Corporate Governance in the UK

Increasing belief institutions of ownership and control can directly effect economic performance

Recently:

-collapse major companies eg Polly Peck, Maxwell, Enron…etc

-financial irregularities eg Maxwell, Barings, Enron, Parmalat

-excessive compensation and severance pay -eg public utilities

-fraud and deceit (BICC, Astra)

Called into question corporate governance and led to investigations of Cadbury Committee (1992) on Financial Aspects of Corporate Governance and Greenbury Report on Directors Pay

Corporate Governance

-Broadly conceived refers to mechanisms by which companies are controlled, directed and made accountable

-Derek Morris contrasts inside control and outside control

-Stakeholders: growing literature

-internal stakeholders –workers, managers

-external stakeholders: shareholders, local community, customers etc

-importance of recognising companies general impact and responsibilities

-Corporate social responsibility initiatives

Why should governance matter?

Traditional Model

Employees, managers, investors, and suppliers all contribute inputs which are turned into outputs and all receive appropriate compensation.

Failure leads to inefficiency and takeover/bankruptcy. So role for external forces ie the market and a potential for regulation.

Need to consider

-Agency problems (conflict of interest/moral hazard). Principal-agent considerations are necessary, but not sufficient to provide a role for governance structure. Could in principle have a contract with many contingencies, though in practise infeasible.

-Transaction costs and asymmetric information lead to incomplete contracts

-Failures of external regulation: free rider problem.

In practice:

-separation of ownership and management. Move from entrepreneurial/family firm. External vs internal controlling shareholders

-imperfect and asymmetric information

-principal-agent problem and potential for opportunistic behaviour

-need more than contracts/policing (entrepreneurial behaviour)

-need more general forms of corporate governance (voting rights, cross holdings, control chains etc)

Corporate Governance Mechanisms

Management Compensation

How are rewards used to align management and shareholder interests

1 Managerial pay and company performance: Problems ‘shirking’ and who monitors top executives. Solution performance linked pay?

2. Incentive schemes: include options, stockholdings etc in pay

Academic work focuses on directors pay and corporate performance. Find little evidence of any link in UK and US, using both accounting and market based measures. See Conyon and Peck, who regress change in compensation on the performance of UK companies.

Management Turnover

Suggest dismissal provides incentives to work in interests of shareholders.

Chief Executive Officer (CEO) turnover: some evidence of negative relation between performance and executive turnover, weaker in UK. Much of this work can be criticised in various ways –eg static analysis.

Board of Directors

Directly elected by shareholders to operate in their interests in principal

But:

-do they play sufficient role in monitoring top management?

-Anglo-Saxon unitary board structure with mixture of executive (inside) and non-executive (outside) directors.

-Executives may not have incentive to monitor as too tied in with CEO

Non-executive may have incentive but problems:

-split is somewhat artificial: legally responsible

-asymmetric information

-often marginal holdings of equity and other concerns

Empirical evidence suggests board structure is important

-outsider domination likely to lead to CEO turnover

-outsiders restrain managerial compensation

-some evidence smaller boards better

Large Institutional Investors

UK public limited companies have large number of small shareholders but some evidence that this is changing in UK, allowing for privatisation policies.

-Large shareholders have more control over directors than dispersed small shareholders

-Pension funds important in UK

-but ‘short-termism’ in UK suggests failure of commitment and monitoring

No empirical evidence of this effect

Company Take-overs

Hostile take-overs discipline management but can be harmful and costly – esp if defensive responses

Empirical evidence reflects lacklustre performance of post-take over firms. Jenkinson, OEP

Overall, suggests not management of poorly performing companies that get penalised through take-over, but well performing companies are purchased at great expense.

Problem of free riding: If bid fails lose nothing, if bid succeeds then if it was rejected get higher price once new management removes inefficiencies. So takeovers won’t reduce inefficiencies

Share price effects: Signal problems –allow takeovers, but share price doesn’t always reflect fundamentals, EMH/CAPM questioned and evidence suggests high fluctuations in prices.

Policy Responses:

Cadbury Committee

-boards should appoint renumeration committees composed mainly of non-executive directors

-calibre and number of non-executive directors should be adequate for them to carry weight

-reduce CEO duality -when CEO also chairman of board

But no statutory obligation -only best practice

Company Responses (Table)

Non-executive directors increasing -but at 48% still below US (2/3)

Reduced CEO duality

Directors equity holding relatively constant

Large increase nominating committees (still lower than US c90%)

Large increase in renumeration committees and in proportion of outside directors

Companies do seem to be complying with Cadbury recommendations

-but these only largest

Table: Means of Key Variables Per Annum (96 companies per year; FTSE 100)

	1991	1992	1993	1994
Highest directors compensation (000)	463.2	546.3	768.5	865.9
Shareholder return	0.21	0.27	0.35	-0.04
Total Employ (log)	10.4	10.4	10.3	10.3
% outside directors	45.0	46.1	47.5	48.1
Combined Chair & CEO (% co.s)	52.1	53.1	46.9	36.5
Directors equity holding	45.8	45.8	45.8	46.3
Nominating committee (% co.s)	11.5	36.5	61.5	71.9
Renumeration committee (RC) (% co.s)	78.1	90.6	96.9	99.0
% outside directors on RC	68.3	81.1	88.3	90.6

Source: Datastream and Company Accounts

Differences across countries:

UK and US –high level of hostile takeovers
Germany and Japan –low level of hostile takeovers

1. regulatory rules
    a. dual class shares with different voting rights
    b. but doesn't explain differences
    c. voting right restrictions
    d. argument absence hostile takeovers is countries don't need them
2. Ownership of corporate structure
    a. Industrial groupings –history 'zaibatsus' banks and manufacturers groups in Japan/Sweden families/Germany industry banks
    b. Striking differences in ownership patterns
        i. UK more than 60% financial and non fin corporations with less than 4% of this non financial corporate sector
        ii. Japan cross shareholdings important
        iii. Conc shareholdings in Eur and Japan
    c. insider vs outsider, portfolio diversification at expense of corporate governance? But more to corporate governance than share ownership
3. Structure of corporate boards
    a. UK as above
    b. Germany –
        1. supervisory board: stakeholders with role for banks and specialist advise available
        2. management board
        3. shareholder general meeting

Differences in corporate governance seem to result from differences in structure of corporate organisations. Comparative merits of

Insider vs outsider
Concentrated vs dispersed in sector
Single tier vs 2 tier boards
Employee representation

US and UK

Ownership and control conferred on outside investors with little direct stake in firm

Takeovers break implicit contracts with stakeholders?

But does outsider system encourage implicit contracts

Portfolio allows risk sharing and can have benefits in making speculative investment/venture capital available

No. firms coming onto market in UK and US much large than Germany

Policy Implications

Are 2 sides to argument

Not clear harmonisation would be good

Lessons to be learned for both systems from the other, though