Investor Protection and Corporate Governance[1]

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Abstract.

Recent research on corporate governance has documented large differences between countries in ownership concentration in publicly traded firms, in the breadth and depth of financial markets, and in the access of firms to external finance. We suggest that there is a common element to the explanations of these differences, namely how well investors, both shareholders and creditors, are protected by law from expropriation by the managers and controlling shareholders of firms. We describe the differences in laws and the effectiveness of their enforcement across countries, summarize the consequences of these differences, and suggest potential strategies of reform of corporate governance. We argue that the legal approach is a more fruitful way to understand corporate governance and its reform than the conventional distinction between bank-centered and market-centered financial systems.

1. Introduction.

Some developed countries, such as the United States and the United Kingdom, have extremely broad and valuable stock markets, with thousands of listed securities. Other equally developed countries, such as France and Germany, have much more narrow and less valuable markets relative to their national economies. In some countries, such as Germany and Japan, firms can (privately) borrow money a lot more easily than in others, such as Italy or France. In some countries, such as the United States and Japan, the ownership of corporate shares is widely dispersed. In others, such as Spain and Sweden, it is much more concentrated. What explains these differences? In this paper, we suggest that there is a common element to the explanations: namely, how well investors in different countries, both shareholders and creditors, are protected from expropriation by the controlling shareholders and managers of firms.

When investors finance firms, they face a risk, and sometimes near certainty, that the

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returns on their investments will never materialize because the controlling shareholders or managers simply keep them. (For now, we simply refer to both managers and controlling shareholders as "the insiders.") Corporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by the insiders. Expropriation can take a variety of forms. In some countries, the insiders of firms simply steal the earnings. In other countries, the arrangements they go through to divert the profits are more elaborate. Sometimes the insiders sell the output or the assets of the firm they control, but which outside investors have financed, to another entity they own at below market prices. Such transfer pricing and asset stripping have largely the same effect as theft. In still other instances, expropriation takes the form of installing possibly underqualified family members in managerial positions, or excessive executive pay. In general, expropriation is very closely related to the agency problem first described by Jensen and Meckling (1976), who focus on the consumption of "perquisites" by managers from the firm's profits. It simply means that the insiders use the profits of the firm to benefit themselves rather than return the money to the outside investors.

Extensive expropriation severely undermines the effectiveness of a financial system. When potential investors expect the insiders to expropriate them, they do not finance firms through either debt or equity, making it hard or impossible for entrepreneurs to fund even attractive investment projects. Projects that are financed are those conducted by firms with sufficient internal funds, which are not necessarily the most attractive projects for society. Overall, too few projects are financed, and not necessarily the right ones. And when investment is insufficient and misallocated, productivity and economic growth suffer.

How can expropriation be limited? The principal limitation is the protection of outside investors – whether shareholders or creditors through the legal system, meaning both laws and their enforcement. Although a reputation can help raise funds, law and its enforcement are central to understanding corporate governance in most countries. Potential shareholders and creditors finance firms to a significant extent because their rights are protected by the law. These outside investors are more vulnerable to expropriation, and therefore more dependent on the law, than either the employees or the suppliers, who remain continually useful to the firm and hence are at a lesser risk of being mistreated.

The legal approach to corporate governance is a natural continuation of the field as it developed over the last 40 years. Modigliani and Miller (1958) think of firms as collections of investment projects and the cash flows these projects create, and hence naturally interpret securities, such as debt and equity, as claims to these cash flows. They do not focus on why the managers would return the cash flows to investors. Jensen and Meckling (1976) point out that the return of the cash flows from projects to investors cannot be taken for granted, and that the

Jensen and Meckling view financial claims as contracts that give outside investors certain claims to the cash flows. In their model, the limitation on expropriation is the residual ownership of profits by entrepreneurs that enhances their interest in dividends relative to perquisites.

Research by Grossman, Hart and Moore, summarized in Hart (1995), makes a further key advance by focusing squarely on investor power vis a vis the insiders, and distinguishing between the contractual and the residual control rights that investors have. Economists have used this idea to model financial instruments not in terms of their cash flows, but in terms of the rights they give their holders. In this framework, investors get cash flows because they have power. This may be the power to change directors, to force dividend payments, to stop a project or a scheme that benefits the insiders at the expense of outside investors, to sue directors and get compensation, or to liquidate the firm and receive the proceeds. Unlike in the Modigliani-Miller world, changing the capital structure of the firm changes the allocation of power between the insiders and the outside investors, and thus almost surely changes the firm

But what determines the control rights of the various participants in the firm, especially the outside investors? Our view is that the legal rules and the effectiveness of their enforcement shape these rights. When the rules -- such as the voting rights of the shareholders and the reorganization and liquidation rights of the creditors -- are extensive and well enforced by regulators or courts, investors are willing to finance firms. When the rules and their enforcement do not protect investors, corporate governance and external finance do not work well.

One way to think about this is that legal protection of outside investors makes the expropriation technology less efficient. At the extreme of no investor protection, the insiders can steal a firm's profits perfectly efficiently. Without a strong reputation, no outsider would finance such a firm. As investor protection improves, the insiders must engage in more distorted and wasteful diversion practices, such as setting up intermediary companies into which they channel profits. Yet these mechanisms are still efficient enough for them to want to divert a lot. When investor protection is very good, the most the insiders can do is overpay themselves, put relatives in management, and undertake some wasteful projects. After a point, it may be better just to pay dividends. As the diversion technology becomes less efficient, the insiders expropriate less, and their private benefits of control diminish. Firms then get outside finance on better terms. By shaping the expropriation technology, the law also shapes the opportunities for external finance.

The legal approach to corporate governance has emerged as a fruitful way to think about a number of questions in finance, including those that opened the paper. In section 2, we discuss the differences in investor protection between countries. In section 3, we summarize the research on the economic consequences of these differences. In section 4, we compare the legal

approach to the more standard approach to comparative corporate governance, which focuses on the importance of banks versus stock markets to explain country differences. In section 5, we discuss corporate governance reform. Section 6 concludes.

2. Investor Protection.

When investors finance firms, they typically obtain certain rights or powers. Creditors get the right to repossess collateral, or to reorganize the firm, when the firm does not pay interest or violates debt covenants. Shareholders get the right to vote on important corporate matters, such as the selection of directors. All outside investors, whether shareholders or creditors, also have the right to receive certain corporate information, and indeed many other rights can only be exercised when they have such information. For example, without accounting data, a creditor cannot know whether a debt covenant had been violated. Absent these rights, the insiders do not have much of a reason to repay the creditors or to distribute profits to shareholders.

All non-controlling investors -- large or small, shareholders or creditors -- need their rights protected. Dispersed minority shareholders require the right to be treated in the same way as other shareholders in dividend policies and in access to new security issues by the firm. The significant but non-controlling shareholders need the right to have their votes counted and respected. Even the large creditors -- investors typically viewed as so powerful that they need relatively few formal rights -- must be able to seize and liquidate collateral, or to reorganize the firm. Without an ability to enforce their rights, investors are likely to end up with nothing even if they hold claims to a significant fraction of the firm

Outside investors rights are generally protected through the enforcement of regulations and laws. Some of the crucial regulations are disclosure and accounting standards, which provide investors with the information they need to exercise other rights. Critical laws cover such rights of the shareholders as the ability to receive dividends on pro-rata terms, to vote for directors, to participate in shareholders meetings, to subscribe to new issues of securities on the same terms as the insiders, to sue directors for suspected wrongdoing including expropriation, to call extraordinary shareholders' meetings, etc. Laws protecting creditors largely deal with bankruptcy procedures, and include measures which enable creditors to repossess collateral, protect their seniority, and make it harder for firms to seek court protection in reorganization. In different jurisdictions, rules protecting investors come from different sources, including company, security, bankruptcy, takeover, and competition laws, but also stock exchange regulations and accounting standards. Enforcement of laws is as crucial as their content. In most countries,

laws and regulations are enforced in part by market regulators, in part by courts, and in part by market participants themselves.

The emphasis on legal rules and regulations protecting outside investors stands in sharp contrast to the traditional "law and economics" perspective on financial contracting. According to this perspective, most regulations of financial markets are unnecessary, since financial contracts take place between sophisticated issuers and sophisticated investors. On average, investors recognize that there is a risk of expropriation, and penalize firms that fail to contractually disclose information about themselves and to contractually bind themselves to treat investors well. Because entrepreneurs bear these costs when they issue securities, they have an incentive to bind themselves through contracts with investors to limit expropriation (Jensen and Meckling 1976). As long as these contracts are enforced, financial markets do not require regulation (Stigler 1964, Easterbrook and Fischel 1991).

Note that even this perspective relies on courts enforcing elaborate contracts, which in most countries cannot be taken for granted. Even holding enforcement quality constant, the issue of whether contracts are sufficient for the functioning of financial markets, or whether more extensive laws and regulations are needed, is largely empirical. The theory is ambiguous. If investors and issuers can cheaply write contracts, including non-standard ones, and if such contracts are enforced by courts no worse than standard rules and regulations, corporate and securities laws are indeed redundant. But if writing customized contracts is expensive, and if courts have limited capacity and/or are corrupt, especially when their discretion is enhanced by non-standard arrangements, then a regulation or a law becomes a valuable public good. As the next section shows, the empirical evidence rejects the hypothesis that private contracting is sufficient. Even among countries with reasonably well functioning judiciaries, those with laws and regulations more protective of investors have better developed capital markets.

La Porta, Lopez-de-Silanes, Shleifer and Vishny (LLSV,1998) discuss a set of key legal rules protecting shareholders and creditors, and document their prevalence in 49 countries around the world. They also create shareholder and creditor rights indices for each country. Using these data, they find evidence of systematic variation in laws, regulations, and enforcement quality across countries. Specifically, commercial legal systems of most countries derive from relatively few legal "families" (David and Brierley 1985). Some countries, such as England, Germany, and France, developed their own legal systems, the latter two based on Roman Law. In the 19th century, these systems spread through the world through conquest, colonization, and more voluntary adaptation. England and its former colonies, including the U.S., Canada, Australia and New Zealand, but also many countries in Africa and South East Asia, ended up with the common law system. France, Spain, the former French and Spanish colonies (including all countries in

whereas French civil law countries have the weakest protection

(LLSV 1998). German civil law countries are in between, although comparatively speaking they have stronger protection of creditors, especially secured creditors. Scandinavian origin countries are similar to the German ones. In general, differences between legal origins are best described by the proposition that some countries protect all outside investors better than others, and not by the proposition that some countries protect shareholders and the others protect creditors.

There are significant differences between countries in the quality of enforcement as well. Unlike legal rules themselves, which do not appear to depend on the level of economic development, the quality of enforcement is sharply higher in richer countries. But here as well, legal origin matters: holding the level of per capita income constant, French legal origin countries have the worst quality of law enforcement of the four legal traditions.

Since family origins play such a large role in shaping the content of the law, and since these families have appeared much before the financial markets have developed, it is unlikely that laws were written largely in response to market pressures. The more plausible view is that important political and historical differences between mother countries shaped their laws. This is not to say that laws never change (in section 5 we focus specifically on legal reform) but rather to suggest that history has been influential in shaping corporate governance systems. How so?

One view, suggested by Finer (1997) and other historians, points to the differences in the relative power of the king and the property owners across European states. In England after -- and arguably before -- the Glorious Revolution, the crown lost control of the courts which came under the influence of the Parliament and the property owners who dominated it. As a consequence, common law evolved to protect private property against the crown. Over time, courts extended such protection of property owners to investors. In France and Germany, by contrast, the Parliaments never dominated the kings, and the State dominated the courts and the property owners. Commercial Codes were adopted only in the 19th century by the two great state builders, Napoleon and Bismarck, to enable the State to better regulate economic activity. As the law evolved, the dominance of the State translated into the more political conception of the

s (1999) findings may not hold outside the OECD. Moreover, their evidence may not be indicative of the political bargain, but rather reflect the historical story we have outlined already, namely that the motivating principle of civil law is greater state interventionism, or *dirigisme* (LLSV 1999). The protection of workers in such countries may be as much evidence of such interventionism as the non-protection of outside investors, with no reference to political bargains.

In sum, the degree of legal protection of investors, through regulations, laws, and the enforcement thereof, varies systematically across countries. But does it matter and if so how? In the next section, we summarize some of the research that addresses these issues.

3. Consequences of Investor Protection.

We discuss three broad areas in which investor protection has been shown to matter.

These include its influence on the ownership patterns of firms, the development of financial markets, and the allocation of real resources.

Ownership Patterns

The focus on expropriation of investors and its prevention has a number of implications for the ownership structures of firms. Consider first the concentration of control rights in firms (as opposed to the dividend or cash flow rights). At the most basic level, when investor rights are poorly protected and expropriation is feasible on a substantial scale, control acquires enormous value since it gives the insiders the opportunity to steal relatively efficiently. If they actually do steal, the so-called private benefits of control, or perquisites as Jensen and Meckling (1976) call them, become a substantial share of the firm value. This observation raises a question: will control in such an environment be concentrated in the hands of an entrepreneur, or dispersed between many investors?

The literature in this area originates in the work of Grossman and Hart (1988) and Harris and Raviv (1988) who examine the optimal allocation of voting and cash flow rights in a firm. The specific question of how control is likely to be allocated has not received an unambiguous answer. On the one hand, entrepreneurs who start companies may not want to give up control by diffusing control rights when investor protection is poor. Perhaps most obviously, to the extent that significant expropriation of outside investors requires secrecy, sharing control with other shareholders may interfere with expropriation (La Porta, Lopez-de-Silanes, and Shleifer, LLS 1999). When investor protection is poor, it may be more profitable for the dominant shareholder to keep complete control. In addition, as suggested by LLS (1999) and shown formally by Bebchuk (1999), when control is dispersed among many investors, it would pay a raider to concentrate it and expropriate other shareholders. Diffuse control structures are unstable when investors can concentrate control without fully paying for it. Relatedly, unless the entrepreneur can get a full price for his control, he may be better off retaining control and expropriating outside investors than wasting this right by dissipating control. For these reasons, firms in countries with poor investor protection should be expected to have concentrated control.

Bennedsen and Wolfenzon (1999) make a countervailing argument. When investor protection is poor, dissipating control between several large investors, none of whom can control the decisions of the firm without agreeing with the others, may serve as a commitment to limit expropriation. When there is no single controlling shareholder, and the agreement of several large investors (the board) is needed for major corporate actions, these investors might together hold enough cash flow rights to choose to limit expropriation of the remaining shareholders and pay the profits out as efficient dividends. When the dissipation of control reduces inefficient

expropriation, it may emerge as an optimal policy for a wealth-maximizing entrepreneur deciding on what to do with control. This prediction differs from Bebchuk
control can be acquired without fully paying for it, and here it cannot.

If an entrepreneur chooses to retain control over the firm, he has a number of ways of doing so. He can sell shares with limited voting rights to the outsiders, and retain control by holding on to the shares with superior voting rights. He can use of pyramidal structure, in which a holding company controlled by the entrepreneur issues shares in a subsidiary that it itself controls. The entrepreneur can then control the subsidiary without owning a substantial fraction of its cash flow rights (Wolfenzon 1999). An entrepreneur can also keep control by using cross-shareholdings between a group of firms, making it harder for outsiders to gain control of any one firm without gaining control of all of them.

The proposition that control is valued, and especially so in countries with poor investor protection, implies that the measures of the value of control should be higher in these countries. One commonly used measure is the price of the voting rights relative to cash flow rights, or the suitably adjusted premium on the high voting shares relative to the low voting shares (Zingales 1995, Modigliani and Perotti 1998, Nenova 1999). These measures of the value of control should increase as the quality of investor protection deteriorates.

What about the distribution of cash flow rights, as opposed to control, between investors? If an entrepreneur retains control of a firm, how can he raise any external funds from outside investors -- for financing or for diversification -- when they expect to be expropriated? To some extent, even poor investor protection usually does not mean no investor protection at all, and expropriation in most countries is at least somewhat limited by the law. Such limitations make expropriation costly and less attractive to the insiders, and thus leaves something on the table for investors especially if investment opportunities are good (Burkart, Gromb, Panunzi 1998).

In addition, the insiders can commit themselves to limit expropriation even if they retain full control. Most importantly, they can retain some ownership of cash flows themselves, as Jensen and Meckling have shown in 1976. This would reduce incentives for expropriation, as well as enhance incentives for profit maximization. When an entrepreneur retains some cash flow rights, and expropriation of shareholders is sufficiently costly, he would rather pay out dividends that he has to share with the other shareholders, including the minorities, than steal. Cash flow ownership by the entrepreneur serves as a partial commitment to limit expropriation.

Relatedly, cash flow ownership can be concentrated in the hands of outside investors, who then have an incentive to monitor and discipline the entrepreneur or the professional manager (Shleifer and Vishny 1986, Pagano and Roell 1998). To do this, the large outside shareholders need legal rights, such as voting powers or access to takeover technology.

Asia: outside Japan, the top 10 families in each of the remaining 8 countries they study control between 18 and 58 percent of the aggregate value of listed equities.

More anecdotal but dramatic evidence on the concentration of ownership and control in countries with poor investor protection comes from Russia. Russia pursued a mass privatization program in which the ownership of firms was dispersed among small investors (e.g., Boycko, Shleifer and Vishny 1995). Within 2-3 years, minority shareholders have evidently sold their shares to the insiders, resulting in control of most firms by the insiders, just like elsewhere in the world where shareholders are unprotected (Blasi and Shleifer 1996). The recent takeover by Olivetti of Telecom Italia -- a company whose shares were also initially dispersed through

privatization -- suggests that dispersed ownership is unsustainable in today

The evidence also confirms the prediction that voting premia increase as shareholder protection deteriorates. The early studies of individual countries show that the voting premia are high in countries with poor investor protection, such as Italy (Zingales 1994), and low in countries with good protection, such as the U.S. (Zingales 1995). Nenova (1999) analyzes a cross-section of 15 countries using the LLSV (1998) measures of shareholder protection, and finds that countries with better protection of shareholders have a lower voting premium.

In sum, the evidence has proved to be broadly consistent with the proposition that the legal environment shapes the value of the private benefits of control, and therefore determines the equilibrium ownership structures. Perhaps the main implication of this evidence for the study of corporate governance is the relative irrelevance of the Berle and Means corporation in most countries in the world, and the centrality of family control. Indeed, LLS (1999) and Claessens et al. (1999) find that family-controlled firms are typically managed by family members, so that the professional managers appear to be kept on a tighter leash than what Berle and Means describe. In large corporations of most countries, the fundamental agency problem is not the Berle and Means conflict between outside investors and managers, but rather that between outside investors and controlling shareholders, who in particular have nearly full control over the managers (Shleifer and Vishny 1997).

Financial Markets

The most basic prediction of the legal approach is that investor protection encourages the development of financial markets. When investors are protected, they pay more for securities, making it more attractive for entrepreneurs to issue these securities. This applies to both creditors and shareholders. Creditor rights encourage the development of lending, and the exact structure of these rights may alternatively favor bank lending or market lending. Shareholder rights encourage the development of equity markets, as measured by the valuation of firms, the number of listed firms (market breadth), and the rate at which firms go public. For both shareholders and creditors, protection includes not only the rights written into the laws and regulations, but also the effectiveness of their enforcement. Markets that protect investors should be the more developed ones.

Consistent with these predictions, LLSV (1997) show that countries that protect shareholders have more valuable stock markets, larger numbers of listed securities relative to the population, and a higher rate of IPO activity than do the unprotective countries. For example, in 1994, the ratio of external (non-controlling shareholder owned) stock market capitalization to GDP was on average 60% in common law countries, and 19% in French civil law countries (the

world average was 40%). Common law countries averaged 2.23 IPOs per million people in a year, but French civil law countries only .28 of an IPO (the world average was 1.02). Similarly, countries that protect creditors better have a higher ratio of private debt to GDP. This ratio was 68% in common law, 56% in French civil law, and 97% in German civil law countries.

Johnson et al. (1999) draw an ingenious connection between investor protection and financial crises. In countries with poor protection, the insiders might treat outside investors well as long as future prospects are good and they are interested in continued external financing. However, when future prospects deteriorate, perhaps in a crisis, the insiders step up expropriation, and the outside investors – whether shareholders or creditors are unable to do anything about it when investor protection is poor. This escalation of expropriation renders security price declines in countries with poor investor protection especially deep. To test this hypothesis, Johnson et al. examine the depreciation of currencies and the decline of the stock markets in 25 countries during the Asian crisis of 1997-1998. They find that governance variables, such as investor protection indices and measures of the quality of law enforcement, are powerful predictors of the extent of market declines during the crisis. These variables explain the cross-section of declines much better than the macroeconomic variables that have been the focus of the policy debate. Again, the evidence bears out the predictions of the theory.

Real Consequences

Through its effect on financial markets, investor protection influences the real economy. Financial development can accelerate economic growth in three ways (Beck, Levine and Loayza 1999). First, it can enhance savings. Second, it can channel these savings into real investment and thereby foster capital accumulation. Third, to the extent that the financiers exercise some control over the investment decisions of the entrepreneurs, financial development improves the efficiency of resource allocation, as capital flows toward the more productive uses. All three channels can in principle have large effects on economic growth.

A large literature links financial development to economic growth. King and Levine (1993) initiate the modern incarnation of this literature by showing that countries with better developed capital markets grow faster in the future. Subsequent work by Demirguc-Kunt and Maksimovic (1998), Levine and Zervos (1998), Rajan and Zingales (1998), and Carlin and Mayer (1999) extends these findings. Rajan and Zingales (1998) and Carlin and Mayer (1999) show that the association between external finance and growth holds even at the industry level. Several papers also show that an exogenous component of financial market development, obtained by using legal origin as an instrument, predicts economic growth.

More recent research distinguishes the three channels through which finance can contribute

to growth: saving, factor accumulation, and efficiency improvements. Beck, Levine and Loayza (1999) find that banking sector development exerts a large impact on total factor productivity growth, and a less obvious impact on private savings and capital accumulation. Moreover, this influence continues to hold when an exogenous component of banking sector development, obtained using legal origin as an instrument, is taken as a predictor. Wurgler (1999) finds that financially developed countries allocate investment across industries more in line with growth opportunities in these industries than the financially undeveloped countries. This research suggests that financial development improves resource allocation, and that through this channel, investor protection benefits the growth of productivity and output.

Summary

The research described in this section has a number of implications for the study of financial markets. First, it shows that the most developed financial markets are the ones that are protected by regulations and laws. It does not tell us what the best form of regulation is, which may well include self-regulation as well as government regulation. Still, totally unregulated financial markets do not work well, presumably because they allow too much expropriation of outside investors by corporate insiders. One dramatic illustration of this phenomenon, stressed by Coffee (1998), is the fact that the most sought after place in the world for listing by publicly traded companies happens to be New York City a heavily regulated exchange when it comes to disclosure and protection of minority shareholders -- rather than Mexico City.

Second, improving the functioning of financial markets has real benefits both in terms of overall economic growth and for the allocation of resources across sectors. Finally, one broad strategy of effective regulation, and of encouragement of financial markets more generally, begins with protection of outside investors, whether they are shareholders or creditors.

This analysis raises a number of questions for reform. How can a policy maker try to improve markets? What reforms are good? We address these questions in section 5, but first pause and examine an alternative approach to the study of corporate governance.

4. Bank and Market Centered Governance.

Traditional comparisons of corporate governance systems focus on the institutions financing firms rather than on the legal protection of investors. Thus, bank-centered corporate governance systems, such as those of Germany and Japan, are compared to market-centered systems, such as those of the U.S. and the U.K. (e.g., Allen and Gale 1999). Relatedly, relationship-based corporate governance, in which a main bank provides a significant share of finance and governance to each firm, is contrasted with market-based governance, in which finance

is provided by large numbers of investors and takeovers play a key governance role.

These institutional distinctions have been central to the evaluation of alternative corporate governance regimes, and to policy proposals for improvement. In the 1980s, when the Japanese economy could do no wrong, bank-centered governance was widely regarded as superior (Aoki and Patrick 1993). It enabled firms to focus on the long term in making investment decisions because main banks were far-sighted (Porter 1992). It delivered capital to firms facing liquidity shortfalls, thereby avoiding costly financial distress (Hoshi, Kashyap and Scharfstein 1991). It replaced the expensive and disruptive takeovers with more surgical bank intervention when the management of the borrowing firm underperformed. In the 1990s, as the Japanese economy collapsed, the pendulum swung the other way. Far from being the promoters of rational investment, Japanese banks were the source of the soft budget constraint, over-lending to declining firms that needed radical reorganization (Kang and Stulz 1998). Far from facilitating governance, these banks colluded with enterprise managers to deter external threats to their control and to collect rents on bank loans (Weinstein and Yafeh 1998, Morck and Nakamura 1999). German banks were likewise downgraded as ineffective providers of governance (Edwards and Fischer 1994). Market-based systems, in contrast, rode the American stock market bubble of the 1990s into the stratosphere of wide support and adulation.

Unfortunately, the classification of financial systems into bank- and market-centered is neither straightforward, nor particularly fruitful. To begin, one way to classify is by looking at the actual outcomes. It is easy to classify Germany as bank-centered since it has powerful banks that influence firms through both debt and equity holdings, and an underdeveloped stock market. But what about Japan, which combines powerful banks with substantial control over firms and a highly developed and widely-held equity market (2nd or 3rd in the world by size), with thousands of listed securities? Or what about the French-Civil-Law-based financial systems, in which neither credit markets not stock markets are particularly well developed? In Italy, for example, the stock market is extremely underdeveloped, but so is the banking system, and a typical firms raises a small amount of money from each of a large number of banks (Sapienza 1999). More generally, LLSV (1997) show that, on average, countries with bigger stock markets also have higher ratio of private debt to GDP, contrary to the view that debt and equity finance are substitutes. The prevalent financing modes generally do not help with the classification.

Another way to classify financial systems is based on the existence of Glass-Steagall regulations, which restrict bank ownership of corporate equity. This approach is again useful for distinguishing the U.S., which has such regulations, from Germany, which does not. On the other hand, most countries in the world do not have Glass-Steagall regulations. Some of them, like the U.K., have an extremely developed stock market and few equity holdings by banks, even though

banks are not prevented from holding equity by law. Others have neither a developed banking system nor a developed stock market. Glass-Steagall regulations in themselves do not assure a development of a market system by interfering with corporate governance by banks. Consistent with our scepticism about the usefulness of such regulations for classifying financial systems, LLS (1999) show that Glass-Steagall regulations have no predictive power for ownership concentration across countries.

Perhaps most importantly, the reliance on either the outcomes or the Glass-Steagall regulations to classify corporate governance regimes misses the crucial importance of investor rights. All financiers depend on legal protection to function. A method of financing develops when it is protected by the law that gives financiers the power to get their money back. Germany and other German Civil Law countries have a well-developed banking system because they have strong legal protection of creditors, particularly of secured creditors. Without such rights, German banks would not have much power. The U.K. also has a large banking and public debt sectors, again because creditors have extensive rights, as well as a large equity market. Italy and Belgium, in contrast, have developed neither debt nor equity markets because no outside investors are protected there. The point here is simple: all outside investors -- large or small, creditors or shareholders -- need rights to get their money back. Investor rights are a more primitive determinant of financial market development than the size of particular institutions.

Hard as the classification of financial systems as bank or market centered is, the question of which one is "better" is even harder. Rajan and Zingales (1999) suggest that bank-centered systems have a comparative (rather than an absolute) advantage in countries with poor investor rights. In such countries, banks possess tremendous power over borrowers through monopoly over information and perhaps other means, and hence can force repayment even with fairly limited rights. When put at the mercy of these monopoly banks, firms also develop reputations for paying back. In these regimes, monopoly bank lending works better than equity financing.

One prediction of this theory is that monopoly banking should appear in countries with poor shareholder protection. Within OECD, however, firms in countries with weak shareholder protection, such as Belgium and Italy, on average use more rather than fewer banks each than do firms in countries with better protection, such as the U.S. and the U.K. (Volpin 1999). Perhaps, then, this comparative advantage argument is more appropriate for emerging markets. It may thus be the case that, at early stages of development, when disclosure is limited and courts do not work well, monopoly banking is the only workable source of private outside financing. But this is hardly a general endorsement of this arrangement. First, as Rajan and Zingales (1999) themselves indicate, there are many efficiency problems with monopoly banking, and the thrust of academic research has shifted toward finding fault rather than virtue in this model (Rajan 1992,

Burkart, Gromb, Panunzi 1997). Second, even this model relies on some legal powers of the banks. If the banks have no legal powers, as in Colombia or the Phillippines, there would be no monopoly bank lending either. In the end, the rights create finance.

The emphasis on monopoly bank lending also distracts attention from the important role that stock markets play in external finance. Equity financing is essential for the expansion of new firms, whose main asset is growth opportunities. In principle, firms could utilize private equity financing, but it has many of the same problems of excessive investor power suppressing entrepreneurial initiative as monopoly banking does (Myers 1977, Burkart, Gromb, Panunzi 1997). Public equity financing, for which a developed stock market is needed, has other advantages over private equity financing. It allows the buyers of equity to diversify. It offers the initial equity holders, such as venture capitalists, an attractive exit option through the public equity markets. Last but not least, it allows firms to time their equity issues to take advantage of favorable investor sentiment toward their industry, or the market as a whole. Such sentiment may play a beneficial role when shareholders are skeptical about the likelihood of getting back a return on their money. Indeed, Keynes (1931) and others have argued that bubbles play an important and positive role in stimulating investment.

To summarize, bank- versus market-centeredness is not an analytically useful way to distinguish financial systems. Investor rights work better to explain differences between countries. Moreover, even if monopoly-banking is a stage through which some countries go in their development process, this stage has little to recommend it other than as a stepping stone toward more developed markets. And to get to more developed markets, it is essential to improve the rights of outside investors. Doing so strikes the balance between making outside investors too powerful and thus dulling entrepreneurial incentives, and making them too weak and unwilling to invest in the first place.

5. Possibilities of Reform.

In the last decade, the reform of corporate governance has attracted interest in Western and Eastern Europe, Latin America and Asia. The proposals of how to make governance better have covered a broad range of areas. The Cadbury Committee (Charkham 1994) focuses on the reform of the boards of directors. The European Corporate Governance Network (1997) advocates improved disclosure, although Berglof and von Thadden (1999) note that this initiative has not been implemented successfully in the European Community. In the wake of the emerging markets crisis, several Latin American and Asian countries are reforming bankruptcy, disclosure, and several other aspects of governance, yet progress has been tentative there as well.

To discuss any reform, it is important to start with its goals. Our analysis suggests that the objective of corporate governance reform in most countries is to protect the rights of outside investors, including both shareholders and creditors. As the evidence shows, the benefits of such reform would be to expand financial markets, to facilitate external financing of new firms, to move away from concentrated ownership, and to improve the efficiency of investment allocation. So what, if anything, can be done to achieve this goal, and what are the obstacles?

To organize this discussion, we follow Coffee (1998) in drawing a distinction between legal and functional convergence. Legal convergence refers to the changes in the rules and in enforcement mechanisms toward some desirable standard. To achieve legal convergence to effective investor protection, most countries require extensive legal, regulatory, and judicial reform. Alternatively, functional convergence refers to more decentralized, market-based changes, which do not require legal reform per se, but still bring more firms and assets under the umbrella of effective legal protection of investors. We discuss these paths of reform in turn.

For most countries, the improvement of investor protection require rather radical changes in the legal system. Security, company, and bankruptcy laws would generally need to be amended, and the regulatory and judicial mechanisms of enforcing shareholders and creditor rights would need to be radically improved. There is no reason to think that the particular list of legal protections of investors developed by LLSV (1998) is either necessary or sufficient for such reforms. In principle, some mechanisms relying on private action by outside investors -- such as giving shareholders the right to a class action suit against directors -- could work powerfully even in an environment where other shareholder rights are missing. On the other hand, the evidence on the importance of the historically determined legal origin in shaping investor rights -- which could be thought of as a proxy for the law s general stance toward outside investors -- suggests at least tentatively that many more rules need to be changed simultaneously in countries with poor investor protection to bring them up to best practice.

Effective legal reform runs into tremendous political obstacles. Perhaps the most important objections come from the families that control large corporations in most countries. From the point of view of these families, an improvement in the rights of outside investors is first and foremost a reduction in the value of control, as expropriation opportunities deteriorate. The total value of these firms may increase as a result of legal reform, as expropriation declines and investors finance new projects on more attractive terms. Still, the first order effect on the insiders is a massive redistribution of wealth from them to the outside investors. No wonder, then, that in all countries -- from Latin America, to Asia, to Western and Eastern Europe -- the families are opposed to legal reform. As Hellwig (1999) describes the attitude of German industrialists to

corporate governance reform: "You can wash my face but do not get it wet.
opposed transparency and other governance reforms in the European Community.

There is a further reason why the insiders in major firms oppose corporate governance reform and the expansion of capital markets. Under the status quo, the existing firms can finance their own investment projects internally or through captive or closely connected banks (Mayer 1988). In fact, LLSV (1997) show that the lion share of credit in countries with poor investor protection goes to the few largest firms. As a consequence, the large firms obtain not only the finance they need, but also the political influence that comes with the access to such finance, as well as the security from competition that could come if smaller firms could also raise external capital. When new entrepreneurs have good projects, they often have to come to the existing firms for capital. Poor corporate governance delivers the insiders not only secure finance, but also secure politics and markets. They thus have an interest in keeping the system as is.

In some countries, the opposition to reform from the existing controlling shareholders is supplemented by that from the protected parts of the labor force. The losers in the existing arrangements are the new entrepreneurs who cannot raise external funds to finance new investment, and the parts of the labor force lacking access to the privileged jobs.

Consistent with these apparent difficulties of reform in the context of interest group politics, the successful reforms have only occurred when the special interests could be destroyed or appeased. In this respect, corporate governance reform is no different from most other reforms in developing or developed countries (Hirschman 1963). One example of successful legal reform of corporate governance is Japan after World War II, where General McArthur, assisted by attorneys from Chicago and an occupying army, introduced an Illinois-based company law in Japan (Ramseyer and Nakazato 1999). The result has been a tremendous expansion of equity markets to Japan, despite the common designation of Japan as a bank-centered system. When General Pinochet reformed the financial system in Chile by improving transparency and investor rights, markets there grew rapidly also.

Without military intervention, corporate governance reforms occur under fairly special circumstances. One instance is the transition from socialism, where legal rules protecting investors can sometimes be introduced before concentrated control over firms, and the attendant opposition to reform, is established. A striking example of such a reform is the introduction, in the early 1990s, of a tough securities law in Poland, modeled on the U.S. regulations. The law provided for a creation of a powerful SEC with significant enforcement powers which did not require a reliance on courts. This reform was followed by remarkable growth of the Polish stock market. By contrast, the Czech government failed to introduce effective securities laws or to create a powerful market regulator at the time of privatization. As a consequence, markets

and regulators had to cope with powerful banks and mutual funds expropriating minority shareholders. Their opposition to reform, as well as the government
severely undermined the development of the Czech financial markets (see Coffee 1998, Pistor 1998, Johnson and Shleifer 1999). The comparison of Poland and the Czech Republic is an almost perfect experiment, since the two countries share roughly similar incomes, economic policies, and quality of judiciaries. Yet they had radically different experiences with financial development because Poland protected investors and the Czech Republic did not.

Another important lesson for reform comes from Russia, where the protection of outside investors has been poor despite the fact that, according to most criteria, Russia has a good securities law, a good bankruptcy law, and a good company law on the books. It also has an independent and aggressively-minded SEC. Yet, unlike the Polish SEC, the Russian regulator has relatively few enforcement powers. With a relatively ineffective judiciary, the mechanisms of enforcement of either laws or regulations are weak, and blatant violations of the law are common. The ineffectiveness of enforcement has kept Russia s financial development significantly behind that of most East European countries.

One way to introduce reforms protecting investors without upsetting the incumbent insiders is to apply regulations only to new firms. In this way, the entrepreneurs who wish to raise capital benefit, and the insiders of the existing firms do not lose. This has been recently done in Germany, with the creation of the Neuer Markt as part of the Frankfurt Stock Exchange (Johnson 1999). Companies wishing to list on the Neuer Markt, unlike the already listed German firms, have to comply with international accounting standards. The new listing venue -- with its greater legal restrictions on the entrepreneurs -- sharply accelerated the pace of initial public offerings in Germany.

From the economic perspective, improving creditor rights is harder than improving shareholder rights. Unlike minority shareholders, different creditors want different things. Senior creditors, especially secured senior creditors, prefer rapid liquidation of bankrupt firms. Junior creditors and shareholders, whose claims are less secure, may prefer more orderly liquidation or even reorganization. These conflicts have assured that most countries have opted for rather slow, reorganization-focused bankruptcy schemes rather than liquidations (Hart 1999).

On the other hand, improving creditor rights should be politically easier than that of shareholder rights, since banks are politically influential and should be interested in expanding their power. However, banks are often government-owned, or belong to financial groups controlled by the same families as the potentially bankrupt firms. This makes banks less interested in streamlining bankruptcy. Moreover, commercial banks in many countries are periodically

bankrupt themselves. From the perspective of such banks, improving creditor rights has two disadvantages: first, banks may have to recognize their bad loans as part of initiating bankruptcy procedures, thereby pushing themselves into liquidation; and second, creditor rights might be used against such banks by their own creditors. As a consequence, banks in most countries have not become champions of creditor rights.

Creditor rights reform is also made difficult by the fact that bankruptcy procedures almost inevitably rely on courts. Poor enforcement of bankruptcy rules by courts makes creditor rights in most developing countries especially weak. Courts in many countries are reluctant to get involved in matters as complicated as the resolution of financial distress, especially when the rules of the resolution are changing. As an illustration, several East Asian countries, including Indonesia and Thailand, have reformed their bankruptcy laws in the aftermath of the Asian crisis. The anecdotal evidence, however, indicates that this legal reform has had only limited success so far, largely because courts are politicized and not ready to adopt the new procedures, and throw out most creditor applications -- especially those against powerful borrowers -- on technicalities.

Despite these difficulties, there are signs that the situation is changing, in part because capital market integration has introduced new political actors into the discussion. These include foreign investors -- both shareholders and creditors -- who have demanded better protection of their rights in the aftermath of the Asian crisis, and who are often supported by the international financial institutions, such as the IMF and the World Bank. While the voice of these investors would in general be fairly quiet, it gets heard better when companies and governments desperately need external funds. Indeed, the attempts at bankruptcy reform in several East Asian countries have been partly a response to such external pressure.

In the meantime, "functional convergence" can play a role in improving investor protection. There are several forms of such convergence. Most obviously, if contracts are enforced well, companies in unprotective legal regimes can offer their investors customized contracts, such as corporate charters, with greater rights than the law generally provides. This strategy relies on perhaps a greater contracting capacity of investors and courts than is warranted, and ignores the empirically clear public good benefit of standard rules. A more promising approach is for companies to opt into the more investor friendly legal regimes. One way of doing this is to list a company's securities on an Exchange that protects minority shareholders through disclosure or other means. This, in fact, is done by many companies which list they shares as American Depositary Receipts (ADRs) in New York. But such listing imposes only limited constraints on the insiders: although it improves disclosure, it frequently allows firms to issue ADRs with no voting rights, further undermining minority shareholder protection.

A related mechanism of opting into a more protective legal regime is acquisition by a company already operating in such a regime. When a British company acquires a Greek company, the possibilities for legal expropriation of investors diminish. The controlling shareholders of the Spanish company can be compensated in such a friendly deal for the lost private benefits of control, making them more likely to go along. By replacing the wasteful expropriation with publicly shared profits and dividends, such acquisitions enhance efficiency.

It is important to recognize the limitations of functional convergence, particularly in the area of creditor rights. Assets located in particular countries generally remain under the jurisdiction of these countries laws. Without bankruptcy reform, opt-in mechanisms are unlikely to address the legal problems faced by domestic, and especially foreign, creditors. Despite the benefits of opting into the more protective legal regime for external finance, then, this mechanism is unlikely to fully replace *bona fide* legal reform. Slow and difficult as it is, real legal reform needs to take place in many countries.

6. Conclusion.

This paper describes a potentially useful way of thinking about corporate governance. Our starting point is legal protection of investors, both shareholders and creditors, through the legal rules and the mechanisms of their enforcement. Empirically, strong investor protection is associated with effective corporate governance, as reflected in valuable and broad financial markets, dispersed ownership of shares, and efficient allocation of capital across firms. Using investor protection as the starting point appears to be a more fruitful way to describe differences in corporate governance regimes across countries than some of the more customary classifications, such as bank- or market-centeredness.

An important implication of this approach is that leaving financial markets alone is not a good way to encourage them. Financial markets need some regulation -- whether by law, by agencies, or by market participants themselves. Improving this regulation is a difficult task. In part, the nature of investor protection, and of regulation of financial markets more generally, is deeply rooted in the legal structure of each country, and in the origin of its laws. Reform on the margin may not successfully achieve the reformer s goals. In part, the existing corporate governance arrangements benefit the entrenched economic interests, such as the families that manage the largest firms in most countries in the world. Corporate governance reform must circumvent the opposition by these interests. Despite these difficulties, investor protection reform can bring significant benefits, and is politically feasible in some circumstances. It can take the form of opting into the more protective legal regimes, as well as the more radical change in the legal structure. The integration of world capital markets makes such reforms more likely today

than they have been in decades and perhaps centuries.

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