Corporate governance

Knut Nygaard

ECON1810, Spring 2011

This lecture

What is corporate governance?

Governance and responsibility

- Corporate governance: firm/manager versus financiers
- Corporate social responsibility: firm/manager versus stakeholders *other than* financiers

Case

I am the CEO in a large company. You are a group of corporate social responsibility experts.

I want your advice. There is a new initiative where firms can voluntarily commit to carbon emission reductions that go beyond current regulation.

- Should I join? Provide arguments for and against based on how different stakeholders are likely to react

Defining corporate governance: the problem

- The agency problem results from the separation of management and finance
- The financers need the manager's specialised human capital to generate returns on their funds.
- The manager needs the financers funds, since he either does not have enough capital on his own to invest (or wants to cash out his holdings).
- But how can the financers be sure that they get anything back from the manager?

Thus, the agency problem refers to the difficulties financiers have in assuring that their funds are not expropriated or wasted on unattrative projects

Defining corporate governance: the solution

Product market competition forces firms to minimise costs: they must adopt rules that enable them to raise external capital at the lowest cost.

Does product market competition solve the agency problem?

- No: production capital is highly specific and sunk, and manager may still expropriate or waste the competitive return

So what do we do?

- Incentive contract (management aligned with shareholders)
- Manager and firm reputation (no shareholder power)
- Large owners (shareholder power)
- Legal protection (shareholder power)
- Codes of practice (self-imposed constaint on management)

The agency problem: examples

- Pyramid schemes: Bernard L. Madoff Investment
- Selling products at price=0 to manager-owned trading company: Russian oil companies
- Selling firm assets to manager owned firm below market price: Korean chaebol
- Selling manager owned assets to the firm above market price: Aker
- Consumption: plush office decor, private jet
- Empire building: bidder stock price falls in takeovers
- Pet projects, and staying on the job when no longer qualified

Solution: incentive contracts

Offer manager a highly contingent long term incentive scheme to align managers interest with those of financiers

Examples: shareholding, stock options, threat of dismissal

Drawbacks:

- Optimal contract depends on manager risk aversion, and ability to pay for cash flow right
- Creates additional opportunities for self-dealing

  Contract negotiated with poorly motivated board

  Stock options negotiated just before release of good news

  Manipulation of accounts and investment policy (Enron)

Solution: manager and firm reputation

Reputation of manager and firm in capital markets. Managers repay investors because they want to come to the capital market and raise funds in the future.

Yes, but backwards recursion problem:

- Suppose that at some point in the future the future benefits to the manager of being able to raise outside funds are lower than the costs of paying what he promised investors already
- He rationally defaults on his repayments
- Investors anticipate this possibility, and they do not finance the firm in the first place.

Solution: large owners

- Small investors face a free-rider problem with respect to management control
- With concentration of ownership there is an increasing match between control rights and cash flow right
- Therefore, large investors require less legal protection than small investors to protect their interest
- This is at the cost of large investors expropriating small investors

Solution: legal protection

- Voting rights: elect board of directors, and vote on important corporate decisions (e.g. mergers and acqusitions).
- Shareholders' voting rights often correspond to the capital they put at risk: 1 share - 1 vote
- Limitations on shareholder influence:

  Difficult to remove board members

  Incumbent influence on director nomination process

  Little control over executive compensations

  Lack of timely and adequate information

Large owners versus legal protection

Shleifer and Vishny (1997):

- Less legal protection leads to large owners: more family and insider dominated firms with little external financing
- Increased legal protection facilitates more diffuse ownership

Thus, large owners and legal protection are complementary governance mechanisms

Solution: codes of practice

- Codes of practice usually elaborate and supplement the requirement of corporate law
- Involve self-imposed constaints on management, and the structure and work of the board of directors
- Voluntary compliance (may require explanation for non-compliance)
- In Norway we have "Norsk anbefaling for eierstyring og selskapsledelse" (NUES): aims to clarify the respective roles of shareholders, board of directors and executive officers beyond the requirements of the legislation

Conclusion

- The separation of management of finance leads to the agency problem: the difficulty financiers have in ensuring that their funds are not expropriated or wasted on unattractive projects
- Corporate governance deals with the various approaches to solve this problem
- Corporate social responsibility arises from the relation between the firm and stakeholders *other than* financiers

Answer to case question

Fisher-Varden and Thorburn (2009):

- Firms that became members of the US *Climate Leader* initiative, experienced a drop in their stock price when they announced:

  participation (on average 0.9%),

  specific emission reduction targets (on average 1.3%)

- The likelihood that a firm joins the programme decreases with the firm's corporate governance quality

Thus, commitment to the programme resulted in a reduction in shareholder wealth, and CEOs with less shareholder oversight are more likely to join

References

Fisher-Varden, K. and K. S. Thorburn (2009). "Voluntary corporate environmental initiatives and shareholder wealth." *mimeo*.

Shleifer, A. and R. W. Vishny (1997). "A survey of corporate governance." *Journal of Finance*, **52**, 737–783.