman of the board, all improve the protection of shareholders, especially minority shareholders.

Company laws usually specify the fiduciary responsibilities of directors. These legal arrangements help ensure that managers who were hired to run companies and board directors elected by shareholders to oversee managers, will act in the best interest of the companies and shareholders. A fiduciary is someone who has the legal responsibility to care for something held in trust for someone else. Fiduciary arrangements impose the duties of loyalty and care on managers and directors in carrying out their responsibilities. The duty of loyalty requires that managers or directors avoid conflicts of interest and refrain from self-dealing transactions that compromise the interest of corporations and shareholders. The duty of care requires that directors and officers act in good faith and in a manner they reasonably believe to be in the best interest of corporations and shareholders. Treating managers and directors as fiduciaries provides a mechanism for imposing sanctions if they fail to exercise their responsibilities to corporations and shareholders, without necessarily requiring that those responsibilities be spelled out in precise detail in advance.

Executive Compensation. The separation of ownership from control means that the compensation of executives plays a central role in governance. The key problem here is one of aligning the interests of managers and shareholders. The exact form of the optimal incentive package depends on the specific details of the agency problem but often involves performance-related pay and the award of stock options to

managers. Empirical studies of the relationship between this type of contract and corporate performance, however, find little evidence of a strong link between the two.⁴ Resolving the agency problem requires that shareholders or agents acting independently on behalf of the shareholders determine executive remuneration.

Minority Shareholder Rights. A sound corporate governance system requires that shareholders can actively participate in, and exert influence on, corporate strategic decision making. This depends on whether shareholders' legal rights are adequately protected. Basic shareholder rights, mostly specified in company laws, include the right to (i) secure methods of ownership registration; (ii) convey or transfer shares; (iii) obtain relevant information on the company on a regular basis; (iv) participate and vote in annual general meetings (AGMs) and special general meetings (SGMs), including electing members of the board and participating in making decisions concerning fundamental corporate changes such as amendments to the articles of incorporation and extraordinary transactions such as mergers and dissolution; (v) file derivative suits on behalf of the company; (vi) adopt resolutions making recommendations to the board of directors; and (viii) share in the residual profits of the company.

The effectiveness of shareholder participation through voting in the AGMs and the SGMs also depends on the voting procedures, including notification of the dates and agenda of the AGMs and the SGMs and voting and counting methods. An important rule relating to the voting method is "proxy voting" whereby shareholders not in attendance may nevertheless exercise voting rights. Proxy voting improves shareholder participation. Allowing cumulative voting⁵ strengthens the position of minority shareholders under concentrated ownership structures. An important principle for voting rights is the equal treatment of all shareholders of the same class. A key consideration concerning these requirements and rules is whether or not they tilt the

⁴ Jensen and Murphy (1990) find that in the US, managers' remuneration changes by about \$3 for every \$1,000 change in the value of the firms they manage. The authors argue that this is a low level of incentive-based remuneration. However, even at this level, it represents a high proportion of executive compensation and of executives' wealth. Higher levels of incentive-based remuneration would require executives to have significant risk tolerance.

⁵ Shareholders may cumulate their votes, for instance, for directors, by multiplying the number of votes the shareholders are entitled to cast by the number of directors for whom they are entitled to vote and casting the product for a single candidate or by distributing the product among two or more candidates.

balance of power towards incumbent management and controlling shareholders and against outsiders and minority shareholders.

Transparency and Information Disclosure. Transparency and information disclosure are keys to effective shareholder control and protection. Information about a company usually includes financial results of the company, major share ownership, who the members of the board of directors and key executives are and their remuneration, foreseeable major risk factors, governance structures, and company objectives and policies. The quality of transparency and disclosure depends crucially on accounting and auditing standards and the financial reporting system. The adoption of internationally acceptable accounting standards will certainly improve the quality of transparency. Independence of auditing is the key to ensuring that the information disseminated is reliable and credible. Good financial reporting systems facilitate easy access to reliable and credible information by shareholders and other investors.

2.4 **Creditor Monitoring, Disciplining and Protection**

Creditor Monitoring and Disciplining. Creditors have some control rights in companies and hence are also important players in corporate governance. Creditors can influence major decisions of companies and, through a variety of controls, discipline companies that default on debt payments or violate debt covenants. The very fact that creditors provide short term loans and borrowers have to come back to them at regular intervals for more funds also gives creditors significant influences. The effectiveness of creditors' influence depends on how well they are protected legally. It also depends on their own corporate governance structures.

There are two principal forms of debt: bank debt and market debt (i.e., corporate bonds). Bank debt typically takes the form of a bilateral relationship between a borrower and a lender, although this may be undertaken on a syndicated basis. Corporate bonds are fixed income-lending agreements between an issuing company and dispersed bondholders. Borrowers from banks and issuers of corporate bonds have certain contractual obligations, such as promising to make a pre-specified stream of future payments to lenders. However, creditors can also influence corporate decision-making in solvent states. They can

impose sanctions over investment policies of a company, including mergers and acquisitions and spin-offs, and impose restrictions on the overall level of borrowing of the company and, if the company is close to insolvency, on dividend payments and other company decisions that may damage their security.

If a borrowing firm violates any covenant and, in particular, defaults on a payment, the lender has certain contingent rights, including repossessing some of the firm's assets (collateral). The lender also has the opportunity to put the firm into bankruptcy. This threat may prevent managers from investing in poor projects, or force them to sell assets that are worth more in alternative uses. On the other hand, debt as a disciplining device has its costs. Companies may be prevented from undertaking good projects because debt covenants prevent them from raising additional funds; or they may be forced by creditors to liquidate even when it is not efficient to do so.

The effectiveness of debt as a mechanism of corporate governance depends on the quality of monitoring, on how difficult it is to renegotiate in default states and on the extent to which creditors' rights are enforceable in the courts. The creditors' own corporate governance structures, including regulations and supervision of lending institutions, determine to a large extent the quality of their monitoring. Bank regulations and supervision involve (i) setting minimum entry requirements to guarantee that only suitable institutions and qualified managers operate in the market, (ii) imposing quantitative restrictions on bank operations to promote sound banking practices, and (iii) inspecting banks' loan books. Quantitative restrictions include risk-adjusted capital adequacy ratios, portfolio concentration limits by sector and type of borrowers, limits on lending to insiders and other connected parties, and limits on exposures to different risks with respect to liquidity, maturity and foreign exchanges.

Banks usually have much larger stakes in companies than dispersed individual bondholders and hence have stronger incentives to monitor corporate activities. But bank debts reflect bilateral relationships and, when borrowers default, renegotiations may be relatively easier, especially if banks are at the same time equity-holders of or owned by borrowing companies. On the other hand, renegotiating with dispersed bondholders may be difficult in default states and borrowers might be forced into bankruptcy. It has been suggested that the difficulty of renegotiations, and the power of dispersed creditors, might explain why market debt is an uncommon financing instrument. Market debt is used

mostly in developed countries, such as the US, that have a strong investment banking ethos and well developed securities laws, and even there market debt is much less common than bank debt.

The quality of creditor monitoring and effectiveness of creditor disciplining also depend on the nature of the relationship between creditors and borrowers. In some countries, creditors, including banks and non-bank financial institutions, and non-financial corporations are often interlocked through ownership arrangements. These can take the form of either financial institutions owning non-financial companies, or non-financial companies owning banks and non-bank financial institutions. An example of the latter occurs when a commercial or merchant bank is an affiliate of a conglomerate or business group. The interlocking ownership relationship between creditors and borrowers could compromise the role of creditors as external agents in monitoring and disciplining borrowers, especially when bank and financial regulations and supervision are weak.

Insolvency Procedures. Bankruptcy, or formal insolvency, provides a means by which creditors can settle their claims against an insolvent company in an orderly manner. Formal insolvency procedures provide an efficient mechanism for solving creditors' co-ordination problem and allow dispersed creditors to save on direct and indirect costs of a race to grab assets when a company defaults.⁶ Without such a mechanism, the cost of recovering debt by creditors acting on their own would reduce the value of their claims substantially and deter them from taking action. Formal insolvency procedures therefore provide effective protection for creditors.

Bankruptcy is likewise important as it provides a forum for debt restructuring and an opportunity for an insolvent company to be reorganized. There are cases where the immediate liquidation of an insolvent company is an inefficient response to insolvency, but which may nevertheless occur in the absence of formal procedures. Giving the insolvent company a reprieve to continue operations and to be free from efforts of creditors to enforce their claims may solve this premature liquidation problem.

The laws governing corporate insolvency are usually contained in bankruptcy laws or company laws. These laws set rules relating to (i) the initiation of bankruptcy, (ii) the timing of bankruptcy, (iii) the manage-

⁶ See Baird and Jackson (1985).

ment of insolvent companies during bankruptcy, (iv) who decides initially whether the companies should be reorganized or liquidated, (v) the priority of different classes of claims, (vi) reorganization plans and mechanisms for their approval, and (vii) the protection of insolvent companies during reorganization.

These rules differ substantially across countries. An important issue is whether the rules favour debtors or creditors. The US bankruptcy law is sometimes perceived as favouring debtors. It has two principal provisions: Chapter 7, which deals with liquidations and, Chapter 11, which deals with the reorganization of insolvent firms. Chapter 11 gives a distressed company and its management protection from creditors while a reorganization plan is being drawn up. It has been argued that Chapter 11 creates incentives for management to seek debtor-in-possession protection from creditors. Because it ostensibly protects managers from the full consequences of their poor decisions, Chapter 11 makes poor decisions more likely. In contrast, bankruptcy laws in France, Germany and the UK have often been viewed as being creditor orientated. Although there are procedures for reorganization in the bankruptcy laws of the three countries, in no procedure does the management retain control of a distressed company. In the event of insolvency, the receiver or administrator becomes the manager of the company. There is no mechanism for debtor-in-possession restructuring. This has led some scholars to argue that the UK system is biased towards premature and inefficient liquidation.⁷ However, since the mid-1980s, the focus of bankruptcy laws in these countries has also been shifting away from exclusively protecting creditors' interests and toward a balance between protecting creditors and saving distressed firms.

2.5 The Market for Corporate Control

Many economists believe that the market for corporate control is also a key ingredient of corporate governance. The central mechanisms for the transfer of corporate control are mergers and takeovers. Takeovers are much more common in the US and the UK, where ownership is dispersed, than in Continental Europe and East Asia where ownership

⁷ See Aghion, Hart and Moore (1992).

is more concentrated. The market for corporate control disciplines managers with the threat of losing control.⁸

This line of reasoning is, however, not without controversy. First, free-riding strategies on the part of shareholders in companies with dispersed share ownership could prevent successful bids. It is argued that shareholders of a target company, believing their own actions have a trivially small effect on the probability of success of a particular bid, would have an incentive to decline the offer. They would accept the offer only when the value of the bid fully reflects the value of the increased profitability that the acquiring company creates. This would leave no incentive for the acquiring company to make a hostile bid in the first place.⁹ Second, even with concentrated ownership, information asymmetry may render the takeover mechanism ineffective. The insiders, or managers, are likely to know more about the performance of the company. Thus, when controlling shareholders in the target company are willing to sell their shares, it indicates that the acquiring company has paid too much; if they refuse to sell, it indicates that the acquiring company has paid too little. A takeover will only be successful when the company taking over pays too much.¹⁰ Third, incumbent managers are often well placed to take strategic actions that deter takeovers, including committing companies to long-term contracts with severe penalties for breach, and employing devices such as “golden parachutes”,¹¹ “poison pills”,¹² and changing the corporate charter to make takeovers more costly.

These considerations would suggest that takeovers are unlikely to take place in practice. However, available evidence tells a different story: takeovers do take place and, moreover, in waves. It is now generally agreed that takeovers also occur for reasons that are unrelated to the disciplining function of the market for corporate control. These include

⁸ See Jensen and Ruback (1983), Burkart (1997) and Burhart, Gromb and Panunzi (1998) for discussions of the market for corporate control and takeover regulations.

⁹ See Grossman and Hart (1986).

¹⁰ See Stiglitz (1985).

¹¹ Golden parachutes are arrangements between a company and its managers that give the managers the right to seek substantial compensation when their contracts are terminated before expiration.

¹² Poison pills are defense tactics that corporate managers sometime use to fight hostile takeover bids. In particular cases, existing shareholders are issued rights which, if there is a significant purchase of shares by a bidder, can be used to purchase the company's common stocks at a bargain price, usually half the market price. In the case of a merger, the rights can be used to buy shares of the acquiring firm. Such tactics can make the shares of a target company worth less or dilute the control of an acquiring firm in the target company after a takeover and therefore make the takeover less attractive.

the pursuit of monopoly power, empire building, tax motives, and certain defensive and strategic considerations. There is a significant body of evidence suggesting that while takeovers may serve to discipline the management of targeted companies, they themselves could be major instances of the failure by acquiring companies' management to act in the best interest of their shareholders.

Legal arrangements for takeovers are usually found in company laws or takeover codes. The basic objective of these arrangements is to ensure that the market for corporate control functions in a fair and transparent manner so that shareholders have ultimate influence over strategic corporate decisions and the rights of all shareholders are protected. Hostile takeover is the major form of gaining control of a company without the approval of controlling management. Laws governing takeovers usually contain rules and procedures for disclosing information relating to an acquirer's shareholding in a target company and the takeover plan, and the timing of information disclosure. The laws may also include restrictions on certain types of takeover defence devices including "greenmail"¹³ and "poison pills". In addition, the stock exchange may set rules to ensure the protection of shareholder rights and the liquidity of the market. For example, in the UK Takeover Code, there is a compulsory bid rule whereby an investor who acquires 30 percent of the shares of a company must bid for the remaining shares.

2.6 Securities Market Regulations

Because of severe information and incentive problems, securities markets need to be regulated. The basic objective of the regulations is to instil public confidence in the reliability and accuracy of information reported by companies, in order to protect investors' interest, maintain order in the markets, and promote market efficiency. Securities market regulations usually cover (i) requirements for registration of companies and of securities offered or sold to the public, (ii) requirements for timely and accurate reporting and disclosure of financial information, (iii) restrictions on securities trading by certain groups of people (such

¹³ Greenmail is a targeted repurchase, an offer by the incumbent management to repurchase the shares of a subset of shareholders at a premium. The purpose is to prevent these shareholders, usually potential raiders, from taking over the company. Such offers are not made to other shareholders.

as “insiders”, i.e., controlling shareholders and managers), (iv) prohibitions against certain types of trading activities and behaviour such as “fraud or deceit” or “manipulative or deceptive devices or contrivances”, (v) rules of stock exchanges and membership requirements of associations of securities dealers and, in some countries, (vi) restrictions on levels of shareholdings by financial institutions in non-financial corporations. These regulations are mostly specified in securities acts and listing rules of the stock exchanges.

The mechanisms for implementing regulations can vary. The complex structure of incentive and informational problems that exist between regulators and the regulated means that there are great costs of enforcing compliance with regulations. Increasingly, therefore, regulators try to shift regulations back to the regulated organizations. This has led to the increased use of mechanisms of self-regulation or governance structures, which, if effective, comply with regulatory objectives. Of course, the incentives to comply depend upon the costs and benefits of doing so.

2.7 Market Competition

Market competition puts pressure on managers to act in an efficient manner, as otherwise they will be forced out of business. It therefore provides a mechanism to tackle the agency problem and to provide protection for shareholders and creditors.¹⁴ In fact, in a perfectly competitive world, market discipline could be a sufficient guarantee that managers act in investors’ interests. However, firms generally do not operate in a perfectly competitive world. Product markets may be concentrated and firms may enjoy monopoly power, exploit consumers and engage in rent seeking activities. Pervasive informational problems may prevent market forces from functioning efficiently in monitoring corporate performance and in allocating and overseeing the use of finances. Market imperfection could also be a result of “government failure”. In

¹⁴ Berglof (1997) argues that while competition in factor and product markets will to some extent mitigate the agency problem, it is in itself insufficient because market signals are generated after funds have been committed. The role of corporate governance is to ensure that these signals and other relevant information are actually translated into investment decisions: for example, by replacing management following poor performance or by closing down unprofitable units. Competition and corporate governance are seen to be substitutes with strong corporate governance being more important when competition is weak.

many emerging markets, government interventions such as directed credits, implicit and explicit guarantees, and state ownership seriously distort incentive structures and weaken market discipline. In such settings, measures that promote market competition can strengthen governance of the corporate and financial sectors.

2.8 Corporate Finance

Theory suggests that corporate financing decisions are influenced by considerations of cost, risk, and control. The nature and extent of the agency problem also affect corporate financing behavior.

Cost Considerations. Other things being equal, a firm will choose financial instruments with the lowest possible cost. Cost differences among financial instruments can be due to taxation. For instance, interest paid on debt is deductible from income and reduces a firm's tax liabilities; therefore, debt has a tax advantage over equity. The differences can also be due to asymmetric information between corporate insiders and outsider investors. If managers or corporate insiders have private information about the characteristics of a firm's return stream or investment opportunities that are not available to outside investors, they may find that external financing is more expensive than internal financing as outside investors will demand a risk premium. This is the basis of the "pecking order" theory of financing, which predicts that capital structure will be driven by firms' desire to finance new investments, first internally, then with low-risk debt, and finally with equity only as a last resort.

The cost differences can also be caused by market segmentation, with different sets of investors measuring risk differently or simply charging different rates on the capital that they invest. By choosing instruments that tap the cheapest market, firms lower their cost of capital. Government policies and regulations and information problems can cause market segmentation. Many believe that domestic capital markets are segmented from international capital markets, so that by issuing financial instruments abroad firms gain an advantage over their purely domestic competitors. Domestic markets too can be segmented, for instance, by tax policies that exempt some investors from certain taxes, thereby driving wedges among the after-tax costs of various financial instruments.

Risk and Financial Instruments. Considerations about risk associated with alternative financial instruments also affect the financing decisions of a firm. As a firm piles on more and more debt, its ability to meet fixed interest payments out of current earnings diminishes. This increases the probability of bankruptcy and, as a result, the cost (or risk premium) of both debt and equity. Firms that adjust their capital structures so as to keep the risk factor of their debt and equity reasonable may be able to pay lower cost for extra fund they raise.

Control and Dilution. For some firms, a single and often overriding factor is control. In most firms, whoever controls the equity controls the firm and is recipient of all its attendant perquisites. In the emerging markets where the tradition of family ownership is especially strong, control can dominate the financing decisions of firms, forcing them to defer public issues of equity that would dilute control. The control theory is based on the notion that it is very difficult and expensive to write, verify, and enforce complete contracts. In the absence of complete contracts, the allocation of control over the deployment of assets matters.

Agency Cost. A related but slightly different factor that affects corporate financing is the agency problem, namely, conflicts of interest between equity- and debt-holders and between managers and shareholders. The debt contract provides that if an investment gets returns well above the face value of the debt, equity-holders capture most of the gain. If, however, the investment fails, because of limited liability, debt-holders bear the consequence. As a result, equity-holders may benefit from investing in very risky projects by borrowing. The conflict between shareholders and managers may lead to managers investing less effort in managing firm resources or transferring firm resources to their own outfits. Increasing the proportion of managerial equity ownership could reduce this inefficiency. Holding constant the managers' absolute investment in a firm, an increase in the fraction of the firm financed by debt increases the managers' share of the equity and could mitigate the loss from the conflicts between managers and shareholders. Moreover, as debt commits the firm to pay out cash, it reduces the amount of "free" cash available to the managers to engage in the type of pursuits that waste the firm's resources.¹⁵ This mitigation of the conflicts

¹⁵ See Jensen (1986).

between managers and equity-holders constitutes the benefit of debt financing.

2.9 Two Models of Corporate Governance and Finance

The financial systems of the US and the UK are based on the so-called “arm’s length” model that promotes dispersed ownership of debt and equity and liquid financial markets.¹⁶ The basic agency problem is usually seen to be between management and investors. Corporate governance is exercised by portfolio investors through the enforcement of shareholder and creditor rights and through the market for corporate control. The “arm’s length” based financial system relies heavily on the courts to enforce shareholder rights over assets and cash flows.

On the other hand, the relationship model, common in Continental Europe and East Asia, emphasizes long-term relationships between firms and investors. In contrast to the “arms length” system, this model places greater emphasis upon enforcement through the trust embodied in the relationship itself and internal controls. Countries fitting this model typically have more concentrated ownership and less liquid financial markets and emphasize the importance of control-oriented block holders. Corporate governance is exercised by block-holders, with the predominant conflict being between controlling block-holders and minority shareholders. Of course, this agency problem will differ depending upon whether the controlling block-holder is a family or an independent financial institution. In this type of system, minority shareholder rights tend to be weak, as does the role of independent board directors. The market for corporate control plays virtually no role.

High ownership concentration and severe information asymmetries manifesting themselves in illiquid and opaque financial markets, combined with government interventions in financial markets through subsidized lending and loan guarantees and poor legal infrastructure, explain the predominance of relationship finance. However, the causality runs both ways. Relationship finance does not promote the development of liquid financial markets and may foster government involvement in allocating capital. Thus in economies with relationship finance, banks are in the best position to monitor company performance, and therefore the most logical source of external finance. This

¹⁶ See Zingales and Rajan (1998).

can take the form of debt or equity holdings with significant control rights. Equity issues to the public will be expensive, reflecting high issue costs, significant information disadvantages and lack of effective rights. While small shareholders recognize that their interests and those of the banks do not coincide, they know that creditors' concerns afford them some degree of safety for their investment. Such assurance, along with a minimum of legal protection, can induce small shareholders to invest in companies.

The effectiveness of the relationship model depends on the extent of creditor rights and the ability of lending institutions to enforce the terms of loan agreements and to take action in the event of defaults. These in turn depend upon the incentives and governance of the banks and non-bank financial institutions and the effectiveness of bankruptcy procedures.