Corporate Financing and Governance: An International Perspective

THE DRAMATIC DIFFERENCES across countries in how firms are financed and how their managers are held accountable to shareholders have long been the subject of intense academic scrutiny. Only recently, however, have these issues become a hot policy topic.

In the United States, there is ongoing debate about the best methods of financing and governing firms. In Japan and Germany, corporate finance markets have been substantially deregulated in recent years. Other countries, such as France and Italy, are considering vast privatization efforts and corresponding changes in their financial systems. And the formerly communist countries are putting in place entirely new systems of property rights, business law and financial markets.

In deciding how to fashion their financial markets, policymakers must determine the optimal way to organize their corporate sectors. In doing so, they clearly would benefit from understanding the factors behind the different corporate finance and governance systems in the major industrialized countries.

Table 1
Composition of Companies' Credit Market Debt as a Percentage of Total Credit Market Debt, 1995

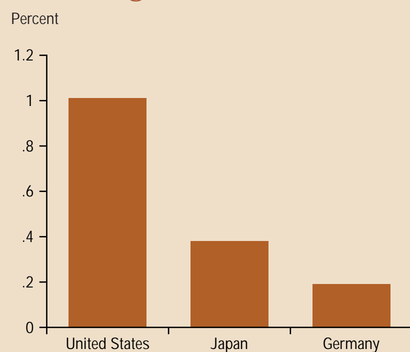
	United States	Germany	Japan
Total intermediated debt	54	74	77
Intermediated debt from banks	17	66	60
Securities	46	26	23

NOTE: Credit market debt excludes trade debt. Intermediated debt refers to loans from financial intermediaries. Securities include commercial paper, other short-term bills and long-term bonds.

SOURCE: *OECD Financial Statistics, Part III.*

Even the casual observer can see significant differences in how firms are financed and governed in the major industrialized countries. For example, U.S. firms rely heavily on corporate securities markets to finance investment, whereas for Japanese and German firms, intermediaries—principally banks—have traditionally been the most important source of external finance. This is illustrated by the relatively small amounts of money raised in the Japanese and German stock markets (*Chart 1*) and the much higher share of external finance that comes from banks (*Table 1*) in Japan and Germany.

Chart 1
Gross Issuance of Public Equity as a Percentage of GDP, 1995



SOURCES: Federal Reserve Board; *Securities Markets in Japan*, 1996; *Monthly Report of the Deutsche Bundesbank.*

The three countries also exhibit big differences in the primary mechanisms of corporate governance. One important mechanism is high ownership concentration. If a firm's ownership is concentrated in the hands of a few investors, each will have sufficient incentive to invest in acquiring information and monitoring management. Large shareholdings also confer the ability to exert control over management, through either voting power or board representation, or both. A second important mechanism is the credible threat of a hostile takeover, which can motivate managers to act in shareholders' best interests.

One of the starkest differences between the United States and Germany and Japan is the frequency of such hostile takeovers. Since World War II, for example, only four successful hostile takeovers have occurred in Germany. They're almost as rare in Japan. Conversely, in the United States, more than 10 percent of the 1980 Fortune 500 have since been acquired in a transaction that was hostile or started off that way. Obviously, the threat of a hostile takeover is a more important component of the corporate governance mechanism in the United States than it is in Germany or Japan.

In contrast, firms in Japan and (especially) Germany exhibit much higher degrees of ownership concentration than does the United States. Ownership is very heavily concentrated in German firms. The five largest shareholders of a firm own, on average, close to 50 percent of the firm's outstanding equity, compared with around 33 percent in Japan and about 25 percent in the United States (*Chart 2*). These large shareholders in Japanese and German firms are primarily banks, other financial institutions such as life insurance companies, and nonfinancial corporations. Together they hold about 70

percent of the outstanding shares of German and Japanese firms, in contrast to the United States, where, despite the fast growth of mutual fund holdings in recent years, direct individual holdings remain relatively more important (*Table 2*).

These differences in finance and governance are not simply accidents of history but a result of major differences in the legal and regulatory environments of the countries' financial systems. The differences are essentially of two kinds. First is the degree to which firms are restricted from utilizing nonbank financing. In contrast to the United States, Germany and Japan have traditionally discriminated heavily against the development of corporate securities markets. The restrictions have revolved largely around stiff securities transaction taxes and cumbersome issue-authorization procedures that are required for security offerings. Combined, they have imposed a heavy burden on firms seeking nonbank finance, domestically or abroad.

Second are differences in the legal and regulatory restraints on large investors being "active" in firms. U.S. laws are generally much more hostile to investors taking large, influential equity stakes in firms and actively monitoring management. These laws—which include Glass–Steagall restrictions on banks' holding of corporate equity, portfolio regulation of other financial institutions, and tax, insider trading and corporate bankruptcy laws—have led to relatively dispersed holdings of equity in the United States. The absence of such restrictions in Japan and Germany has encouraged the higher levels of ownership concentration in these countries.

Of course, as a financial system's legal and regulatory environment changes, so may methods of corporate finance and governance. Both Japan and Germany have lifted many of the more onerous restrictions on their corporate securities markets in the past 15 years. This is already reducing their firms' dependence on bank lending. In the United States, there has been some relaxation of the numerous restrictions on financial and nonfinancial corporations taking large equity stakes in other firms.

Clearly, there is some long-term convergence of the legal and regulatory environments of these countries. However, this convergence is not toward the German, Japanese or U.S. system as they now exist but to an environment in which financial institutions and other investors are free to take large equity stakes in firms and in which corporate capital markets are unhindered by regulatory and legal obstacles.

Speculating about the primary mechanisms of corporate financing and control in such a system is interesting, given that these conditions don't currently exist in any industrialized country. The closest approximation to this emerging model may be the United States in the early 20th century, before the passage of Glass–Steagall.

In addition, there is no guarantee that a convergence of the three countries' regulatory environments will mean a convergence in their methods of corporate financing and governance, if institutional history has any influence on the financial system's structure. For this reason, differences in methods of corporate financing and governance may persist long after differences in the legal and regulatory environments have disappeared.

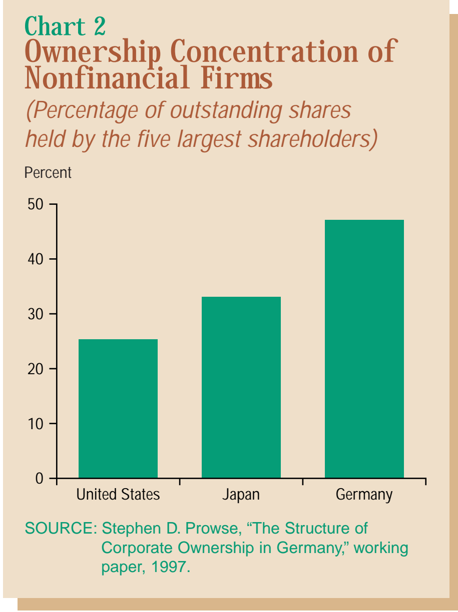
—Stephen D. Prowse

Table 2
Percentage of Outstanding Corporate Equity Held by Various Sectors in the United States, Germany and Japan, 1995

	United States	Germany	Japan
Financial institutions	44.5	30.3	35.8
Banks	.2	10.3	13.3
Other financial institutions	44.3	20.0	22.5
Nonfinancial firms	15.0	42.1	31.2
Individuals	36.3	14.6	22.4
Foreign	4.2	8.7	10.1
Government	0	4.3	.5

SOURCE: Stephen D. Prowse, "The Structure of Corporate Ownership in Germany," working paper, 1997.

Chart 2
Ownership Concentration of Nonfinancial Firms
(Percentage of outstanding shares held by the five largest shareholders)



SOURCE: Stephen D. Prowse, "The Structure of Corporate Ownership in Germany," working paper, 1997.