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KNOWLEDGE AND MODELS OF CORPORATE GOVERNANCE

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Abstract

The issue of corporate governance has been largely debated in the literature. Conventionally, corporate governance is viewed either from a stakeholder or a shareholder perspective. This paper discusses the informational aspects of the two models of corporate governance.

The role information plays in corporate governance cannot be overstated. Agents involved in corporate governance acquire, create, use and transmit information. Therefore, how the notion of knowledge is conceived is important for the analysis of alternative systems of corporate governance. Basically, there are two types of information processing: internalization and externalization. The internalization-based information processing system corresponds to the stakeholder model of corporate governance. A shareholder model of corporate governance relies on information externalization. Externalization of information is made via the market price system.

Keywords: knowledge, economics of information, information processing, corporate governance, market-based corporate governance

1. Introduction

The issue of corporate governance has been largely debated in the literature. The role information plays in corporate governance cannot be overstated. Agents involved in corporate governance acquire, create, use and transmit information. Therefore how the notion of knowledge is conceived is important for the analysis of alternative systems of corporate governance.

The distribution of information is of general importance for the economy. But it is particularly important in the context of financial relationships. The problems of asymmetric information and moral hazard are particularly severe in financial relationships.

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In this paper we analyze the relation between information processing and systems of corporate governance. We begin by pointing out what is the major informational problem, namely moral hazard. Then we see how corporate governance systems attempt to mitigate the consequences of moral hazard and ensure that managers act in the best interest of shareholders. We distinguish between two large systems, information internalization – stakeholder approach – bank-based governance and information externalization – shareholder approach – market-based governance, and attempt to evaluate how they manage to alleviate the problem of moral hazard.

2. The economics of information and moral hazard

So extensive is the discussion of information in the analysis of economic systems that we already have a discipline – the economics of information. The origins of this field of science can be traced back to 1945, when Hayek published his seminal work "The use of knowledge in society". Later, Arrow, Nelson and others continued to fuel an increasing and fascinating debate about how knowledge is produced and distributed among economic agents.

One of the central issues in the economics of knowledge is the asymmetric information problem. It points to a situation in which one party in a transaction has more information than another. The party that is insulated from risk generally has more information about its actions and intentions than the party paying for the negative consequences of the risk.

Moral hazard is related to asymmetric information, and occurs when the party with more information about its actions or intentions has a tendency or incentive to behave inappropriately from the perspective of the party with less information. More precisely, moral hazard arises because an individual or institution does not bear the full consequences of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to bear some responsibility for the consequences of those actions. For example, an individual with insurance against automobile theft may be less vigilant about locking his car, because the negative consequences of automobile theft are (partially) borne by the insurance company.

However a moral hazard problem occurs in making sure that managers put forth appropriate effort and make decisions aligned with the interests of shareholders. Specifically, shareholders worry that managers may overpay themselves, give themselves extravagant perks, carry out unprofitable but power-enhancing investments, and be reluctant to lay off workers that are no longer productive. In this sense, managers may make decisions based on their own interests. The moral hazard problem is then that managers may deceive investors to pursue their own goals.

There are also many other situations when upper management is shielded from the consequences of poor decision-making. This can occur for example when: a manager has a sinecure position from which they cannot be readily removed; the manager is protected by someone higher in the corporate structure, such as in cases of nepotism or pet projects; funding and/or managerial status for a project is independent of the project's success; the failure of the project is of minimal overall consequence to the firm, regardless of the local impact on the managed division; there is no clear means of determining who is accountable for a given project.

3. Corporate governance and moral hazard

From a financial point of view, "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". (Schleifer and Vichny, p. 2) Corporate governance was first established to combat the moral hazard issue of ensuring that managers act in the best interest of shareholders that arises as a result of the structure of corporations and the market in which they exist.

If shareholders are in fact seeking assurance that management is acting in their best interest, then the concerned shareholder should have the incentive to monitor the corporation themselves. However, Hart believes that monitoring is a public good, saying that "if one shareholder's monitoring leads to improved company performance, all shareholders benefit" (Hart 1995). The idea is that all shareholders will look to the other shareholders to do the monitoring for them. In this case, no one investor has the incentive to monitor because any benefits they receive will be received by all investors, regardless of whether they invest in monitoring themselves. This is a free-rider problem for monitoring among some shareholders; resulting in none of those shareholders choosing to monitor their companies. In addition, the lack of information that shareholders have about performance is an impediment to enforcing accountability. Shareholders have only the information presented in the financial statements and the shareholders generally do not have the tools to make those statements useful in monitoring.

Hayek (1945) pointed out that the efficiency of an economic system should be assessed on the basis of how well that system performs in transmitting information among its agents. The same thing is true with regard to systems of corporate governance. Basically, there are two types of information processing: internalization and externalization.

Internalizing information means resolving the problems of non-appropriability, non-tradability and credibility by maintaining a close social distance (proximity) among all the factors involved in the functioning of the firm. As Schmidt and Tyrell (2005, p. 488) explain, "the problems resulting from the public good character of information are also less acute if the information is kept

within a close relationship, or more precisely, within a network of several long lasting relationships". The internalization-based information processing system corresponds to the stakeholder model of corporate governance. In such a system we cannot speak about a clear fundamental goal of the company. Rather, company's management seeks to achieve a harmonization of stakeholders' interests.

In the stakeholder model of corporate governance, managerial decisions are overseen by a supervisory board, which includes representatives of all significant interests groups related to the company's activity. This board is an essential element in a internalization-based information processing system or insider control system, because includes individuals and institutions who, given their close ties with the company, posses critical information which is not publicly available. The existence of this supervisory board suggest "what kind of information the board members can contribute… It is largely non-public, sometimes soft, and confidential and internal or inside information which relates, for instance, to the question of what certain management decisions would imply for the respective constituencies with which board members are affiliated." (Schmidt and Tyrell, p. 492).

Schmidt and Tyrell (p. 495) define the relation between information processing, corporate governance and financial systems as follows: "The capital market-based financial system and the outsider control system are complements and are consistent, and both rely on the externalization of information. The converse features make up a ban-based financial system. An insider control system of corporate governance belongs to and complements this system, which also relies on the internalization of information. Thus the nature of information is not only the key to understand specific corporate governance systems and their differences, but also the systems at large to which they belong."

4. Information and corporate governance systems

Since the 19th century, many economists have argued that bank-based systems are better at mobilizing savings, identifying good investments, and exerting sound corporate control. Others, however, emphasize the advantages of markets in allocating capital, providing risk management tools, and mitigating the problems associated with excessively powerful banks. Reflecting these schisms, economists and policymakers continue to struggle with the relative merits of bank-based versus market-based financial systems in making policy decisions.

a. The bank-based view. The bank-based financial system emphasizes the role of banking institutions in allocating capital. In economies like Germany and Japan banks are the main source of funds for corporations. The bank-based view highlights the positive role of banks in (i) acquiring information about firms and managers and thereby improving capital allocation and corporate governance.

Furthermore, powerful banks can more effectively force firms to re-pay their debts than atomistic markets, especially in countries with weak contract enforcement capabilities. Thus, the bank-based view holds that banks -- unhampered by regulatory restrictions on their activities -- can exploit scale economies in information processing, ameliorate moral hazard through effective monitoring, form long-run relationships with firms to ease asymmetric information distortions, and thereby boost economic growth. Also, it can be argued that banks – as coordinated coalitions of investors – are better than uncoordinated markets at monitoring firms and reducing post-lending moral hazard (asset substitution).

The bank-based view also stresses the shortcomings of market-based systems. Stiglitz (1985), for instance, argues that well-developed markets quickly and publicly reveal information, which reduces the incentives for individual investors to acquire information. Banks, however, mitigate this problem since they form long-run relationships with firms and do not reveal information immediately in public markets. Banks avoid the free rider problem by holding the loans they make. Thus, investors cannot observe banks' activities and profit by mimicking them. By mainly holding loans that are not traded in financial markets, banks earn a profit on information collection. Although banks reduce information costs for savers, savers realize that banks have private information about the quality and the risk of the bank's loan portfolio, and that a bank might use this information in a way that jeopardizes savers' deposits.

Proponents of the bank-based view also stress that liquid markets create a myopic investor climate. In liquid markets, investors can inexpensively sell their shares, so that they have fewer incentives to exert rigorous corporate control.

There exists a widespread consensus that an 'insider system' of corporate governance, dominated by universal banks engaging in the full range of intermediation services (including brokerage and investment banking) and being allowed to hold equity in borrowing firms may bring a number of advantages. The use of strip finance (debt-equity finance) is regarded as an effective strategy for a bank willing to lessen moral hazard (controlling riskiness of firms' strategy, monitoring and influencing managerial effort, as well as preventing distribution of assets to shareholders at the disadvantage of creditors and innaccuracy in reported return realizations), obtain access to insider information (also through interlocking directorates) and commit the firm to longterm, exclusive business relationship (especially useful in case of restructuring).

The bank-based corporate finance and governance has a number of shortcomings. Most importantly, potential for conflict of interest in this system is endemic. A list of possible conflict-of-interest situations should include: (a) stuffing fiduciary accounts. A bank acting as an underwriter and unable to place securities in a public offering (therefore exposed to potential underwriting loss) may seek to ameliorate this loss by 'stuffing' unwanted securities into accounts

managed by its investment department. (b) bankruptcy-risk transfer. A bank with loans to a firm whose bankruptcy risk has increased (to the private knowledge of the banker), may induce the firm to issue bond or equities (underwritten by its securities unit) to an unsuspecting public; proceeds are then used to pay-down the bank loan. In this case the bank transfers debt-related risk to outside investors. (c) third-party loans. To ensure successful underwriting, a bank may make favourable loans to third-party investors on condition that funds are used to purchase securities underwritten by the bank itself. (d) tie-ins. A bank may force a firm to buy its securities products under threat of credit-rationing. The problem is therefore that universal banks may well be able to get better information, but also have incentives to exploit information asymmetries to misrepresent this information to the market or to extract extra surplus from client firms.

b. The market-based view. In contrast, the market-based view highlights the growth enhancing role of well-functioning markets in (i) fostering greater incentives to research firms since it is easier to profit from this information. by trading in big, liquid markets, (ii) enhancing corporate governance by easing takeovers and making it easier to tie managerial compensation to firm performance, and (iii) facilitating risk management. Moreover, the market-based view stresses problems with banks. Specifically, powerful banks can stymie innovation by extracting informational rents and protecting established firms with close bank-firm ties from competition. Furthermore, powerful banks with few regulatory restrictions on their activities may collude with firm managers against other creditors and impede efficient corporate governance. In contrast, competitive capital markets play a positive role in aggregating diffuse information signals and effectively transmitting this information to investors, with beneficial implications for firm financing and economic performance.

The market-based view of corporate finance and governance stresses how corporate management is constrained to follow closely the interests of shareholders by using the concept of "market discipline". We can explain the relevance of this notion thus: if stock prices are low it is hard to get external financing. It is also more costly to raise new funds through new share issues. Managers want to manage big companies with exciting business prospects so want easier financing. If stock price is too low it's easier to be taken over. If internal control mechanisms such as the monitoring by board of directors fail, shareholders suffer and the company would become a takeover target. This situation arises as the company is not performing well and has a poor governance structure. Therefore post merger/acquisition, improved performance will surface coupled with a more effective governance structure. New people and new ideas enter the company that in essence, may make it a better company

If the merger is successful, the bidder will most probably bring in new directors and CEO's. These new individuals within the new firm will not have a link with managers and hence, will not act in their interests. This helps to

eliminate conflicts of interests, which are seen in the principal-agent problem. Therefore, businesses will be more effectively directed and controlled leading to a better governance structure. Even if the takeover is unsuccessful, the fear of a takeover can result in top management and the CEO fearing dismissal if they know their behavior and past action has been in conflict with shareholder interests.

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