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DIVERGENCE OR CONVERGENCE: PARADOXES IN CORPORATE GOVERNANCE

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ABSTRACT The study is a review paper to explore the various dimensions of the traditional governance models namely the Anglo-Saxon model and the German-Japan model. The study identifies the different strands of the researches on the various dimensions of these models and also on the possibility, challenges to the convergence of these governance mechanisms. The literature review on corporate governance models suggests that the two mechanisms differ broadly in their internal and external control mechanisms. The review considers agency theory as the fundamental theory explaining the need for governance structures. The traditional models of governance are moving towards a system of 'dual convergence', which is expected to result in a hybrid model inculcating the best of both the worlds. However, the convergence in the true sense does not seem to be possible due to fundamental differences pertaining to cultural, economic, and legal and socio economic aspects confirming the presence of the paradox in the near future. The study explores the arguments in the existing literature about the diverging dimensions of the traditional models. It helps to understand the adaptation of the traditional governance models to the dynamically changing external and internal mechanisms of the firms.

KEYWORDS : Agency Theory, Comparative Corporate Governance, Corporate Governance Models, Convergence, Divergence, and Globalization

1. INTRODUCTION

Globalization of the world economy and the integration of the financial markets have brought the traditional models (Anglo-Saxon Model and the German-Japan Model) of corporate governance at the crossroads. With increasing debate about the convergence of the governance models amongst practitioners and academicians resulting from the economic systems convergence across world and other unseen forces; the objective of the present review paper is to explore the arguments in the existing literature about the diverging dimensions of the traditional models. Convergence refers to the gradual movement of policies and practices towards a common point. The different dimensions of convergence can be source, learning process, principles, content and structures and the perfect alignment among these dimensions promises seamless convergence. Comparative governance literature provides the evidences for the existence of transition systems in the eastern European countries, which are characterized as the midpoint between the completely distinct insider systems and outsider systems .In this context, the review also identifies the forces and challenges to the process of convergence as discussed in the existing literature with an aim to identify the future direction of governance mechanisms, which can have important implications for the corporations across world.

The review paper has been structured as follows: Section II discusses the agency problems as the seed for having governance systems. Section III explains the existing traditional models of governance and their functioning. Section IV articulates the dimensions of the governance models (internal control mechanism and external control mechanism), which make them distinct as documented in the literature. Section V reviews the forces, possibilities and challenges to convergence, with conclusion and implications in the last section.

2. AGENCY THEORY: EXISTENCE OF GOVERNANCE ISSUE

Agency theory is the dominant theory in the corporate governance literature. However, in the absence of an overarching theory, the literature on the corporate governance provides evidences of existence of many competing theories of corporate governance other than agency theory. The major competing theories are stewardship theory, managerial hegemony, resource dependency theory, stakeholder theory and multi governance theory"' .

3. CORPORATE GOVERNANCE MODELS & MECHANISM

Corporate governance mechanism at the macroeconomic level defines the ethics of the game for the business houses in the corporate world. Withdrawal of capital by the investors after the Asian crises compelled the international community to focus on investor confidence and on the basic principles of governance namely transparency, accountability and the fair treatment of shareholders. Corporate Governance refers to the ways in which the suppliers of finance to corporations assure themselves of getting a return on the investments. It can also be defined as the system of laws, rules, and factors that control operations at a company .Corporate Governance mechanism is considered to be the nexus of contracts. Hence the governance mechanism includes the systems pertaining to regulations and laws, which ensure the absence of misbehavior by the agents, efficient and effective utilization of the finances provided by the investors. For instance, the emerging economies (BRICnations) differ from the developed economies on many dimensions such as relation versus rule based governance, ownership structures, institutional development, enforcement of laws and regulations . According to OECD "corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders".

In this type of governance systems the shareholders play a central role in the governance systems. Shareholders, who are the owners of the corporations as they invest funds in the organizations, have the right to control the firms. However, to avoid the conflicts in management of the firms 'Board of directors' is appointed to carry out the managing activities in the business, which is continuously monitored by the shareholders externally. Boards of directors in turn delegate the managing activities to the management of the company and closely monitor and evaluate their performance. In such type of model, the effectiveness of internal control systems of the organization is heavily dependent on the board of directors as the "board, at the apex of the internal control system, has the final responsibility for the functioning of the firm and the job of the board is to hire, fire, and compensate the CEO, and to provide high-level counsel".

Essentially, the businesses are not managed with only the shareholder value maximization in mind but also the welfare of other stakeholders such as the employees, creditors, suppliers and community at large. Hence, the stakeholders are at the center of the governance systems and do not focus aggressively on the market value maximization objective. The corporations in the model are characterized by the large block of shareholding controlled by the large institutions such as financial institutions, banks and public shareholding. The corporations not only focused on value maximization for the fund providers but also the society at large. In this type of mechanism the corporations are also not prone to hostile takeovers unlike the corporations in the market based governance systems. The model is characterized by the system of governance wherein the board exists in two parts namely, the management board and supervisory board without the overlap of the members of these boards.

Essentially, in reality, the governance models across globe adopted by various countries do not belong to the two extreme ends of the continuum, rather they lie somewhere in between these two extremes according to the legal, social, economic and cultural dimensions of the nations. Also at the same time both the models of governance are not perfect in their own sense and are not ideal to be considered as the best model.

4. DIVERGENT DIMENSIONS: CORPORATE GOVERNANCE MODELS

Often, the researchers have viewed the governance mechanism to be classified into two categories namely: Mechanisms internal to the firm and external to the firm.

4.1 Internal Mechanism:

It is presumed that the higher number of outside directors increases the board independence. The emerging economies are characterized by the family based systems, concentrated ownership, pyramidal structures and lesser-developed capital markets. In the context of emerging economies with a special reference to the Turkish listed firms, suggested that the firms have smaller boards with non-executive members and occasion CEO duality. The studies suggest that in reasonable number of German firms there is no separation of ownership and control because "managers own" and "owners manage". An inverse U shaped relationship had been found between the firm value of the German firms and the employee representation on the board. The two tier boards dominate the German-Japan model of governance with a clear distinction between the supervisory board (consisting of employees and shareholders) and the management board (includes the executive directors).

Managerial Incentives:

The reforms in the governance models suggest that the German firms are moving towards the increased variable pay component in the CEO compensation structure. The author also suggested an inverse 'U'-shaped relationship between ownership concentration and governance reform. However, the compensation structure of executives in the U.S. has undergone similar reforms much earlier. Apart from the manifold increase in the compensation structure, the contribution of option based compensation has increased to even higher degree. The increase in the equity-based compensation in U.S has invited discussions both in favors of and against the shift. The academic as well as corporate community emphasized the shift to be as favorable as it is expected to align the interest of the shareholders and the management, while the counter argument suggests the increase in the conflict of interest between the two parties. Empirical studies have found a negative relationship between the degree of stock holder control and managerial remuneration suggesting that concentrated ownership leads to lower managerial remuneration.

Capital Structure:

With reference to the ownership control and capital structure the Anglo-Saxon model of governance essentially have dispersed ownership, hence weak monitoring by the shareholders while in the German Model the ownership is concentrated resulting into stronger control by the shareholders. Dispersed ownership structures give rise to more agency problems because of lack of incentives to monitor the firm by the dispersed shareholding. Ownership concentration is larger in the Japanese firms with financial institutions holding large blocks of shares than the U.S. firms. Hence, the 'stakeholder model' of corporate governance in Japan depends essentially on the direct monitoring resulting from the concentrated ownership structure than in U.S. The Bank holding Companies Act does not allow banks to participate in the shareholding of the non-financial corporation's on their own account. Another strand of research in corporate governance is the role of debt in the capital structure and its relation to the governance models. Presence of debt in the capital structure reduces the wasteful expenditure in the hands of the managers on one side and increases the interest payment obligations of the firm thus constraining the liquidity. Empirical studies on the role of debt as a governance mechanism has confirmed the disciplinary role of leverage.

4.2 External Control Mechanism

Financial systems: The financial systems are classified into market based and bank based systems. The key differences in the corporate governance systems emanates from the characteristics of two financial systems. Instead of managerial incentive, finance and disciplining as the fundamental distinguishing features of financial systems; ownership and control reflect more variation across countries. Hence the stakeholder model of Continental Europe and Japan is considered to be better equipped in implementing policies involving relations with stakeholders while the Anglo Saxon model is considered to be more responsive to change. That the legal system of a nation is the main antecedent for the efficacy of financial systems.

Legal & Regulatory Mechanism: The legal system is defined as a system which "ensures a minimum of compliance with the stakeholders/shareholders standards of corporate governance". Essentially, the legal system around the globe is divided into Common Law and Civil Law, which defines the rights and the protection mechanism for the investors (majority as well as minority shareholders) in the different financial systems. For instance, India is country common laws country and having a bank based model as compared to Brazil, which is a civil law country with a market based model of governance Research by analyzed the external finance of 49 countries with respect to origin of their legal frameworks to study the quality of legal investor protections, and the quality of law enforcement. The results of the study suggested that the civil law countries are found to have weaker investor protection and the least developed capital markets as compared to common law countries. Hence, the type of the legal system applicable in a country defines the type of corporate governance systems in place in a particular country and might also pose a challenge to the unification of the governance systems around the globe. empirically tested the data on 81 emerging and developed countries and explained the determinants of investor protection and its impact on financial markets across various countries using legal, political and cultural variables. The historical legal origin of the countries affects regulations and laws systematically and differences in the legal rules eventually affect the social and economic outcomes.

5. CORPORATE GOVERNANCE CONVERGENCE: POSSIBILITIES & CHALLENGES

Globalization of world economy and the increased competition in the global markets has resulted into enquiries pertaining to the possibility of convergence of the corporate governance models. The increased reliance of corporations on the external or direct or market finance has resulted in decreased importance of the role of banks, which is also supported by the decrease in the role of institutional investors through crossholdings in Germany and Japan. The major factors contributing to the change are global deregulation leading to expansion of the financial markets with lesser restriction on capital flows; increase in the budget deficit of the industrialized countries forcing them to issue public debt; rise in the value of the financial investments stimulating the investors to go to capital markets; and unprecedented changes in the activities of institutional investors.

The initiatives at various levels by various agencies such as Organization for Economic Co-operation and Development (OECD), has been taken in order to integrate the corporate governance codes across globe by establishing principles for good corporate governance. The changes are taking place in both the market oriented system of corporate governance (such as decrease in the take-over activity in Anglo-Saxon countries) and network oriented system of corporate governance (such as criticisms for the interlocking board seats) and these transitions are analyzed to be converging in character. OECD countries are also showing a pattern

of convergence as the globalization of economies with integration of capital markets have forced the firms to compete in the international markets leading to convergence of product costs, structural organization of the firms and the financing patterns.

Research has been carried on beta and sigma convergence in corporate governance models of a sample of corporate governance ratings for 198 European corporations listed on the FTSE Euro first 300 index. The finding of the study rejected the hypothesis that there is no process of convergence, found a significant difference in the companies having two different models of governance and concluded that institutional factors are important in the convergence process. studied the legal reforms by developing three new corporate governance indices (dealing with different agency problems). The study concluded that there are significant reforms in the regulations since 1990 across all the countries under study, however there were significant differences in the patterns of reforms such as reforms related to creditor protection and investor protection. However, research on the convergence of the corporate governance models suggest a middle path to converging at one of the extremes of the continuum (two models being the extremes of continuum). The fundamental differences pertaining to legal, regulatory, economic and institutional environment of the economies have led to a 'dual convergence' resulting in a hybrid model, which has borrowed, from both stakeholder model and shareholder model of governance.

6. CONCLUSION

The good governance practices tend to positively impact the performance of the firms. Across globe the firms have been continuously working to adapt the best governance practices. The corporate governance models adopted in the various countries over decades have differed on various dimensions such as Board's structure, Ownership patterns etc. due to the unique set of socio-economic, cultural, legal and political dimension of the countries. Although, the researchers suggest that the two models are converging due to prevalence of certain the macro-economic forces, however, it has been suggested the difference in the fundamental frameworks and financial systems of the countries making these corporate governance models are difficult to see a convergence in true sense. However, despite the differences in the legal frameworks and institutional structure, the political, cultural and historical factors play an important role in establishing the good governance. The governance structures at the firm level can be decoupled from the legal and institutional set up of the countries, which provide a possible explanation for the patterns of convergence documented in the literature. For instance, despite weaker enforcement of laws in the emerging economies, the firms are adapting the best governance practices. Dual Convergence of the traditional models is expected to result in a hybrid model addressing the gaps of both the traditional models and borrowing the best of both the worlds. The interplay between the forces to adapt the best governance practices at the firm level and the differences in the legal and institutional frameworks at the macroeconomic level are expected to contribute towards the presence of convergence- divergence paradox in future.

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