TOWARDS A GLOBAL CORPORATE GOVERNANCE MODEL

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ABSTRACT

In 1776 Adam Smith wrote "Given the role of self-interest in human affairs, the proposition that a faceless and uncoordinated group of outside investors could be brought to entrust their savings to professional corporate managers – people whose interests were almost sure to diverge from their own – was doubtful at best.[1]

What Smith failed to foresee was the development of effective corporate governance systems. The emergence of effective corporate governance systems has required the evolution of corporate procedures and financial institutions, which can work together within a legal framework to assure investors that professional managers, will make efficient use of their capital.

Today, corporate governance is a global issue. More investors are buying shares in companies outside their home market. US holdings of U.K. equity and debt, as of December 31, 2004 amounted to $738 billion. The U.K. holdings of US equity and debt as of June 30, 2004, totaled $488 billion.[2]

Stock exchanges in both the US and the U.K. attract high numbers of international companies.

INTRODUCTION

Governance Systems

It is common today to distinguish between two types of corporate governance systems. In shareholder systems, shareholders are the dominant interest groups exercising influence on management, and the major goal pursued by companies is the maximization of shareholders value, that is, of the financial value of the firm. The U.S.A. and U.K. are the best-known examples of shareholder systems. In stakeholder system, in contrast, power is shared between shareholders and other groups with an interest in the firm, particularly employees. Reflecting the diverse interests of these different groups, increasing the value of the firm may be only one of a number of key goals pursued by firms in these types of systems. Germany and Japan are examples of stakeholder systems.

In shareholder systems, power is concentrated in the hands of shareholders, while other groups have little or no influence. Shareholder systems are "outsider" systems, in which market mechanisms play a

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[1] Smith, Adam "Wealth of Nations", 1776.

[2] Federal Reserve Bank of New York, "Report on U.S. Portfolio Holdings of Foreign Securities as of December 31, 2004" December 2005.

much stronger role in governance, and owners exert influence on management through the threat of "exit" (selling the shares). Stakeholder systems are "insider" systems, in which interested groups are closely tied to the firm and exercise influence through institutional mechanisms for expressing "voice" within the firm.

Owners in insider system frequently hold large blocks of shares, often majority or controlling interests. Owner in outsider systems in contrast, tend to hold much smaller percentage of shares, lending to a highly dispersed system of ownership.

This heterogeneity in the distribution of influence is reflected in differences in company practices between corporate governance systems. The dominant goal of companies in shareholder systems is to maximize the shareholders value. Correspondingly, firms in stakeholder systems are concerned with a broader mix of strategic goals. Although, profitability is a consideration in stakeholder systems, it will not be maximized if it conflicts with the interests of key stakeholders.

The shareholders (or outsider) model, which is predominant in the U.S.A. and U.K., is institutionally a much simpler construct. Ownership is dominated by institutional investors, such as mutual funds, pension funds and insurance companies, who are generally reluctant to hold ownership stakes of more than one or two percent, and who, in principle, don't wish to be represented on company boards. Other stakeholders such as employees generally don't enjoy voice in the company through formal representation. The U.S.A. and U.K. have a single board system, and this board has been dominated (at least in the U.S.A.) by a single strong chief executive officer who also holds the role of the board's chairman.

In practice Germany has become one of the most prominent national examples of an insider or stakeholder system of corporate governance.

The role of large private banks has received special attention in the system of ownership in Germany. In contrast with banks in other countries, such as the U.S.A., German banks are allowed to hold large blocks of shares in individual companies on their own account. Furthermore, to a much greater extent than in the U.S.A. or U.K., individuals purchase their shares through banks and leave these shares on deposit with the banks. Banks have been able to exercise votes on the shares of these small, largely passive individual investors through a system of proxy voting.

Employees are a second key stakeholder group in the German model. Employees enjoy particularly strong rights of representation within the firm through the institution of the work council. In large companies up to half of supervisory board members are employee representatives. The influence of employees as stakeholders has remained stable, and in some respects, even been strengthened by the reform of the Works Constitution Act.

While the latest developments in Germany will indicate a change in the role of banks as well as the integration of institutional investors in the augmented stakeholder coalition, the practice of shareholder value in Germany differs in two important ways from the Anglo-American variant of shareholder value. First, the introduction of shareholder value concepts must be negotiated with other members of the coalition. The German variant can be characterized as a negotiated shareholder value model.

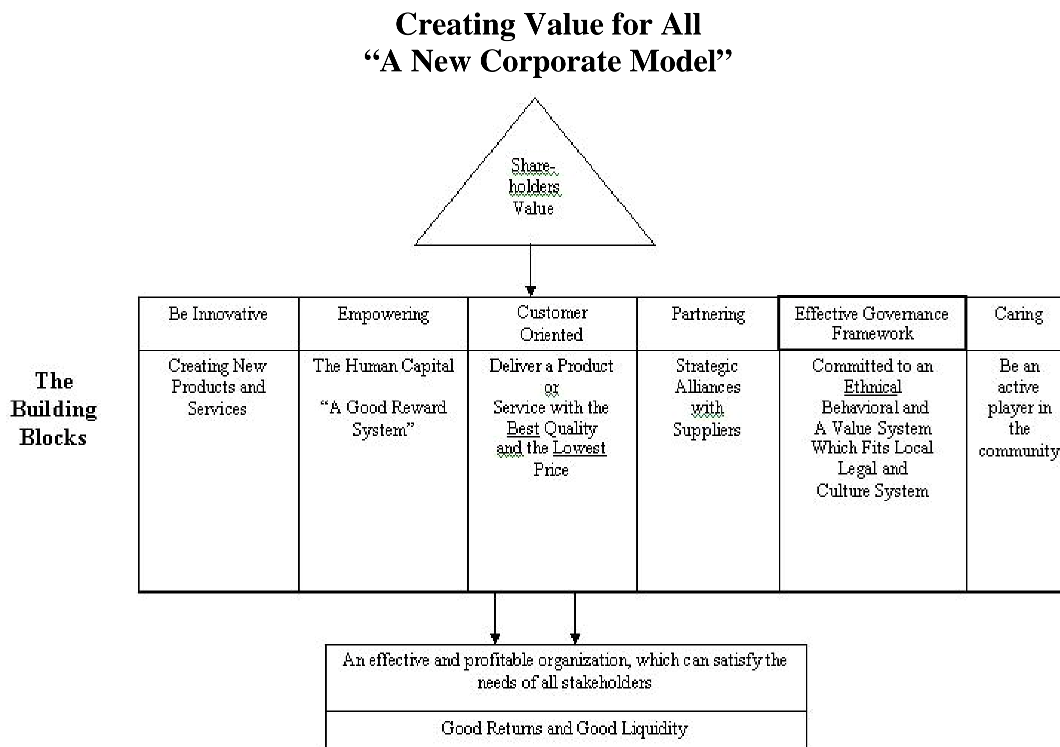
Convergence vs. Divergence

The dichotomous nature of shareholder-stakeholder typology is forcing people to decide between "convergence" and "divergence" (convergence to one shareholder model versus continuing distinctiveness). Convergence advocates argue that the changes currently taking place in global markets and the increase in the size of foreign investments across boarders will push for the change. The internationally active investors, who increasingly have the capacity to cut off funding to companies that do not fulfill their demands for shareholder value is the driving force behind change.

The Authors however, argue that the varieties of capitalism paradigm among the different nations will result in only incremental changes in those economies known as coordinated market economy (Germany for example).

One fairly rapid and universal change, which may help with convergence, is the introduction of the international accounting standards in the EU countries. Transparency in financial reporting will enable institutional investors to compare investment opportunities in different countries as many companies adopting shareholder value as one of their main corporate goals. The Authors believe that while, it is almost impossible to find a one single approach to corporate governance, it is important and easier to develop a model for corporate governance which allies the interests of all stakeholders and creates value for all. The Model is presented in the following graph.

Creating Value for All
"A New Corporate Model"



The model that will take into consideration the interests of all the stakeholders with the emphasis on shareholder value. The new model can be adopted by any company in any country. The main challenge is how to balance the interest of all groups who in many situations will not share a common interest. However, as institutional investors start to play a major role in the financial global market, the concept of shareholder value will always prevail even in the stakeholders systems.

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