A tale of three countries, dispersed ownership and greater risk taking levels by management: risk monitoring tools in bank regulation and supervision – developments since the collapse of Barings Plc (re – visited)

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ABSTRACT

This paper is aimed at explaining why higher concentrations of the ownership of large firms do not necessarily and automatically facilitate lower risk taking levels – where there is scope for the abuse of powers. As well as illustrating why effective corporate governance systems are essential in facilitating high levels of monitoring, accountability and disclosure, the paper also highlights why a consideration of the costs of ownership concentration and its benefits, is required in determining whether corporate governance systems will be effective or not.

Key Words: corporate governance, ownership structures, banks, risk, regulation, monitoring, disclosure, accountability, liquidity, internal controls.

A Tale of Three Countries, Dispersed Ownership and Greater Risk Taking Levels by Management: Risk Monitoring Tools in Bank Regulation and Supervision – Developments Since the Collapse of Barings Plc (Re – Visited)

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A. Introduction

The conclusions derived by Laeven and Levine that:[2]

Firstly, owners who have "diversified" their assets have greater incentives to indulge in higher levels of risk taking than managers who are non shareholders and that as a result, banks which have powerful and diversified owners are more likely to be riskier than "widely held banks" – provided other factors are constantly maintained;

Secondly, bank regulations such as capital requirements and deposit insurance, generate effects which differ when considered in relation to incentives of owners as opposed to that of managers and that as a result, the "comparative power of shareholders relative to managers within each bank's corporate governance structure" influences the real impact of regulations on risk taking;

is acknowledged to be the result of a combination of three theories:[3]

- That the effect of regulation on risk is dependent on the relative influence of owners who exist within governance structures of individual banks
- That bank regulators influence risk taking incentives of owners in a different manner to those of managers (banking theory),
- That ownership structures affect the ability of owners to influence risk (corporate governance theory)

The first of the above conclusions, namely, that: owners who have "diversified" their assets have greater incentives to indulge in higher levels of risk taking than managers who are non shareholders, also provides further support to the argument put forward by Edwards and Nibler, who assert that in countries like the UK and the US where ownership is more dispersed, "control is exerted by managers with considerable freedom to pursue their own interests at the shareholders' expense – since their actions are not monitored adequately."[4]

Does a greater level of dispersed ownership of firms (particularly large firms) result in greater risk taking levels? Conversely, could it facilitate greater monitoring levels - than is the case where higher concentrations of ownership exists? This paper is aimed at explaining why higher

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2 See L Laeven and R Levine, ‚Bank Governance, Regulations and Risk Taking' 2008 Journal of Financial Economics at page 6

3 ibid

4 J Edwards and M Nibler „Corporate Governance in Germany: The Role of Banks and Ownership Concentration." 2000 Journal of Economic Policy 31: 237-260

concentrations of the ownership of large firms do not necessarily and automatically facilitate lower risk taking levels – where there is scope for the abuse of powers. Further, it seeks to illustrate why effective corporate governance systems are essential in facilitating high levels of monitoring, accountability and disclosure.

B. Corporate Governance in Germany and the UK

The typical public limited liability company in Germany is comprised of two boards of directors, namely:[5] i) The supervisory board (*Aufsichtsrat*) – which could be described as the equivalent of an audit committee and ii) the management board (*Vorstand*). Whilst the management board is responsible for conducting daily operations and is accountable to the supervisory board, the supervisory board maintains oversight over the management board, "having the power to appoint and dismiss members of the management board , and also to stipulate their salaries."[6]

In drawing comparisons between the German and British corporate governance systems, Vieten is of the opinion that "it is also improbable that the Cadbury proposals can effectively curtail the powers of the dominant interested party , namely the management" and that audit committees may "constitute no more than symbols of control" – having due regard to the German system which "invests power in non executive directors by statute – failing to prevent scandals."[7]

"The German corporate governance system is generally considered to be a standard example of an insider-controlled and stake holder-oriented system."[8] However, transformation from this classic and traditional "insider-controlled" system to a "modern capital market based and outsider controlled" system has been observed.[9] The advantages of the traditional insider systems were considered to include:[10]

- i) Its ability to enable management to take a longer-term perspective in its planning and strategies
- ii) As a result of the need to finalise incomplete and implicit contracts, it offered the benefit of flexibility and created stronger incentives to undertake relationship- specific investments than a market based and purely shareholder-oriented outsider control system."

Identified weaknesses of the system include criticism that: "The supervisory board does not function in the way it was intended to function."[11] As well as the reliance of the insider control system on informal contracting being considered to have contributed to "lack of transparency" and its anti competitive effects", "a systematic neglect of the stock market, greater opportunities for abuse of power, the real danger that such as system is inimical to all reforms – even those which might improve its functioning without altering its fundamental structure," are further criticisms attributed to an insider control system.[12]

The next section is aimed at illustrating how corporate governance systems could facilitate higher levels of monitoring.

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5 See G Gorton and F Schmid, 'Universal Banking and the Performance of German Firms' NBER Working Paper 5453 1996 at page 28

6 ibid

7 H R Vieten, 'Auditing in Britain and Germany Compared : Professions, Knowledge and the State' European Accounting Review at pages 506 and 507; In Vieten's view, no proof has been provided to suggest that audit committees may improve corporate governance and audit independence; see ibid at page 506

8 See RH Schmidt, „Corporate Governance in Germany: An Economic Perspective" 2003 page 2 of 44

9 ibid at page 22 of 44

10 ibid at page 18 of 44

11 ibid at page 19 of 44

12 see ibid

C. Corporate Governance in Germany, the UK and the US.

The German system of corporate governance is distinguished from that which operates in Anglo Saxon countries owing to its incorporation of lenders and employees in the governance of large corporations.[13] It views corporations as entities which serve the interests of shareholders –as well as other interests, and is defined by a legal tradition which can be traced back to the 1920s.[14]

Two features which distinguish the German system of corporate governance from that of the US and the UK include:[15]

- Less dispersed/Higher concentration of the ownership of large firms. In countries like the UK and the US where ownership is more dispersed, it is argued that "control is exerted by managers with considerable freedom to pursue their own interests at the shareholders' expense – since their actions are not monitored adequately."[16] It is argued further that there is little incentive for individual shareholders to monitor since they are individually responsible for any accrued monitoring costs – even though such monitoring ultimately serves the benefit of all shareholders.[17]

- Involvement of banks as part of supervisory boards of companies (as shareholder representatives). This allows banks to monitor the management of companies – particularly when a banker assumes the head of the supervisory board. The election of banks to the supervisory boards of companies (as shareholder representatives and sometimes as heads of supervisory boards), provides them with invaluable insight which facilitates their ability to monitor the management of companies.[18]

A further characteristic which distinguishes Germany from stock market economies exists in the way in which voting occurs at annual meetings.[19] Whilst both stock market economies[20] and universal banking systems[21] share the common feature of enabling shareholders to exercise control over management (through votes at general meetings), in Germany, banks also own their equity[22] and "have proxy rights to vote the shares of other agents who keep their shares at the bank."[23] The importance of proxy voting rights stems from the fact that "it concentrates the voting power of

[13] See RH Schmidt „Corporate Governance in Germany: An Economic Perspective" 2003 at page 2 of 44
[14] ibid at page 3 of 44
[15] J Edwards and M Nibler „Corporate Governance in Germany: The Role of Banks and Ownership Concentration." 2000 Journal of Economic Policy 31: 237-260
[16] ibid at pages 239 and 240
[17] ibid
[18] ibid at page 241; This being the case where a banker assumes the head of the supervisory board – owing to the fact that the chairman is frequently consulted by the management (usually on a monthly basis) – whilst the full board may hold meetings twice a year; ibid.
[19] G Gorton and F Schmid, 'Universal Banking and the Performance of German Firms' NBER Working Paper 5453 1996 at page 1
[20] Such as the UK and the US.
[21] For instance, Germany.
[22] As well as having the capacity to lend
[23] ibid; Such right being referred to as *Auftragsstimmrecht.* The bank requests for permission to vote on behalf of the shareholder. Even though such a right is typically granted and lasts for about 15 months, it could still be revoked. Even though such a right has its limits, it enables banks to exercise a degree of influence on management irregardless of banks' equity holdings in the firm; ibid.

dispersed household shareholders in the hands of banks – making them potentially powerful."[24] The influence of banks (with or without proxy voting rights) may have altered dramatically over the years owing to the different world of German corporate finance which currently persists. Apart from the fact that security markets have become more developed and complex, the extent of banks' block holdings has, correspondingly, also become very much reduced.[25]

Having considered the above features, it can be inferred that the inclusion of banks as part of the supervisory boards of companies, and less dispersed ownership of large firms have the benefits of facilitating higher monitoring levels. However, as observed by Schmidt,[26] the Stock Corporation Act *(Aktiengesetz*) accords to the management board *(Vorstand*) a wide scope in the discharge of their powers. Furthermore, Edwards and Nibler argue that although banks may influence corporate governance through their control of proxy votes, their presence on supervisory boards, and their provision of loan finance, they do not play a role in the governance of large German firms in practice – that is, a role which is distinct from that of other types of large shareholders.[27] They arrive at the conclusion that "any case for the superiority of German corporate governance of large firms" must accordingly "be based on high ownership concentration rather than a special role for banks" – as well as a consideration of the costs of ownership concentration and its benefits."[28]

D. Conclusion

The dual system of disclosure which exists in Germany should facilitate greater accountability and disclosure. Furthermore, it should reduce the scope for the abuse of powers – if an adequate degree of independence existed within the supervisory board. Whilst the weaknesses of an insider controlled system of corporate governance have been highlighted, it is also important to add that an insider controlled system serves as a valuable source of acquiring information and understanding about a firm or company – which could otherwise, not be provided by an external expert.

Common characteristics which audit committees and supervisory boards should ideally have, as revealed in a survey[29] include: "That non executive directors have relevant industry experience; that some members should have sound grasp of current developments in financial markets; that there should be openness to regular training; that there should be distinct appointment policies and criteria; succession planning and membership criterion; that there should be clear delineation between their role and that of management; that there should be clear strategies for setting an appropriate control culture within their organisations; that there be regular, clearly structured meetings held at least four times a year; that there exist regular flow of relevant, timely information

[24] ibid at page 2; Other ways through which banks could exert control over firms (even though such banks may appear to have insignificant equity holdings), include: i) "where the bank retains proxy rights – in addition to the votes attributed to their shares; (ii) where restrictions on voting (which prevents a block holder from exercising control) exists – such restrictions do not apply to bank proxy voting – giving banks unique power to the extent that they vote proxies; (iii) where block holders may have votes, but not enough information to use their power effectively – whilst banks, on the other hand, may have privileged information which they could use to their advantage – even if their holdings are small and even though a large block holder is present." See ibid at page 10

[25] See ibid at pages 30 and 31

[26] RH Schmidt „Corporate Governance in Germany: An Economic Perspective" 2003 at page 10 of 44

[27] J Edwards and M Nibler „Corporate Governance in Germany: The Role of Banks and Ownership Concentration." 2000 Journal of Economic Policy 31 at 237; The scope of banks in influencing corporate governance "through an exercise of proxy votes and their representation on supervisory boards", as further argued by Edwards and Nibler, "does not apply to all German firms."

[28] ibid

[29] See V Beattie S Fearnely and R Brandt*, Behind Closed Doors: What Company Audit is Really About* ICAEW 2001 at page 29

from company executives; private meetings meeting internal and external audit leaders; and the existence of self-assessment procedures."

Whilst problems, challenges and risks presented by internal controls still persist, regulators currently face greater challenges presented by liquidity risks.[30] As highlighted in a previous paper, greater focus on market based regulation, greater focus on initiatives and incentives aimed at deterring management from taking undue and unneccessary risks (improved governance measures aimed at ensuring that internal controls are effectively managed), will immensely contribute in addressing these challenges.

30 For further information on liquidity risks and other risks and challenges presented to regulators, see M Ojo, „The Role of External Auditors in Corporate Governance: Agency Problems and the Management of Risk" at pages 2 and 3 http://mpra.ub.uni-muenchen.de/15989/1/MPRA_paper_15989.pdf and http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1427899; for information on the impact of regulations and disclosure requirements on risk taking levels, please refer to M Ojo, „The Impact of Capital and Disclosure Requirements on Risks and Risk Taking Incentives" <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1547023> and http://mpra.ub.uni-muenchen.de/20404/1/MPRA_paper_20404.pdf and also M Ojo, „Preparing for Basel IV : why liquidity risks still present a challenge to regulators in prudential supervision (II)" <http://mpra.ub.uni-muenchen.de/27778/> and <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1732304>

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