Convergence goes both ways

An alternative perspective on the convergence of corporate governance systems[1]

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Abstract

The possible convergence of international systems of corporate governance has become the topic of a lively debate. In opposition to the political theory (Roe 1991, 1994), Gilson (2000) and Coffee (1999) have persuasively argued that although little formal convergence may be taking place in ownership and board structure, corporate behaviour seems to be converging in a functional sense. This paper reviews Coffees argument and some of the ensuing debate emphasising internationalisation of equity markets as the powerful driving force behind convergence. But while the debate has focused rather narrowly on convergence of European governance to American standards, I argue that US corporate governance has also converged to European standards: insider ownership and managerial incentives have increased; outside board members, independent subcommittees and chairmen have become more common and the banking system has been deregulated to allow banks to play a more active governance role.

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1. Introduction

While convergence of corporate governance systems has been discussed for some time, the discussion accelerated recently with Ronald Gilson´s thought-proving *paper "Globalising Corporate Governance: Convergence of Form or Function*" (Gilson 2000) and John Coffee's follow up: *"The future as history: The prospect for global convergence in corporate governance and its implications"* (Coffee 1999).

Gilson (1999) makes the important distinction between formal and functional convergence.

Companies within a particular institutional framework may change their behaviour in order to succeed or survive in international competition even though the formal structure is unchanged. Coffee (1999) argues that a number of forces pull and push towards convergence: the growth of European stock markets, disclosure harmonisation, the appearance of institutional investors, harmonisation of international accounting standards, migration to foreign markets and the need for global scale. He emphasises foreign listings in the US as a migration from European to US governance. But at the same time, he argues, the forces of inertia are very strong: rent seeking by incumbent interest groups, reluctance of controlling shareholders to give up their control premia by selling out, historical path dependencies, and complementarities between various elements of each systems which make it difficult to change one element without also changing a number of others. In other words strong forces for convergence meet with strong forces for resistance and inertia. The outcome of this dilemma, Coffee argues, is that formal governance structures change very little, but that a functional convergence in corporate governance takes place as European companies change their standards and behaviour to American standards.

2. Factors driving convergence

In economics, it is commonplace to explain changes in economic behaviour by changing relative prices (Becker 1976). Accordingly, if there is a worldwide change in corporate governance it seems relevant and necessary to look first to changing relative prices as a possible cause. And the price measure that naturally comes to mind is the price of shares relative to the price of other financial and non-financial assets.

As is generally appreciated, share prices surged during the 1990s (see www.stockcharts.com for a 100-year graph of the American Dow Jones Index). After trebling in the 1980s, the Dow -Jones index trebled again in 1990s. Such increases cannot be taken for granted. The increase during the 80s and 90s clearly represent a change of regime from the 60s and 70s where the index hardly rose at all. Furthermore, Dow Jones mainly includes so-called old economy stocks. An even more explosive development has taken place among the high tech stocks listed on NASDAQ (se www.stockcharts.com for a 22-year graph on the NASDAQ index). And the surge in new-economy high tech shares began in the 1990s.

Although the prices of real assets have also increased over the same period (due to inflation) as have bond prices (due to falling interest rates), there is little doubt that stock prices have increased by a different order of magnitude. The net result is a dramatic shift in relative prices. The behavioural consequences of this shift have been significant. Altogether increasing stock prices mean increasing incentives to cater to the stock market in order to share in this value creation: new listings, stock issues, financial instruments and services as well as new forms of organisation and management. Major changes like these are large enough to move the world economy and the ways in which companies do business, including corporate governance.

To be sure, stock price surges do not come out of no-where. One can speculate whether policy changes, new technology or other factors caused the boom 1980-2000 – and even whether changes in corporate governance and management have something to do with it. But for the present paper it is sufficient to note that a really large shift in relative prices appears to have taken place over the period. To the extent that the increase in US stock prices was paralleled by a similar development in other countries, the business world was influenced in the same direction all over the world. And in some sense this may have induced the business world to move towards similar corporate governance structures (a kind of convergence, although somewhat different from what has been envisioned in recent research).

International stock returns

Share prices have increased all over the world but there is some evidence that over a long period of time they have increased more in the market-based Anglo-American corporate governance systems where the stock markets are highly developed compared to other parts of the world.

A study by Jorion and Goetzman (2000) compares stock market returns on stock exchanges all over the world since 1921. Their figures show that the American and British exchanges

(New York and London) have outperformed the global index and (in particular) representative German and French stock exchanges which have underperformed relative to the global index. For example, over the period 1970-1996 investment in the US and UK indices achieved average returns of 6.15 pct. per year and 6.34 pct. per year respectively compared to global index returns of 5.93 pct. per year. In contrast, investors in the French and German indices obtained average returns of 5.5 and 4.5 pct. Respectively over the same period. It is also notable that returns to the global index appear to have been much higher from 1970 to 1996 than over the entire 1921-1996 period – another indication of the unusual global surge in stock prices 1980-2000.

Laporta et al. (1999) compare stock valuations in 1997 by estimating Q-values (the average market value of the listed companies relative to the value of their assets at replacement cost). These figures show the same tendency – stocks are prices higher in the US/UK (Q-values of 1.39 and 1.52 respectively) than the global average (Q=1.15). And they are also higher than in France (1.09) or Germany (1.23).

Differences like these are sufficient to stimulate different kinds of arbitrage. High US/UK share prices induce US/UK investors to diversify their portfolios by investing in cheaper international shares with more potential. Foreign companies feel attracted to list their shares on the US/UK exchanges. And in order to attract international capital companies have an incentive to change their corporate governance even though they decide not to list. The increasing international popularity of concepts like “shareholder value” provides a striking example.

International investment

There is also evidence that investors have internationalised their equity portfolio.

Evidence as to the importance of international capital flows was reported in a study commissioned by the Oslo Stock Exchange on international ownership of shares listed on European stock exchanges. The study showed that in 1997 foreign investors owned 31-32% of the shares listed in the Helsinki, Oslo and Stockholm stock exchanges, 22 % of the Paris market and 12% of the shares listed on the German stock exchanges. In other words, international ownership is substantial and was furthermore found to increase over the period 1994-1997.

Christop van der Elst (2000) reports the same trend in a cross-country study of listed companies. According to his data international share ownership as a percent of total ownership has increased considerably in the large European countries over the period 1990 to 1998. In rough figures international ownership increased from 12 to 15% in Germany, from 14 to 35% in France, from 8 to 12% in Italy, from 16 to 36% in Spain, from 12 to 24% in the UK. Similarly, international ownership increased rapidly from 4 to 13% in Japan, but only marginally in the US from 7 to 7%+.

Changes like these imply increasing pressure from international investors for companies to reform their corporate governance practices to fit international, particularly US/UK standards. Admittedly, international investors seldom hold controlling positions, but as highly mobile marginal investors they account for a much larger share of the stocks traded and exert an even larger influence on share prices.

3. Convergence to US – and European - Standards

It is easy to understand why the lure of high stock prices, particularly in London and New York, has induced companies (and occasionally even legislators) in continental Europe to reform their corporate governance. And there is substantial anecdotal evidence that some convergence to American standards has in fact taken place. The increasing emphasis on shareholder value. The growing popularity of stock options. Stricter rules regulating insider trading, tender offers and accounting standards (as emphasised by Coffee 1999). An increasing number of foreign listings on US/UK exchanges (also emphasised by Coffee). The rise of the markets for corporate control, including hostile take-overs.

It is tempting therefore to think of convergence as convergence of European governance to US standards. But this is only part of the picture. Corporate Governance in the US and UK has hardly stood still over the past 20 years. In fact, Anglo-American corporate governance has been revolutionised over this period, and many of the changes have moved the system(s) towards European standards. In other words, there has also been a convergence of US/UK corporate governance to European standards.

First, the separation of ownership and control has increasingly been overcome by giving ownership and profit incentives to officers and director of the corporations, directly through stock ownership and since 1980 through an explosive growth in the use of stock options. For example, US ownership structures have become more concentrated, and the fraction of insider ownership has increased substantially. A study by Holderness et al. (1999) found that managerial ownership (stockholdings of officers and directors) amounted to 12.2% of total equity in 1995 for NYSE companies and 21.1% for all American exchanges. This is up from 8.6% (NYSE) and 12.9% (all exchanges) in 1935 . Murphy (1999) documents the increasing use of stock options, which is a more modern phenomenon. Furthermore, the increasing importance of institutional investors means that ownership among outside owners has also become more concentrated. In effect this development means that US share ownership has "converged" in the direction of European ownership structures where insider ownership and large blockholders are much more prevalent (Pedersen and Thomsen 1997). This change has both taken place among the large old economy firms, but in addition insider ownership has become more important because of the increasing market values of small, new economy firms (many of which have only floated a relatively small fraction of their shares).

Secondly, US and UK board structures have changed in the direction of European style two-tier boards in which the functions of decision management and decision control are separated. The use of subcommittees composed of outsiders (non-managers) for remuneration, auditing, nomination and other issues introduces elements of a two-tier system. And so does the increasing separation of the positions as chairman of the board and chief executive officer / managerial director.

Thirdly, US banking has been deregulated. The Glass Steagal Act and the Bank Holding Company Act has been abolished in recent years, and over the long term this is likely to enable American banks to play a more active role in investment banking and corporate governance in line with the German system. First, the banks will be allowed to grow larger which will enable them to take larger positions in individual firms without incurring excessive lending risk. Secondly, the large-scale economies in commercial banking may give universal banks (which are active in both investment and commercial banking) greater financial strength. While there are signs that the large German banks aim to reduce their shareholdings in the largest German firms (convergence to US standards), US banking deregulation seems to imply at least some convergence to European standards.

As these examples show, convergence is not a one-way process. In addition to European convergence to US/UK standards, US corporate governance has also converged to European standards.

4. Discussion

This paper has addressed the discussion on convergence of corporate governance systems.

The findings yield some support for the proposition that UK/US and continental European corporate governance is converging: there are strong forces towards convergence, and there is evidence that some kind of convergence is in fact taking place. However, the paper has also argued that current research on convergence needs to be supplemented in several important respects.

First, the forces driving convergence need to be reassessed. Relative share prices provide an obvious, direct explanation of convergence in corporate governance. Coffee (1999) emphasises the role of foreign listings on NYSE where the number of listed foreign companies rose from 119 in 1992 to 361 in 1998. To be sure the increase has continued, but at a modest pace – to 390 in 2000 (according to the NYSE home page). Trends like these may be important beyond mere numbers, but in all fairness they are not going to change the world. In contrast surging stock prices, differences in stock returns/valuation, and rapid internationalisation in the world's most important financial marketplaces provide a powerful impetus for change.

Secondly, the nature of the convergence process needs to be reassessed. There is evidence of a two-way convergence both from European to US/UK standards and from US/UK to European standards.

Thirdly, much of the observed convergence appears to be a results of different corporate governance systems reacting to the same set of international challenges: High stock prices, technological change, capital market internationalisation, the growing importance of institutional investors. Both US/UK and European corporate systems are changing to meet these challenges in an efficient way which leads to convergence in the sense that governance systems come to resemble each other more over time.

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