EDITORIAL: WOLFGANG DROBETZ

CORPORATE GOVERNANCE – LEGAL FICTION OR ECONOMIC REALITY

In the past few years, corporate governance has become a popular area of discussion in continental Europe. Having been a topic of academic research for a long time in the Anglo-Saxon literature, corporate governance has only recently moved from a special interest into all sections of the corporate sector and the political scene. For example, the recent publication of the German Corporate Governance Code for publicly listed companies has for the first time established a unique standard of "best practice" with rules and recommendations for German publicly listed firms. A similar code for Switzerland has just been passed. There are three principal drivers for an increased demand for good corporate governance. First, the institutionalisation of shareholdings, i.e., the process of accumulation and managing of capital by professional asset gatherers, is a worldwide trend. In particular, Anglo-Saxon institutional investors are important as providers of capital and put pressure on publicly listed companies. This pressure is exercised by either selling shares of those firms that do not follow internationally recognized corporate governance standards ("Wall Street Walk") or by exercising direct control over the incumbent management of the respective firms ("Voice"). While institutional investors in continental Europe have been rather passive in exercising their control rights in the past, they are becoming more and more active. Second, although economies are becoming increasingly global, firms with international operations are still subject to national corporate governance from a judicial perspective. Notwithstanding country-specific legal frameworks, Swiss firms need to adopt internationally recognized corporate governance principles in order to compete efficiently with their peers for capital in the global equity markets. As a result, there is an increasing convergence of corporate governance principles and practices. Continental European governance systems have already converged in some areas toward the Anglo-Saxon model, which among institutional investors is widely regarded as the role model. Finally, the prominent examples of recent corporate collapses give reasons to believe that a firm's valuation does not only depend on the profitability or the growth prospects embedded in its business model, but also on the effectiveness of control mechanisms ensuring that investors' funds are not expropriated or wasted in value-decreasing projects.

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There is a widespread belief that only more stringent laws and regulatory controls can prevent management self-interest and expropriation of outsiders and alleviate governance malfunctions in general. Not surprisingly, therefore, the current corporate governance debate is still heavily dominated by proponents of the legal profession. Given the recent experiences, there is no doubt that adequate legal protection and prosecution capabilities are essential for effective corporate governance. But is it fair to ignore market forces at all? Is there no kind of market self-regulation with regards to severe firm-specific governance deficits? Ever since the early work by MANNE (1965), the corporate finance literature has emphasized the role of mergers and proxy contests, called the market for corporate control, in disciplining managers. While merger and acquisition activities (M&A) are an important aspect of corporate reality in the Anglo-Saxon world, they are much less frequent in continental Europe. Nevertheless, increased shareholder activism, tightened rules and regulation, and additional self-regulation on behalf of market participants in the United States, but also in Europe, are the result of the growing conviction that better corporate governance will deliver higher shareholder value. Accordingly, corporate governance is not only important from a legal point of view, but specifically from an asset pricing perspective. The academic discussion has led to the central hypothesis that better corporate governance reduces the required rate of return of investors and, therefore, a firm's cost of capital. In a nutshell, with adequate disclosure and transparency standards in place, it is ultimately the capital market which rewards good governance practices and punishes bad ones. The intuition behind this notion is easy to grasp. Good corporate governance reduces the agency costs brought about by the separation of ownership and control, e.g., it allows investors to spend less time and resources on monitoring management teams.

To set the stage, corporate governance is important from a "law and finance" view, as shown in a recent empirical study by LEVINE (2001). He argues that the debate should not overly focus on the traditional distinction between market-based systems (such as the United States or the United Kingdom) or bank-based systems (such as Germany and, to a lesser extent, Switzerland). In contrast, the

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issue is the specific environment in which both intermediaries and markets provide sound financial services. The overall level and quality of financial services, as determined by the legal system, improves the efficient allocation of resources and economic growth. As expected, there is a statistically significant positive relationship between financial development and economic growth. Maybe more surprising, the component of financial development explained by the legal rights of outside investors and the efficiency of the legal system in enforcing those rights is and positively linked with long-run growth.

From a more direct financial markets perspective, it must be noted that in integrated world capital markets with no transaction or agency costs of external finance, the traditional Capital Asset Pricing Model (CAPM) predicts that expected returns on equity only depend on the level of covariance risk with the world market portfolio, and corporate governance related differences between countries or individual firms should have no explanatory power. However, in the presence of agency problems, the induced agency costs ought to be important for explaining the cross-section of expected stock returns. In fact, there is now a growing body of literature that shows evidence for the relationship between corporate governance and firm valuation. In the first of a series of articles, LA PORTA, LOPEZ-DE-SILANES, SHLEIFER and VISHNY (1998) show that that countries whose legal rules originate in the common law tradition tend to protect investors considerably more than the countries whose laws originate in the civil-law, and especially the French-civil-law, tradition. Their findings confirms the hypothesis that being a shareholder or creditor in different legal jurisdictions entitles an investor to very different bundles of rights; these right are determined by laws, and are not inherent in securities themselves. In their latest piece of research, LA PORTA, LOPEZ-DE-SILANES, SHLEIFER and VISHNY (2002) provide for the first time empirical evidence that firms in more protective legal environments exhibit higher Tobin‘s Qs (defined as the ratio of market value and replacement value of a firm’s assets). In a similar vein, LOMBARDO and PAGANO (2000) report that stock market returns are positively correlated with measures of the quality of institutions, such as judicial efficiency and rule of law. Controlling for risk and earnings growth, divi-

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dend yields and earnings-price ratios correlate positively with judicial efficiency and rule of law.

Unfortunately, virtually all empirical studies so far have analysed the impact of various legal variables on the cost of capital in a cross-section of developed or emerging stock markets. Rather than looking at the legal environment, which affects all firms equally within a single jurisdiction, an interesting research question is to focus on the relationship between a broad firm-specific corporate governance rating and an individual firm's expected rate of return. The German case is of special interest due to its pronounced difference to Anglo-Saxon countries in many respects of capital market issues. Most important, the German Corporate Governance Code explicitly defines the aims of corporate governance as follows:

> "The purpose of corporate governance is to achieve a responsible, value-oriented management and control of companies. Corporate governance rules promote and reinforce the confidence of current and future shareholders, lenders, employees, business partners and the general public in national and international markets."[1]

This is in strong contrast to the Anglo-Saxon view of corporate governance, where there is no room for the general public. For example, SHLEIFER and VISHNY (1997) merely refer to "the risk which financiers face in assuring that their funds are not expropriated or wasted in value-diminishing projects." Similarly, LA PORTA, LOPEZ-DE-SILANES, SHLEIFER and VISHNY (2000) define corporate governance as "a set of mechanisms through which outside investors protect themselves against expropriation by the insiders". Given this peculiar institutional environment in Germany, and to some extent this is also the case for Switzerland, it seems interesting to analyse the relationship between the cost of capital for individual firms and governance mechanisms, which are mainly concerned with protecting shareholders as opposed to the general public.

One such study in this direction is by GOMPERS, ISHII and METRICK (2001), who construct a „Governance Index" for U.S. firms based on takeover measures that

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are related to stock returns, firm value, profits, sales growth, capital expenditure, and corporate acquisitions. They find that firms with weak shareholder rights are less profitable and have lower sales growth than their peers with strong shareholder rights. In addition, firms with weak shareholder rights have higher capital expenditures and more acquisitions than firms with strong shareholder rights. Another recent study by DROBETZ, SCHILLHOFER and ZIMMERMANN (2002) explores the link for a broad sample of German firms. This study is the first of its kind that constructs a corporate governance rating for German firms, based on a large survey among all segments of the German stock market. The rating includes a wide range of firm-specific and, to a large extent, voluntary governance proxies related to different control mechanisms. It acts as a proxy for the quality of firm-specific corporate governance in different categories, such as general corporate governance commitment, shareholders' rights, transparency, management and supervisory board matters, and auditing. To explore the relationship between firm-specific corporate governance and firm valuation, the resulting governance rating can be related cross-sectionally to fundamental valuation measures, such as dividend yields, price-earnings ratios, and market-to-book ratios. Figure 1 shows the relationship between the governance rating and price-earnings ratios, Figure 2 displays the same analysis for market-to-book ratios.[2]

There is convincing evidence that both price-earnings ratios and market-to-book ratios are positively related to the quality of firm-specific corporate governance. While the explanatory power of a linear regression is only small (5% for price earnings ratios and 10% for market-to-book ratios), the coefficient estimates are positive and highly significant in both cases. The interpretation of these results is straightforward: 'Good' corporate governance (i.e., a high governance rating) leads to higher firm valuations, hence, investors are willing to pay a premium, and 'bad' corporate governance (i.e., a low governance rating) is punished in terms of valuation discounts.

Cost of capital and firm valuation are inherently related. From an asset pricing view, a premium on the current stock price can only be justified if the expected rate of return on equity is reduced. For a given stream of expected dividends,

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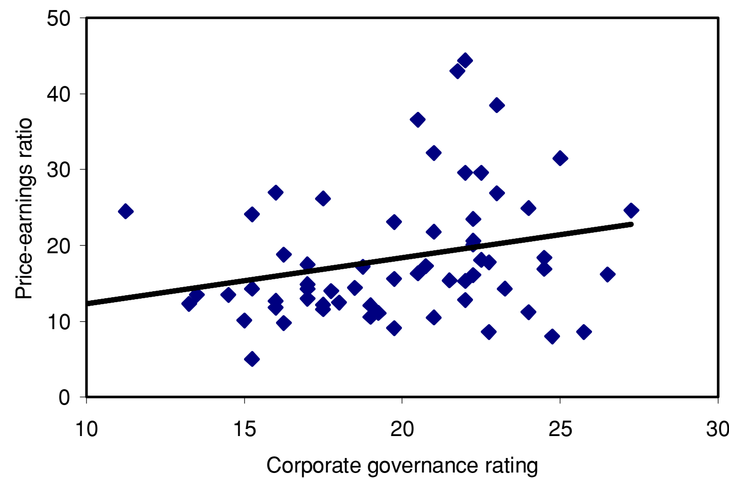
Figure 1: Corporate Governance Rating and Price-Earnings Ratios



simple discounted cash-flow models posit that a firm's valuation is inversely related to the required rate of return on its shares. Therefore, fundamental ratios involving a price variable can also be interpreted as proxies for the cost of capital. Viewed from this perspective, however, several adjustments are necessary. The study by DROBETZ, SCHILLHOFER and ZIMMERMANN (2002) shows that the results in Figures 1 and 2 are robust to a variety of adjustments. Most important, the positive relationship between the firm-specific governance rating and the fundamental ratios holds conditional on differences in market risk and growth prospects. Therefore, the empirical results render an alternative interpretation: 'Good' corporate governance (i.e., a high governance rating) leads to lower cost of capital, and

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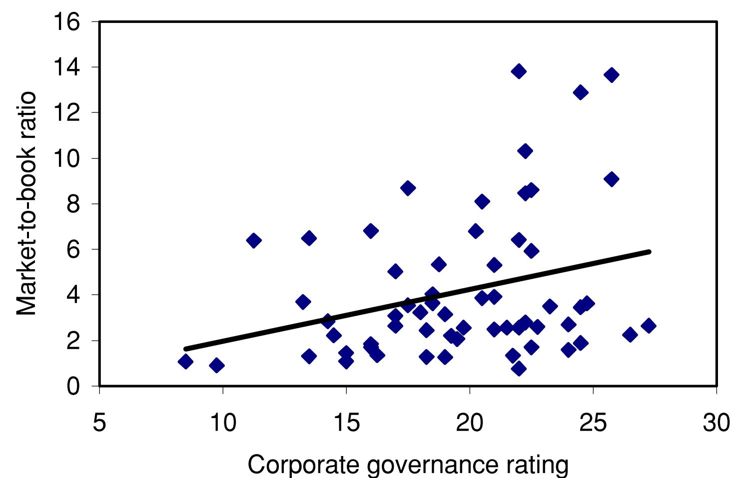
Figure 2: Corporate Governance Rating and Market-to-Book Ratios



'bad' corporate governance (i.e., a low governance rating) implie higher hurdle rates.

To conclude, there are good reasons to believe that adequate legal protection and prosecution capabilities are essential for effective corporate governance. However, corporate governance also matters from an asset pricing perspective. By striving for better governance, firms are able to reduce their required return on equity. Therefore, some caution is necessary as to which governance categories do require further regulation. With adequate disclosure and transparency standards in place, the ultimate verdict is out for the capital markets. In addition, it can be expected that professional investors will become more active in shareholder

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engagement programs in the future also in continental Europe. This may ultimately lead to higher expected returns and lower valuations for those firms with governance deficits, since investors want to be compensated for their increased-monitoring and second opinion activities. Similarly, by removing certain governance malfunctions, large investors are able to achieve higher valuations for their assets, because their required return becomes lower.

Corporate governance should be understood as a chance rather than an obligation from a firm's perspective. However, there is one caveat to mention. Adequate firm-specific governance standards are not a substitute for the solidity of a firm's business model. Super-transparent disclosure standards cannot replace unproven business models and inexperienced management practices. The fall of "Neuer Markt" in both Germany and Switzerland has taught us this simple lesson with all its consequences.

ENDNOTES:

[1] See the German Corporate Governance Code (http://www.corporate-governance-code.de).

[2] The sample covers 60 firms from all segments of the German stock market. The data is as of March 2002. The governance score ranges from 0 to 30; the maximum score of 30 indicates an outstanding standard of firm-specific corporate governance.

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