Changes in Corporate Governance of European Corporations: convergence to the Anglo-American Model?

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Paper Summary

I Introduction

Triumphant claims but also fears have been voiced that one model of capitalism – the liberal market economy – is replacing all others. Are coordinated market economies in the process of erosion?

Debate has focused on changes in capital markets and their impact on corporate governance, seen as cornerstones of different models of capitalism. (Loose definition of corporate governance: all those rules and arrangements structuring the exercise of control over company assets and patterns of interaction.) Interest has focused particularly on Japan and continental European economies to establish whether they are converging towards the Anglo-American model, whether they are resistant to fundamental change, or whether a new hybrid variety of capitalism might be emerging.

This paper joins the debate to examine the process of transformation in continental Europe and to determine both sources, extent and outcomes of change. Germany is taken as the paradigm case for coordinated market economies.

The paper argues that convergence is, indeed, beginning to occur. To make the case, I offer a theoretical explanation of the notions of institutional change, institutional complementarity and hybridisation, but also a thorough empirical substantiation of the claim. Finally, the consequences of convergence for the German production paradigm in general and for labour in particular are being drawn out.

II Theoretical Considerations

II.1 Approaches to corporate governance

Contrast of the 'principal-agent' approach, with its focus on the shareholder as the main beneficiary of business returns, with a stakeholder approach. The latter is concerned with the entire network of relations which determines how control is exercised within corporations. This system of 'insider control' is then contrasted with 'outsider' control of management by investors and the more arms' length relation connected with it.

II.2 Analysis of institutional persistence and change

Analysis of varieties of capitalism has long focused on institutional reproduction in a path-dependent manner. Such analysis is based on an assumption that the cohesion or complementarity of different system elements inhibit change.

Complementarity exists when the presence or absence of one institution affects the efficiency or lack of it of another.

More recently, the occurrence of apparently radical change has put this analysis in to question. Writers have argued that

a) **system change may be evolutionary and cumulative, rather than radical;**
b) **that not only external precipitators but also powerful internal actors may promote change;**
c) **that institutional complementarity therefore may not be as strong as hitherto assumed;**
d) **that some parts of the system may change independently from the others; and**
e) **that, therefore, hybrid systems are being created.**

This paper takes on board some of these arguments but then critically evaluates and extends them. It suggests

a) **that institutional complementarity can only be disturbed temporarily; and**
b) **that hybridisation therefore is an unstable transitional phase;**
c) **c) that the final direction of change strongly depends on the strategies of powerful internal actors;**
d) **and that return to the old path or convergence to another one are the main alternatives.**

System change has occurred when a new logic, defined as predictable strategies, routines and shared roles, has replaced the old logic. In the case of corporate governance in Germany, system change can be said to have taken place if capital market actors come to play the most decisive role also in decision-making within firms.

In contrast, in a hybrid system, different logics prevail in different parts of the system, due to the fact that one system element has changed and another has remained stable. In the case of a changed German system of corporate governance, different scenarios for a hybrid system have been suggested in the literature:

a) **the logic may be accepted in some firms or industries but not in others;**
b) **the new logic may determine one aspect of business, e.g. product markets, but not others, e.g. labour relations;**
c) **that managers have different perceptions and evaluations of contingent events and this would mediate the impact of external constraints and prevent uni-directional change.**
d)

To conclude this section, the following claim is being advanced:
If a cumulative change in a central instituiton has fundamentally changed the logic governing relations within it and if that change is supported by powerful actors in the economy, the polity and within firms, then hybridisation will not endure. Instead, system transformation will occur.

III Review of Empirical Change

III.1 Historical sketch of the German financial system and form of corporate governance

Outline of the credit-based system, the role of banks within it and of the system of cross ownership between non-financial firms.
Description of the long-termism in investment strategies, resulting from the access to 'patient capital' which is entailed by this system.
System has existed from the end of the 19th century until the mid-1990s.
Description of underdeveloped stock market (SM), low market capitalisation and low degree of listing of even large firms, and the influential role of banks within firms and the economy as a whole.
Focus on labour as a stakeholder and on the opportunity of labour participation in strategic decision-making and the adoption of a high-skill/high-security model of human resources development.

III.2 Recent institutional changes in the German capital market and system of corporate governance.

III.2.1 Sources of change
Two sources of change:

a) **liberalization of international capital markets;**
b) **b) enhanced internationalisation of markets for products and services and greatly intensified international competition between firms.**
a) **has entailed the following:**

Spread of liberal market model to Japan and continental Europe.
Modernization of capital markets there on the Anglo-American model and spread of the notion of 'shareholder value'. Investor pressure on firms to raise efficiency and transparency, inducing de-diversification and return to the core in product markets, as well as introduction of performance criteria at all levels of the firm;

b) **has forced the pace of innovation and has raised the cost of R&D. Increased costs, together with the necessity to achieve a certain size to exercise market power has led to a trend towards capital concentration. Has occurred through external growth by merger and acquisition and made possible by stock market listing. Logic of the capital market has begun to shape firm-internal decision-making.**

External sources of change have not been imposed on unwilling banks and firms, but, in many cases, have been embraced and welcomed by powerful internal actors. The German state also has provided legislative support.

III.2.2 Changes in capital markets

Long list of formal and informal changes during the second half of the 1990s have completed the modernization of the German stock market and converted it to the Anglo-American model.

Significant steps:
Establishment of a centralised market in Frankfurt.
Creation of New Market for smaller, technology-intensive firms.

Introduction of Federal Agency for Market Supervision.
New legal rules and conventions to ensure greater transparency and accountability of firms and to protect minority shareholders – establishment of principle of one share/one vote.
Take-over code.
Curtailment of banks' influence on supervisory boards.

Other new legislation has reinforced the impact of the SM on firms:

a) **authorisation of share buy-backs;**
b) **payment of managers in share options;**
c) **introduction of new investor-friendly company code;**
d) **law, passed in 2000 and implemented in 2002, giving tax exemption on sales of shares, previously tied up in cross-holdings. Likely to unravel the system of cross holding, to diminish block holding and to make companies more vulnerable to take over. Will enliven and enlarge the stock market. Banks and insurance companies would lead the way in this process of unravelling the network system.**

Change of role for banks. Their traditional lending business has been declining. Have been attracted to new opportunities for quick earnings and lucrative deals SM offers. Have reduced their representation on company boards and do no longer 'rescue' ailing firms. Deutsche Bank has led the way and others have followed.

III.2.3 Changes within firms

Slight increase in listing of firms and more listing on foreign markets.
Small but significant increase in foreign investors – institutional investors. Share ownership slightly more dispersed. But overall number of listed companies has remained small. Market for corporate control has not developed although monitoring by 'outsiders' has increased significantly. Has shaped internal decision-making. Influence has spread to non-listed companies, legitimises pressure for performance.

Many firms have adopted international accounting standards, issue quarterly reports and have opened investor relations departments. Have restructured companies into profit centres and introduced performance-related pay. Managers are given share options. Financial specialists are pushing aside engineers in competition for top management posts, and managers move more between firms for promotion. Pressure for de-diversification through the conglomerate discount on share prices. Even family firms are transforming themselves. Amount spent on dividends has risen and that spent on labour has fallen in firms committed to shareholder value. No decline in pay, but decline in employment.

III.3 Persistence of the German model

Fundamental change coexists with reproduction of old arrangements.

a) **listing on SM still very low – market remains undercapitalised.**
b) **Ownership of large blocks of shares and family ownership still common.**

c) Influence of institutional investors only in about 10 per cent of listed companies.
d) Individual shareholding still low in international comparison.
e) Cross holding still developed.
f) Dual board structure and co-determination system not abolished.
g) Hence still influence by labour on company boards and on works councils.

III.4 Balance of change and persistence: hybridization?

Many contemporary analysts diagnose hybridization.
Is a hybrid system stable and viable in the longer term?
Or are underlying pressures likely to make coexistence of opposed logics incompatible in the longer term? Is convergence the more likely outcome?

III.5 Pressures for system convergence

Changes in capital market now irreversible. Have been accepted by powerful actors. Banks' interests aligned with SM-oriented economy.

Banks have not intervened in the Mannesmann takeover.
Suspicion that they have put pressure on the state to pass the 'Eichel' law, which encourages the unravelling of cross shareholding. The consequences of such unravelling will be vast. Will mean the end of the 'insider' system. Will usher in market for corporate control.

Such claims widely accepted in the literature, but the consequences they might have for German model of capitalism are still not admitted. Hybridization, rather than convergence is the orthodoxy.

Claim that diversity will win out over uniform trend in one direction. But diversity within industries much reduced. De-diversification has become general trend. Merger and Acquisition more widely embraced, even by family firms. Illustrate claim by reference to recent development of the three chemical/pharmaceutical giants. Managers who resist shareholder value trend see their share price suffer.

Smaller firms, although not listed, are affected by changes in their large buyer firms.

Claim that stakeholder system so well established and part of German business culture that it will not be abandoned. German production paradigm dependent on highly-skilled, highly-paid and participative labour.

Difficult to grasp how there can be complementarity between clamour for more shareholder value and employees' claims for employment security, investment in more training and continuation of high wages.

Is an enlightened shareholder value position tenable? Can investors be persuaded to continue to adhere to long-termism, in order to keep the German system of labour relations alive, as some writers argue?

My conclusion is 'no' – capital markets cannot exercise this kind of highly flexible behaviour. Nor is it clear what the incentives for investors would be? What makes long-termism palatable to them?

IV Conclusions

Paper has tried to show complexity of change and of outcomes of change. Has argued for complementarity asserting itself in the long run, if system stability is to be restored.
Convergence towards Anglo-American liberal market economy is highly likely. . Can only be prevented if

a) **some as yet unknown powerful coalition will develop to protect the old system of labour relations; or**
b) **if the Anglo-American system suffers some legitimation crisis, brought about by deep recession and its inability to cope with it.**