Corporate Governance, Organizational Structure, and Business Research

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Outline

- Corporate Governance
- Organizational Structure
- Research Topics
- Research Issues
- Structure Changes
- Some Results
- Conclusion
Corporate Governance

“A set of relationships between a company’s management, its board, its shareholders and other stakeholders. It also provides the structure through which the objective and monitoring performance are determined” (OECD 2004)
“[D]eals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”

It is a finance perspective
Corporate Governance (cont.)

- Why do we need corporate governance?
  - Agency Problem:
    - Perks
    - Agents (managers) have shorter horizon than firms
Why do we need corporate governance? (cont.)

Agency Problem:

- Agents (managers) exhibit different risk preferences because they have more undiversified portfolios than average investors
- The “free-riding problem for minority shareholders”
Corporate Governance (cont.)

- External Control
- Internal Control
Corporate Governance (cont.)

- External Control
  - Capital Markets
    - China: Until 2005, nearly 2/3 of stocks cannot be traded
    - Germany
    - Japan
    - US. (best)
Corporate Governance (cont.)

- External Control (cont.)
  - Law and/or regulation (special to regulated industries, e.g., the banking industry and insurance industry)
  - Politics (Republican vs. Democrat)
  - Culture (Japan vs. U.S.)
  - Communities (Occupied on Wall Street)
Corporate Governance (cont.)

- Internal Control
  - One-Tier System (Anglo-American System)
    - Committees: e.g., audit committee, compensation committee, nomination committee
    - E.g., Britain and U.S.
Corporate Governance (cont.)

- Internal Control (cont.)
  - Two-Tier System
    - Management board
    - Supervisory board
  - E.g., France, Germany, and Taiwan
Corporate Governance (cont.)

- Corporate governance in several countries
  - China
  - Germany
  - Japan
  - U.S.

- Note that there were many reforms in these countries in recent years. The following characteristics may not be 100% accurate
Corporate Governance in China

- Background
- 1990s economic reform
  - Retain government control of large state-owned enterprises (SOEs)
  - Retreat from small and medium-sized enterprises
- More than 80% of listed companies are controlled by the state in 2001
Corporate Governance in China (cont.)

- **Two-tier system**
  - Supervisory board cannot hire or fire executive board directors.

- **Independent directors**
  - No sufficient resources and mechanisms to ensure its monitoring role
  - Independent directors find it difficult to exert any substantial influence
Corporate Governance in China (cont.)

- Dual role of the state: regulator vs. company owner
  - State acts the regulator of corporate governance system
  - State also control a majority of listed companies
Corporate Governance in China (cont.)

- The conflict of interest between China Securities Regulatory Commission (CSRC) and State Economic and Trade Commission (SETC)
- It has been advocated that the state should withdraw its control of companies
Corporate Governance in Japan

- Post-war system
  - Bank-dominated financial system
  - Cross-shareholding
Corporate Governance in Japan

- The permanent employment system and norms of community

- “I could not help but cry, when I thought about the future of our 7,600 employees and their families”
  – Nozawa Shohei, President of the failed Yamaichi Securities
Post-war system (cont.)

- Board of directors and decision making
  - Boards tended to be large
    - Examples: Sony, 36; Nippon Steel’s 42 in 1990
    - Why? Employees could aspire to be a board member
Corporate Governance in Japan (cont.)

- Post-war system (cont.)
  - Outside directors were rare and far from independent
  - Statutory corporate auditors are required: no vote at board meetings and no power to appoint or dismiss the president
Corporate Governance in Japan (cont.)

- Post-war system (cont.)
  - Commercial code
    - The Japanese system is weakly similar to German supervisory board system
    - First Japanese Commercial Code based on German Commercial Code
Corporate Governance in Japan (cont.)

- Post-war system (cont.)
  - The present Commercial Code based on the Illinois Code
  - The state and administrative guidance
  - State played an important role
Corporate Governance in Japan (cont.)

- Changes in post-war system
  - Beginning in the mid-1980s, some reforms include
    - Moving away from the main bank system
    - Unwinding of cross-shareholding
    - Increasing foreign shareholders
Corporate Governance in Germany

- **Two-tier system**
  - Management board is responsible for the operation of the company. A member can be recalled only when s/he neglects her/his duty.
  - Supervisory board is responsible for appointing, supervising, and advising the management board.
Corporate Governance in Germany

- Two-tier system (cont.)
  - Management board members have equal rights/responsibilities
  - Up to one-half of the supervisory board members are elected by the domestic workers. They should act what is the best for the company, not only for the employees
German system can be characterized as “bank-centered”

Banks played a major role in financing and supervising companies

The importance of bank’s role has been reduced
Corporate Governance Characteristics

- Internal Control (cont.)
  - Board composition
    - Executive directors
    - Non-executive but insider directors
    - Independent directors
  - Board size
  - Duality
Corporate Governance Characteristics (cont.)

- Internal Control (cont.)
  - Ownership
    - Director (Insider vs. outsider)
    - Supervisory board members
    - Employees
    - State
    - Family
Corporate Governance Characteristics (cont.)

- Internal Control (cont.)
  - Blockholders (Top 5, (financial institutional investors))
  - Non-linear relation
Corporate Governance Characteristics (cont.)

- Internal Control (cont.)
  - Diligence
    - Proxied by meeting frequency
  - Expertise
    - Financial
Corporate Governance Characteristics (cont.)

- Internal Control (cont.)
  - Busy board
    - Proxied by number of directorships
Corporate Governance Characteristics (cont.)

- Managerial incentive
  - Equity-based compensation (e.g., stock option)
- Issues
  - Stock option expensing
  - Shareholder voting on compensation related proxy proposal
  - Compensation and investment
Corporate Governance Characteristics (cont.)

- Internal Control (cont.)
  - Capital structure
    - Act as a self-enforcing governance mechanism because of interest and principal
    - Issues: e.g., compensation and the agency costs of debt
Corporate Governance Characteristics (cont.)

- Internal Control (cont.)
  - Capital structure (cont.)
    - Equity-based compensation decreases the agency problem of equity, but may exacerbate the agency problem of debt (e.g., underinvestment)
Corporate Governance Characteristics (cont.)

- Internal Control (cont.)
  - Bylaw and charter provisions
    - Example: poison pills allow firms to issue additional shares to all shareholders other than a hostile blockholder seeking control of the company.
    - It may undermine the market for corporate control.
Corporate Governance (cont.)

- Audit quality
  - Another related issue.
Audit Quality

- Audit quality has become more important issues recently.
- Initiatives to improve audit committee quality
  - Blue Ribbon Committee (1999)
  - SOX (Section 406 and 407, 2002)
  - NAIC (Model Audit Rule Section 16, 2006)
Audit Quality (cont.)

- Audit committee of board of directors – the main responsibility is to oversee the corporate financial reporting process
- Characteristics of audit committee
  - Financial expertise
  - Numbers of meetings
  - Independence
  - Ownership
The passage of the Sarbanes Oxley Act of 2002 (SOX) was to respond to the accounting scandals such as Enron and several other large corporations.

This regulation imposes a number of corporate governance guidelines on all publicly traded companies in the U.S.
Corporate Governance (cont.)

- Despite the claimed benefits of this Act, the passage of the SOX gives rise to a broader concern that the SOX could signal a shift to a more rigid federal and state regulation of corporations, thereby causing that the direct and indirect costs of the SOX can outweigh its benefits.
Banking industry and insurance industry serves as a good research lab to examine whether imposing additional regulations on corporate governance as guided in the SOX Act can enhance the performance for this already highly-regulated industry.
Different organizational structures can provide an interesting experimental setting for banking and insurance research.

Different countries have different organizational structures within their own countries.
Organizational Structure (cont.)

- Stock insurers
- Mutual insurers
- Fraternal insurers
- State-owned insurers or manufacturing firms
- Keiretsu insurers (firms) vs. independent insurers (firms)
- Chaebol insurers (firms) in Korea
Family-owned insurers (firms)

Financial-holding-company-owned insurers (banks)
Special Characteristics of Organizational Structure of Various Countries

- China
  - State-controlled insurers (firms)
- Germany
  - State-owned insurers
- Japan
  - Keiretsu vs. independent insurers (firms)
Special Characteristics of Organizational Structure of Various Countries (cont.)

- U.S.
  - Stock insurers, mutual insurers, fraternal
  - Credit unions vs. banks
Research Topics

- Performance
- Risk taking
- Reinsurance
- Reserve management
- Cash holdings
Research Topics (cont.)

- Note the above issues can be examined in both life insurance and property-liability insurance companies
Performance

- Profitability (ROA, ROE)
- Tobin’s Q (Market value)
  - Not suitable when mutuals involve
- Efficiency scores
Risk Taking

- Various types of risk
  - Underwriting risk
  - Investment risk
  - Leverage
- Standard deviation and/or variance
  - ROI, ROE
  - Stock return
Issues Related to Corporate Governance Hypothesis

- Different theories predict different signs for almost all corporate governance variables
- Example
  - Board size and risk taking
- Some reviewers do not like two directional prediction
- Solution: stick to one theory and have one sign prediction for all variables
Structure Changes

- Japan
  - Bubble, deregulation
- Germany
  - Reunification, deregulation
Structure Changes (cont.)

- U.S.
  - The Sox
  - Demutualization
- Malmquist index analysis is a wonderful tool to analyze time series structure changes
Organizational Structure and Hypotheses

- Expense hypothesis (Mutuals)
- Co-existence hypothesis (Efficiency sorting hypothesis)
- Managerial discretion hypothesis (Stocks vs. Mutuals)
- Public or SOEs hypothesis
- Keiretsu hypothesis
Research Issues related to Corporate Governance and Organizational Structure

- **Endogeneity**
  - Example: Independence vs. performance
  - Example: Organizational structure vs. risk taking
- **Control variables**
  - Line of business
  - Herfindahl Index: Business line and Geographic (U.S. but not Japan)
Research Issues related to Corporate Governance and Organizational Structure

- Control variables
  - Size: Ln(Admitted Assets)
  - Line of business
  - Reinsurance (for risk taking)
Some Results

- Many governance mechanisms matters. For example, board independence, the separation of the CEO from board chairman, auditor independence, and compensation committee independence have significant effects on firm performance in U.S. life insurance industry.

- Organization structure sometimes matters, sometimes does not. (e.g., Japan, Germany, U.S.)
Results (cont.)

- It should be noted that some corporate governance variables have significant effect in one study, but not in another study.

- The effect of audit quality variables on performance is similar to that of corporate governance variables.

- Liberalization and deregulation usually increase the performance.

- Liberalization and deregulation have different impact on different organization structure.
Conclusions

- Corporate governance (including audit quality) and organizational structure, have impact on the performance, risk taking, reserve management, cash holdings, respectively.

- Various country studies provide interesting results.