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# Financial Sector Convergence and Corporate Governance

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## Introduction

- It is postulated that convergence of financial systems on a hybrid model will drive convergence of corporate governance systems.
- This process will be supported by pensions reform
  - non bank institutional investors will play an increasingly important role in corporate governance.



## The Drivers of Change and Trends

- Liberalisation, and re-regulation (regulatory reform) of banking and finance.
- Greater disclosure and freer capital flows and trade in financial services (GATS, globalisation) and also increased competition, drives change and financial innovation.
  - Securitisation
  - Derivatives
- There is a trend towards increased concentration in ‘domestic’ banking systems but greater international competition between banks.



- Some global ‘banks’ are beginning to emerge (Citigroup and HSBC, as well as a number of global investment banks- mostly Wall Street based).
- Financial conglomeration is increasing in Europe, Japan and the US (Universal Banking, Bancassurance) in part due to liberalising re-regulation (Japan and US).



## Convergence and Corporate Governance

- Capital market development is most advanced in the US, but has accelerated in Europe since the introduction of the euro, so ‘Continental European’ financial systems are becoming more ‘Anglo-Saxon’ (though there are major differences between the UK and the US models: principles Vs rules; ‘combined code’ Vs ‘SarboX’)
- SarboX is needed in the US to underwrite internal controls whilst in the UK independent board members, institutional investors and auditors monitor them.
- With financial agglomeration accelerating in the US and Japan, their financial systems are becoming more ‘Continental European’.
- It seems that a **hybrid model** with a large multinational financial conglomerates and more prominent capital markets is evolving, which has implications for corporate governance.



- Bank dominated ('insider') systems, especially when cross shareholding is prevalent (Germany, Japan), tend to exercise more 'hands-on' governance.
  - more 'long-termist'/strategic
  - cheaper insolvency resolution
- More capital market oriented ('outsider') systems rely more on capital market discipline (market for corporate control)
  - more 'short termist'
  - more expensive bankruptcies (loss of goodwill/going concerns and legal fees etc), possibly mitigated by US Chapter 11 - style protection for creditors.
- Cross-shareholding is now being unwound in Germany and Japan and both are becoming more capital market oriented.



- In more capital market oriented systems, pensions, insurance, mutual, venture and hedge **funds** replace banks as the major institutional investors.
- The privatisation of pensions and creation of government funded pensions schemes reinforces this process.
- Because pension funds manage long term savings, as they increase in importance their strategic investment approach should help counteract tendencies towards short-termism.
- Mullineux, Agung and Murinde (2004) find some evidence of convergence of European financial systems, with increasing importance of bond and equity markets.



- The convergence of the systems is likely to lead to convergence of corporate governance mechanisms (the OECD already has an agreed set of ‘best practice’ general principles).
- The continuing importance of internal finance in larger firms means that good corporate governance is required to ensure the efficient investment of retained earnings.
- The role of the financial sector is thus not just to allocate capital efficiently, but also to ensure retained earnings are allocated efficiently.
- Institutional investors, fund managers and trustees thus have a key role to play.



- Through them, the interests of shareholders and other stakeholders can be represented and they must increasingly be seen (through the exercise of voting rights) to represent their clients (savers etc) interests, taking account of social and environmental issues and corporate governance, as well as their traditional fiduciary duties.
- Institutional shareholders will thus need to become increasingly more active in ensuring good management structures and internal controls.
  - as this happens in the US, SarbOx can be relaxed.
- However, institutional investors themselves may face conflicts of interest because the desire of the fund managers to retain mandates may inhibit their proxy voting activity.



- Further, as with SarbOx, there is pressure to reduce compliance costs; especially for smaller firms.
  - The UK's AIM provides a warning against relaxing regulations too far.
- The good corporate governance of institutional investors and fund managers and pensions trustees thus becomes a core issue.
- It is possible that increased 'short-termism' and competition between fund managers to demonstrate good performance may reduce capital 'hoarding' by increasing pressure for dividend pay-outs. Capital may thus circulate more effectively, possibly increasing the supply of funds to innovative new firms, and SMEs in general.



- Triple (or quadruple) bottom line accounting (taking account not just of financial performance, but also environmental impact and social responsibility (and corporate governance/internal controls)) based on common standards, and conformable bankruptcy rules are seemingly evolving (but government pressure may be needed to sustain recent progress in light of the recent UN report of its impending demise).



## **Summing up and Next Steps**

- The paper postulates a link between changing corporate finance flows and corporate governance systems.
- More specifically it postulates that (non SME) corporate finance is converging on a hybrid model with an increasing role for institutional investors and capital markets and a declining role for banks, except insofar as they diversify into investment banking, fund management and insurance.



- It essentially argues that these changing corporate finance patterns are at least as likely to impact on business behaviour (and profitability) as factors such as the number of independent directors , or the separation of the posts of CEO and Chair and that the corporate finance developments will have a strong - separate influence on corporate governance.
- How can we test the link between changing corporate finance patterns and ‘corporate governance’?
  - need time series data on voting behaviour of institutional investors.



# Some Ideas

