Financial sector convergence and corporate governance

Andy Mullineux
Birmingham Business School, The University of Birmingham, Birmingham, UK

Abstract

Purpose – To explore the implications of financial sector convergence for corporate governance systems.

Design/methodology/approach – Globalisation, regulatory harmonisation and pensions reform are driving convergence of bank and market oriented systems of corporate finance towards a hybrid model ("hybridisation"). Given the importance of financial systems in corporate governance, this may lead to convergence of corporate governance systems; legal traditions notwithstanding.

Findings – The growth in the importance of funds (pension, insurance, mutual, hedge, venture capital) and the decline in the importance of bank as shareholders has the potential for forcing convergence in corporate governance if the funds actively use their shareholder (or proxy) voting rights. Data on financial institution voting patterns is required to test the hypothesis.

Originality/value – Hybridisation is increasingly widely recognised, although not universally supported by the data. This paper attempts to draw the implication of the hybridisation process for corporate governance given the breakdown of traditional market and bank-based systems.

Keywords Financial institutions, Economic convergence, Corporate governance

Paper type Viewpoint

Introduction

Since, the early 1970s, there has been substantial liberalisation of the banking sector and financial innovation. The process has been facilitated by re-regulation of banks (Mullineux, 1992), which continue to lie at the heart of all financial systems (Mishkin, 2004). Quantitative and qualitative controls and guidance have been largely replaced in many countries with a price (interest rate) oriented monetary policy and general prudential regulations (Hermes *et al.*, 1998, 2000). The latter include: risk-related capital adequacy requirements (the Basel I accord); deposit insurance schemes (also risk-related in the USA); rules prohibiting overexposure (to individuals, sectors of the economy, or foreign exchange risk) in order to promote portfolio diversification and risk reduction; and rules requiring the holding of adequate reserves to assure liquidity and to make provisions against bad or doubtful debts.

To inform supervision by the authorities, there are confidential disclosure requirements; and to facilitate monitoring by equity and bond holders, there are public disclosure and auditing requirements. In addition, banks and other financial institutions disclose confidential information to credit rating agencies in order to gain ratings that reflect their credit standing and this in turn determines their cost of capital. Finally, to aid comparison in the increasingly global environment, accounting and disclosure rules are in the process of being harmonised and country-based supervisors

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are increasingly sharing information about banks and other financial firms. The general trend is towards establishing a set of rules that encourage banks and other financial institutions to manage their asset and liability portfolio risks effectively. If banks achieve an appropriate balance between risk and return, then depositors will be protected and shareholders will earn an appropriate return. Systemic risk, the risk of destabilising crises in the whole banking or financial system, will be contained, and capital will be more efficiently allocated.

The banking and wider financial markets are rapidly being globalised. The process started in the 1970s with the internationalisation of banking (Pecchioli, 1983). This was followed in the 1980s by a period of rapid innovation in the capital markets, often dubbed securitisation. Securitisation involves both disintermediation, the growth of non-bank-intermediated or direct (from the capital markets) finance, and a process of making loans tradeable on securities markets, using asset-backed securities. The securitisation process continued into the 1990s, and was enhanced by the rapid growth in the use of financial derivatives. In the first decade of the new millennium, securitisation and the use of derivatives look set to continue to grow and to become more widespread. The revised (Basel II) capital adequacy framework is expected to re-enforce this process as a result of the standard risk weightings and internal assessment incentives it entails.

In the 1990s, there was also a progressive relaxation of foreign exchange controls. Some countries moved earlier than others, e.g. the UK in 1979, but relaxation of capital controls has been increasingly encouraged by the IMF as a means of stimulating inward portfolio and direct investment to facilitate economic development. The result has been a rapid growth in overseas portfolio investments by mutual, insurance and pensions funds, with UK and US institutional investors playing a prominent role. Further, the conclusion of the GATS agreement relating to financial services in the mid-1990s encourages the opening of financial sectors in countries around the world to entry by foreign financial institutions. Progress with European financial integration, including EMU and the creation of Euroland, through the Financial Services Action Plan, is encouraging more cross border activity in the financial service sector, including bank branching and cross border alliances and mergers. With some notable exceptions, the merger activity in Europe to date has largely entailed internal consolidation; leading more concentrated national banking systems. These have, however, increasingly faced greater competition from abroad. The USA is probably experiencing the most rapid consolidation, but this is hardly surprising given the highly fragmented banking system that existed in their country at the beginning of the 1990s as a result of strict branching restrictions. At the end of the 1990s, consolidation also began in Japan's banking and wider financial system as a means of resolving bank bad debt problems. This consolidation has proceeded rapidly, fusing 21 lenders into three, hitherto domestically oriented, mega banks.

The picture seems to be one of gradual evolution towards global banks competing on a global stage. This is most advanced in the investment banking sphere, but is likely to become increasingly evident as a result of the internet revolution. Banks can now offer services across borders without a branch network. Entry is thus much easier and competition is consequently intensifying. Retail banks, engaged primarily in deposit taking, the provision of payments services and lending, face competition on both sides of the balance sheet and in service provision. Competition in the provision of loans (home, car, etc.), including that from credit card companies, is clearly increasing. There is also growing competition in the savings market from internet based banks, mutual funds, and the providers of longer term savings instruments such as personal pension products. The big banks have already seen their share of the supply of debt finance to the larger firms decline as the latter switch increasingly to direct finance, tapping the capital (bonds) and money (commercial paper) markets. Increasingly, commercial or retail banks are left supplying commercial loans to small and medium sized enterprises (SMEs). Competition in SME financing is, however, also hotting up in the USA as the big banks attempt to use mailshots based on the analyses of their growing data bases to cherry pick. The UK SME banking market remains uncompetitive, however, due to the existence of a "complex monopoly" (Competition Commission, 2002).

Strategic responses

Banks have been forced to refocus their businesses. Many retail-based banks have diversified into investment banking in order to help their large corporate clients access the money and capital markets. In so doing they have boosted their (broking and market making) fee income to compensate for declining interest-based earnings from loans. The combination of investment and retail banking is sometimes called universal banking and has been the norm in Germany and Switzerland, for example. This has long been permitted in parts of Europe, but was not the custom in the UK (or France before the mid-1960s) and was prohibited in the US post 1933, and in post-war Japan. Japan is in the process of relaxing the restrictions introduced by the US administration after World War II, and the USA repealed the 1933 Glass-Steagall Act, which separated investment and commercial banking, in 1999.

German universal banks commonly hold sizeable shareholdings in non-financial firms. Cross-shareholding between Japanese city banks and other keiretsu member firms are also significant, and cross-shareholding between banks, insurance companies and non-financial firms is also common in Germany, France and Italy, for example. EU banking regulations limit the proportion of a banks capital that can be held as shareholdings in non-financial companies (NFCs) and the current trend is to reduce cross-shareholdings, which raise a number of issues for competition and prudential regulation policy (should banks own non-banks and vice versa?) There are also corporate governance issues and these have come to the fore in the 1990s, leading to pressure on banks to reduce their shareholdings in non-financial firms. The prudential concerns about non-financial firms owning banks relate to the risk of the owning firms exploiting bank depositors by forcing the banks to supply cheap finance and the risk that the owning firms might be brought into the lender of last resort and too big to be allowed to fail safety nets. This might also be true in cases where banks own non-financial firms, whose failure would undermine the banks.

It should also be noted that although financial conglomeration is becoming the norm in many national systems, especially amongst OECD countries, there are two approaches to financial conglomerate structuring. The integrated firm approach has been common in mainland Europe, whilst the UK has tended to favour a holding company structure. Diversification in the USA has hitherto been required to take place through separately capitalised subsidiaries in the hope of erecting fire-walls between them. These have yet to be rigorously tested and there is considerable doubt about their likely effectiveness in face of too big to fail considerations. There does, however, seem to be an emerging trend towards converting integrated universal banks into holding companies with specialist retail (including telephone and/or internet), corporate and investment, asset management and (see below) insurance subsidiaries.

The banks have sought to diversify their retail financial activities, often hoping to cross-sell products (e.g. house insurance on the back of home loans) or simply to exploit the information contained in enlarged data bases for marketing and product development purposes. They have thus diversified their loan portfolios and now commonly offer home loans, which were traditionally the preserve of specialist savings banks in many countries (savings and loans companies in the USA, and building societies in the UK, for example). In addition, they have engaged in offering insurance and pension products, leading to the development of what has been called bancassurance companies. Many insurance companies are also in the process of entering banking; frequently through the internet or telephone-based services.

The development of global bancassurance firms providing retail banking, insurance, and asset management (pensions and mutual funds, etc.), as well as investment banking services worldwide is thus on the verge of a reality. Citicorp and HSBC are perhaps the closest to this reality. The large financial conglomerates will of course, continue to compete with narrower specialist and domestically based institutions, some of which will be national champions formed through domestic mergers.

Pensions reform and capital markets

Pensions reform is another major driver of the increased capital market orientation of financial systems. It is made necessary by demographic factors and in particular ageing populations and increased longevity, which are making pension commitments in a number of (mostly developed) countries unsustainable. The initial response by government to their growing budget liabilities, commonly funded as a "pay-as-you-go" (paygo) basis, in the USA and the UK was to try to "privatise" pensions by reducing state commitments and increasing tax incentives for saving. However, it has increasingly become evident, that substantial reform of state provision is also required to avoid undersaving and disappointment, or worse poverty, in retirement. Many countries are replacing, or are considering replacing in part, paygo with funded provision. A number of governments are also introducing "national" (non-financial) defined contributions schemes in an attempt to limit their income related payout liabilities. Others are following the lead of Chile, Singapore and an increasing number of countries in establishing individual citizen's accounts with various degrees of compulsion as regards contributions. The management of the funds is commonly contracted out to professional private sector fund managers following a tendering process.

The net effect is a rise in funded long-term savings vehicles which must manage the risks caused by mismatches between long-term pensions liabilities and shorter term assets. There has been a drive in the mid-2000s, especially evident in the UK, where equity holding by pensions funds have historically been relatively high, towards increased matching by duration. Asset portfolios have thus been rebalancing away from equities towards bonds. This rebalancing may in part account for the low long-term interest rates that prevailed in the bond markets in the mid-2000s.

The increased demand for long-term, corporate and government bonds is, however, likely to bring forth an increased supply given the historically low funding costs and the relative high government budget deficits in a number of developed countries. Some pensions experts, are, however, advocating greater use of derivates to manage the risks inherent in mismatching, arguing that current attempts to reduce mismatching are unnecessary.

Our main focus, however, is on the implications of pensions reform for corporate governance. Pensions fund development increases the demand for equities and corporate and government bonds and thus encourages the growth of the capital markets. This in turn facilitates the privatisation of formerly state-owned enterprises and "exit" by venture capitalists and other private equity providers. In other words, it facilitates an increase in the capital market orientation of corporate finance and consequently financial sector convergence.

Financial system convergence and corporate governance

"Anglo-Saxon" (more capital market oriented) financial systems, as represented by the US-and the UK, and "Continental" (banking oriented) financial systems, as typified by Germany and much of continental Europe and Japan are frequently contrasted (Doukas *et al.*, 1998, p. 10). The term banking oriented alludes to bank lending via the creation of demand deposits or "credits" in connection with a debt contract between the bank and the borrower. Banks, are however, increasingly engaging in both banking and securities business, i.e. universal banking, fund management and, more recently, insurance business ("bancassurance" or "Allfinance"). The term bank oriented, therefore, may have various interpretations. It could mean a system in which banks are the dominant institutions providing both indirect (or intermediated debt) finance and access to direct finance from the money and capital markets via instruments such as commercial bills and paper (money market debt finance), bonds and Euro-notes (capital market debt finance) or shares (capital market equity finance), *inter alia*. The key distinctions here are between direct and indirect finance and between debt and equity financing. Since, banking fundamentally involves the provision of indirect or intermediated debt finance, bank oriented could more narrowly be taken to mean that the most important source of external financing for NFCs is bank loans. If this is the case, then there are no capital market oriented systems, since even the USA, the country with the most advance capital markets, remains bank oriented because SMEs, the largest sector of most non-centrally planned economies, remain dependent on banks for external finance in the USA, as elsewhere. The issue really is the extent to which countrys systems are more or less bank (capital) market oriented, i.e. the USA is more capital market oriented than any other country, but still bank oriented (Mishkin, 2004, Chapter 8). Further, it is the US corporate bond (debt) market, including the below investment grade "junk" bond market, that is comparatively briefly developed.

With reference to the EU, therefore, a bank oriented system could be viewed as one in which banks are the key financial institutions as regards corporate governance by virtue of being both providers of debt finance and the key institutional holders of equity, as in the universal banking system of Germany, and also to some extent in the French system (Bertero, 1994). In contrast, in capital market oriented systems, the key institutional shareholders are pension and insurance funds. This is especially true in the UK, where share ownership is heavily concentrated (Mallin *et al.*, 2005).

Hitherto, the institutional shareholders in the UK have not exercised their voting rights (including proxy voting rights) as actively as the large German shareholder owned (private sector) banks (Deutsche, Commerzbank, Dresdner, etc.). The capital markets in the UK and USA also influence management behaviour via the threat posed by aggressive mergers and acquisitions activity. In contrast, in continental Europe, unsolicited take-over bids have, at least until recently, been rare.

The "battle of the systems" regarding the relative merits of the more bank oriented and more capital market oriented systems, is integral to the policy debates on the evolution of financial systems in the EU member countries. If direct financing is increasing relative to bank financing, the capital markets will have a greater role to play in the future. To the extent that more bank oriented systems are more "long-termist" this trend may lead to a spread of "short-termism" in investment and "research and development" expenditure decisions. Counteracting this tendency, and helping to deepen capital markets in previously more bank-dominated systems, the aforementioned privatisation of pensions will lead to a build up of pension funds which are likely to increasingly invest in shares (equities) as restrictions requiring large proportions of the funds to be invested in domestic government bonds are removed. The UK, where pension funds have traditionally invested heavily in equities, may be an exception since a number of funds are trying to better match their assets and liabilities by reducing equity holdings and increasing bond holdings of appropriate maturities.

Because pension funds are dealing with long-term savings, they should naturally take a strategic view and this should help counteract any bias towards short-termism. The trend toward greater transparency of pension fund managers decisions (including voting and stock picking behaviour) should reinforce this. The creation of the single currency area within the EU ("Euroland") has already boosted the development of a European corporate bond market. The continued rapid growth in the Euro-based corporate bond market should further reduce the role of bank loans as a source of corporate debt finance. Against this, however, funds in general compete on performance based on short-term league tables and this may tend to engender short-termism. An increasingly important issue is thus the extent to which the fund managers and pensions fund trustees should themselves be regulated to ensure they discharge their fiduciary duties effectively and transparently. There is growing pressure in the UK, for example, to require them to reveal their shareholder voting behaviour. At the moment this is essentially voluntary for pension funds.

The question remains, however, whether the different financial systems in the EU have exhibited a tendency to converge over time following the single European market initiative in 1993 and the subsequent Financial Services Action Plan. In the context of EU financial systems and the patterns of corporate financing, the "convergence criterion" reflects the expectations of EU member countries that the launching of a borderless Europe in January 1993 would impact on the financial systems of these economies by facilitating the achievement of a single financial space in the EU. This moved a step closer with the decision to proceed with the creation of a single currency adopted by most of the EU states in January 1999. In "Euroland" convergence is expected to accelerate.

Murinde *et al.* (2004) obtain results which suggest that over time and across the seven EU member countries NFCs have shifted towards the use of equity finance for new investment. Further, there is evidence that there has been a tendency towards convergence among the EU member countries in terms of the increasing use of corporate bond finance by NFCs. Moreover, the formation of "Euroland" can be expected to accelerate the growth of the Euro-dominated corporate bond market. Our findings also revealed extensive usage of internal finance and is consistent with the results obtained by Corbett and Jenkinson (1994), Bertero (1994) and Edwards and Fischer (1994). Studies using less aggregated data on firms arranged by industrial sector, however, tend to find less evidence of convergence. A reason for this may be the tendency to lump large corporations, SMEs and middle sized companies, or the "Mittelstand" as the Germans call them, together. Large corporations in the most developed countries have tended increasingly to rely on market (paper, notes, bonds, equity) finance since the early 1980s. SMEs remain largely dependent on banks for external finance (howbeit with access to a wider range of products such as leasing and factoring as well as overdrafts and loans) unless they are able to attract venture capital or private equity because they are in "high tech" sectors and have growth potential. Perhaps, the most interesting group is the "Mittelstand" which has an increasing array of financing options open to it. Studies of convergence, using disaggregated data with the firms grouped into at least three size categories, as well as by industrial (including the service) sector, would thus potentially be more revealing.

Thus, as they participate in a single market project inaugurated in 1993 and as a result of the ongoing restructuring of their banking systems, EU member countries may expect convergence of their financial systems on an evolving model, with bank intermediated corporate lending decreasing in importance and direct financing via equity and bond markets (especially the Euro-note and bond markets) increasing. A great leap forward occurred in the development of the corporate bond market following the adoption of the Euro in January 1999; further undermining the dominance of bank debt financing of large corporates and pointing to convergence on the US financial system, where the corporate bond markets are much more developed. Throughout Europe, the banks are also progressively diversifying into the provision of underwriting and broking (of financial instruments) services to NFCs, who previously borrowed from them more heavily via bank loans.

All in all, the EU single market launched in 1993 and the ongoing restructuring of banking systems in most EU countries are expected to facilitate convergence of the financial systems in the EU. This is also true of the UK, given the virtual disappearance of indigenous independent investment banks. It is only in the USA that investment banks flourish as separate entities. However, following the repeal of the Glass-Steagall Act in 1999, the US financial system may well tend to converge on a similar model as large corporations seek both credit lines and the underwriting of securities issues from both their commercial and their investment bankers.

Trends in corporate governance

The competing financial systems (*Anglo-Saxon* vs *Germanic*, or *market* vs *bank oriented*) debate is often couched in terms of implications for corporate governance, and indeed society as a whole (Albert, 1993). As noted above, the debate is frequently somewhat confused as a result of the influence of financial myths (Mishkin, 2004, Chapter 8). In most countries SMEs are the largest employers and are largely dependent on banks for external finance, and that banks are the major suppliers of finance to the non financial business sector. Only in the USA is the corporate bond market a major alternative to loans as a source of debt finance, although the introduction of the euro has resulted in accelerated development of the European corporate bond market. Even in the USA, banks remain the main suppliers of debt finance, however, and it is only the larger corporates that can tap the traditional bond market, whilst growth firms in the new technology sectors can increasingly tap the higher risk junk bond market. Further, the equity market is primarily a market in second hand stocks through which ownership is transferred. In years of high merger and acquisition activity and share buy-backs the net supply of new equity finance through the market is commonly negative in the USA and the UK. Markets specialising in financing new companies, again usually in the new technology sectors (Nasdaq in the USA and AIM in the UK), tend to be net suppliers of equity, but often as a result of replacing the investments of venture capitalists and other private equity holders, as they exit from their investments. Private equity and venture capital funds have been growing in importance as alternatives to bank finance for early stage growth firms in the technology sector.

In sum, in Anglo-Saxon systems banks remain the dominant source of external finance, and there dominance may actually be increasing as they diversify from making loans into wider, securities related, corporate finance. The bank vs market dominated distinction has become unhelpful because the nature of banking has changed as a result of the generally liberalising, re-regulation of banks and other financial institutions is also driving convergence of the scope of banks and other financial institutions (on the continental European model).

It is, however, true that for the larger corporations a larger proportion of indirect finance is being provided through bond (debt), equity and money (commercial paper and bills) markets. As such, there is convergence on a hybrid americanised continental European system, i.e. one in which the main players are diversified bank and insurance companies (and also some specialised investment banks, at least for a while yet) and funds of various sorts in which financial markets are becoming increasingly important. The insurance, mutual and pension funds are, becoming the dominant institutional investors as pensions are progressively being privatised and banks disengage from cross-shareholdings in Japan and the EU (particularly Germany).

The convergence of financial systems is leading to a convergence of corporate governance mechanisms. For the largely private SME sector, there is less change. Banks remain the key players in their governance unless management control is diluted by taking on equity finance from outside (from private equity and venture capital funds). The latter is more common, however, amongst middle sized companies. For larger firms that have issued equity to the public and/or taken on bond financing, institutional investors can be expected to play an increasing role in governance relative to banks; but banks will also remain key actors. Given the, continuing, importance of internal finance in larger firms, good corporate governance is required to ensure that efficient use is made of retained earnings. Here, issues pertaining to the structure of management boards, the role of non-executive directors, and whether the roles of chairman and chief executive officer should be separated become increasingly important. Further, stock markets play a role in providing a market for corporate control to keep the managers on their toes. Behind the markets are the institutional shareholders and fund managers, who must decide which shares to hold in their portfolios and in what proportions.

The growth in importance of private equity and venture capital funds, initially in the Anglo-Saxon economies, but now more widely, raises interesting additional issues. Whilst these funds remain relatively small and focused, they have a number of the attributes of entrepreneurial ownership. This stems from their exposure to the success of the enterprise by virtue of a substantial equity ownership, in contrast with the relatively diluted ownership of the traditional institutional investors. In addition, to try to assure a good return and limit their downside risk, they actively provide managerial support from experienced practitioners, which is potentially more effective than the more impartial advice provided through expert non-executive directors. Further, they tend to be tied in for the medium terms of five years or so prior to exit via an additional public offering on a junior stock exchange, such as AIM in the UK. Thus, at least in the first few years, their focus is unlikely to be short-termist. Their overall impact increased as hedge funds joined the game in the mid-2000s, although the latter do tend to be more short-termist in orientation.

It is also worth noting that insurance and pension funds, the traditional institutional investors, are increasing their investments, directly, or indirectly through funds of hedge, private equity and venture, funds, in "alternative investments" in pursuit of a higher, risk-related return. The "alternative funds" have thus been receiving ample inflows of capital, raising the question of whether they can continue to maintain their relatively high rates of return. Further, as their size increases, the private equity funds may lose their focus and their hands-on managerial input may well be spread more widely. In other words, they may become institutionalised. There will, presumably, be room for new entrants into the private equity market, however.

Through the institutional shareholders and fund managers, the interests of small investors and pensioners are represented and legislation can be used to encourage investors to take account of ethical and environmental considerations in constructing their investment portfolios, as in the 1999 pensions fund legislation in the UK.

The interests of stakeholders other than shareholders can also be brought to bear through legislation on management board membership (e.g. requiring worker and/or consumer representation, as is the case in a number of countries). By such means it is hoped that the tiger of global capitalism can be tamed and capital will be directed in such a way as to ensure its most efficient (from social as well as financial or economic perspectives) use. The optimists hope that growth will be enhanced and poverty reduced as a result. Further, social auditing will increasingly complement traditional financial auditing. To achieve this, however, countries must adopt common accounting standards, and best practices in financial sector regulation and, partly as a result of the former, conformable corporate governance (including bankruptcy procedures) systems.

It is, however, worth noting that the two archetypical "Anglo-Saxon" systems, the USA and the UK, have in fact adopted very different approaches to corporate governance and the bankruptcy laws that underpin them. Indeed, so much so that they might be regarded as different systems. The USA is traditionally more litigious with regard to regulation and this is most recently reflected in the 2002 Sarbanes-Oxley Act in the US corporate governance law. The UK in contrast tends to adapt a "principles based" approach to financial regulation and corporate governance. Further, many of the principles, particularly in the sphere if corporate governance, are introduced on a "comply or explain" basis, where those that choose to not comply are required to publicly explain their position. The differences do not end there since the UK approach has been to favour creditors in bankruptcy proceedings whilst the USA has tended to afford more protection to debtors. Recent changes in bankruptcy laws have moved the two countries closer. In general, few countries appear to believe they have arrived at the optimal corporate government or bankruptcy arrangements. Further, the EU members have yet to agree common bankruptcy, takeover and corporate governance systems to underpin the single market.

La Porta *et al.* (2000) have been influential in arguing that differing legal traditions (*civil* vs *common law*) and sub-systems (they consider three sub-groupings of civil law countries) may account for differences in approaches to bankruptcy and corporate governance. To the extent that this is true, there will be legal traditions that will inhibit the pace of convergence. It may, however, be that as more principles based systems evolve, particularly in Europe, informal regulation based on networks of trust or "my word is my bond" can thrive (Franks and Mayer, 2006). Historically, such networks of trust have underpinned financial markets in London and China, and perhaps continue to do so in the latter (Allen, 2006).

Concluding remarks

The extensive use of internal financing of investment through retained earnings complicates the principle-agent problem and makes good corporate governance essential to assuring that capital is efficiently invested. The growth in direct or market finance is reducing the role of banks in corporate finance and this tendency is enhanced by their declining role as institutional investors through cross-shareholdings (particularly in Germany and Japan). Bondholders (often banks and other financial institutions), not just shareholders, are increasingly important and this leads to complications in procedures for temporarily protecting companies in financial difficulties from creditors (such as "Chapter 11" in the USA bankruptcy law) and more general bankruptcy proceedings. However, banks remain the key monitors of SMEs. Stock markets, through secondary trading, are markets for corporate control as well as sources of new finance through initial public offerings and rights issues, etc. Institutional shareholders (insurance, pension, mutual, private equity, venture and hedge funds) and fund managers are becoming the key players in corporate governance. They are increasingly playing a more active role in ensuring that companies have good management structures internal controls.

The greater emphasis on shareholder-value may, however, lead to short-termism, as opposed to the long-termism associated with universal banking. If the USA is arch-typical, the benefits of greater innovation and flexibility may outweigh any costs of short-termism, although the jury is still out following the over-investment in communications and information technology that occurred in the USA in the late 1990s boom. Further, short-termism tends to increase pressure to distribute profits as dividends, reducing the hoarding of capital for internal investment.

The growing influence of private equity and venture funds may help counteract the tendency towards short-termism and weak governance incentives. Stakeholders other than shareholders may, however, need protecting. This could be done through social auditing. Finally, given the long-term liabilities of pension funds, pensions reform may provide a counterweight to short-termism if trustees and fund managers are themselves regulated or governed in such a way as to ensure that they fulfill their fiduciary duties to investors.

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About the author

Andy Mullineux is a Professor of Global Finance and Director of the Global Finance Research Group in the Accounting and Finance Subject Group in the Birmingham Business School at the University of Birmingham. He has published extensively on monetary policy and business cycles as well as financial restructuring and regulatory and supervisory reform in emerging market economies.