

Alternative Models of Financial System Development

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1. Introduction

Dramatically different systems of corporate finance and governance have emerged among the major industrialised countries in the postwar period. Even the casual observer notices large differences between the way firms finance and govern themselves in the United States and United Kingdom on the one hand, and in Japan and Germany on the other. In this paper I describe how firms obtain external finance and how the primary mechanisms of corporate governance operate in these four countries. In addition, I consider where the Australian financial system fits in on the spectrum that has the United States and United Kingdom on one end and Japan and Germany at the other. I analyse reasons for the dramatic differences observed in corporate finance and governance systems. I discuss some of the costs and benefits of each system. Finally, I evaluate the current pressures to change that each system is under, and make some prophecies as to how corporate finance markets will evolve in the future in each country.

These issues are of course fundamental to the theories of the firm, corporate finance and corporate governance that have exercised academics for many years. However, recently they have taken on a policy relevance that they have not enjoyed before. In the United States and United Kingdom there is an intense ongoing debate about the most preferred methods of financing and governing firms.¹ And in the past few years, both Japan and Germany have initiated substantial changes in their corporate finance markets. In Australia, the financial system has undergone significant changes since the early 1980s when the Campbell Committee recommendations were put in place, involving the lifting of interest ceilings on bank deposits, ending quantitative controls on bank lending, relaxing barriers to bank entry and allowing freer access to international capital markets. More recently the direction of the financial system has become a topic of debate once again with the recently announced inquiry into the structure of the financial system. Some of the areas likely to be examined are directly related to the finance and governance mechanisms of Australian firms.

Examination of the corporate finance systems in industrialised countries is also of value to policy makers in other countries considering revamping their financial systems. These include France and Italy, who are both undergoing privatisation efforts, as well as those ex-communist countries putting in entirely new systems of property rights, business law and financial markets. Finally, many of the emerging market countries of Latin America and Asia are also deciding how to craft the outlines of their rapidly

1. In the US, a recent manifestation of this is the Council on Competitiveness' 1992 report, 'Capital Choices: Changing the Way America Invests in Industry'. In the UK, it is the Cadbury Committee's 1993 report, 'The Financial Aspects of Corporate Governance'. See also Fukao (1995) for an overview of some of the policy-related issues on corporate governance.

developing financial markets. These countries would undoubtedly appreciate an understanding of the important differences in the corporate finance systems in the major industrialised countries, why such differences exist, the relative strengths and weaknesses of each system, and the pressures and prospects for change in these systems. This paper attempts to provide insight on these issues.

One argument in this paper is that the large differences we observe in corporate finance and governance between the industrialised countries are not just accidents of history or culture, but are the product of three aspects of the legal and regulatory environment under which each system has evolved. The first aspect relates to the legal and regulatory environment for universal banking and the ability of financial institutions in general to own large stakes in firms and play an active role in their governance (to be 'active investors' as Jensen (1989) puts it). Banks and other financial institutions in Japan and Germany have been allowed to be active investors in the firms to which they lend, whereas Anglo-Saxon financial institutions in general have not. The second aspect is the degree to which corporate securities markets² have been actively suppressed by regulatory fiat, taxation and/or cumbersome mandated issuance procedures. Relative to the Anglo-Saxon countries, Japan and Germany have had severe regulatory constraints on the development of their corporate securities markets. The third aspect is the degree to which securities markets have been 'passively' suppressed by the lack of any mandated standardised disclosure requirements for firms wishing to issue securities to public investors. Japan and Germany have lagged behind the Anglo-Saxon countries in mandating information disclosure by firms issuing securities. For this to influence securities market activity in these countries, there must be a public good aspect to the voluntary provision of information by firms to outside investors. I discuss some evidence on this issue.

Where does Australia fit on the spectrum that has the United States and United Kingdom on one end and Japan and Germany at the other? Overall, the Australian system looks much closer to those of its Anglo-Saxon cousins than it does to Japan and Germany. Equity markets are active and important sources of finance for firms, while banks' ties to firms are more of the arm's-length variety observed in the United States and the United Kingdom, than the 'insider' variety in Japan and Germany.

I also look at the relative costs and benefits of each system of corporate finance and governance. While particular advantages are claimed for both systems, it is impossible to say from the evidence which is the more efficient system overall, or even whether any efficiency differences are important enough in magnitude to be of practical relevance.

I identify some of the emerging pressures for change in corporate finance markets and draw some implications for the future development of financial systems in the industrialised countries. Rapid changes in technology, market innovation, the globalisation of financial markets and the increasing importance of small firms in the economy and of institutional investors in the financial markets have all put pressure on the finance systems of Japan and Germany – which have traditionally relied on regulatory suppression of non-bank sources of finance. These changes are already having an effect: both Japan and Germany

2. Throughout this paper, 'securities' refers to *any* traded corporate security, debt or equity.

have substantially deregulated their securities markets in recent years and vastly increased firms' access to non-bank sources of finance.

These changes have also affected Anglo-Saxon finance markets, although somewhat less drastically, probably because their greater reliance on securities markets has proved to be more consistent with the emerging pressures for change. Corporate finance markets that cater to small and medium-sized firms are growing rapidly in the United States, and are also sprouting in Australia. In addition, institutional investors are changing their view of their role in the corporate finance markets, and appear increasingly willing to take on a more active monitoring and governing role in the companies in which they invest.

Overall, these changes are moving the financial systems of the industrialised countries closer together. However, the focal point of this convergence is not the Japanese/German or US/UK system as it currently exists but an environment where financial institutions are free to be active owners *and* where securities markets are unhindered by regulatory obstacles.

In the following section, I describe the generic information problems of external finance and governance that all corporate finance markets face regardless of their nationality. I then lay out a description of the corporate finance and governance system in the United States, United Kingdom, Japan, Germany and Australia, explaining how each system addresses these problems and highlighting the major differences between countries, focusing on the major legal and regulatory factors I believe are the main determinants of these differences. Finally, I look at the factors that are making some systems of corporate finance untenable in today's world, and that, more generally, are inducing change in corporate finance systems in all countries.

2. Generic Problems of Corporate Finance and Governance

Corporate finance markets in all countries must address two generic information problems facing firms attempting to raise funds from outsiders: sorting and incentive problems.

Sorting problems arise in the course of selecting investments: firm owners and managers typically know much more about the condition of their business than outsiders and it is in their interests to accent the positive while downplaying potential difficulties. Sorting problems and their implications for corporate finance were first analysed by Leland and Pyle (1977) and Ross (1977), who emphasised that the choice of a particular capital structure was important in minimising such problems. More generally, sorting problems require that potential outside financiers conduct extensive information gathering and verifying activities into the firm's operations in order to minimise such information asymmetries.

Incentive problems arise in the course of the firm's operations. Firm managers have many opportunities to take actions that benefit themselves at the expense of outside investors. Jensen and Meckling (1976) were the first to address these issues. They stressed that a combination of methods is usually needed to align the incentives of managers and investors, including the use of an appropriate capital structure, the use of collateral and security covenants and direct monitoring. Diamond (1991) stressed the

role of reputation in mitigating incentive problems: managers of firms that have a stake in maintaining a good reputation with outside investors have strong incentives not to act opportunistically at the expense of such investors.

Problems of external finance thus cannot be separated from problems of governance. Both stem from very similar and related information problems. More importantly, outside investors will not extend external finance to firms without some assurance that mechanisms are in place to control the activities of the firm after funding. Indeed, the form of the governance mechanisms in place often will dictate the characteristics of the external financing.

It should also be clear that information problems are likely to vary with the size of the firm. In particular, they are likely to be worse for small firms. Smaller firms do not produce detailed information about themselves and are often too young to have a credible reputation. Larger public firms make available detailed information about their activities and usually have a clear stake in maintaining a good reputation among potential financiers. They suffer least from these problems. Methods of financing and governance are thus likely to vary between large and small firms. This has implications for how the structure of financial markets evolves in economies where small firms are becoming increasingly important.

The following section describes the structure of the American, British, Japanese, German and Australian financial markets and how they address these financing and governance problems.

3. Corporate Finance Systems in International Perspective

Corporate finance and governance systems in the industrialised countries have two defining characteristics. The first is the degree to which securities markets compete with intermediaries (typically banks) to provide external finance to firms. The second is the degree to which intermediaries have tight ties to the firms to which they lend and use such ties to monitor and influence the firm's decisions on strategic matters. Based on these characteristics, the US and UK systems of corporate finance and governance are broadly similar and very different from those that have existed in Japan and Germany. Securities markets in the United States and United Kingdom have been much more important in the provision of funds to firms than in Germany and Japan. Second, US and UK banks generally have had arm's-length relationships with the firms to which they lend, in contrast to the much tighter ties between banks and firms in Japan and Germany, where banks often take large equity stakes in the firms to which they lend, sit on the board of directors, and act as insiders with respect to the knowledge they have of the firm's operations and the influence they have over the firm's decisions.³

Based on these characteristics, the Australian system looks much closer to its Anglo-Saxon cousins – particularly the United Kingdom – than it does to Japan and Germany. Equity markets are an important source of finance for firms as they are in the

3. This is not to say there are not differences between the US and UK financial systems, or between Japan and Germany, but merely that such differences are of second-order importance when compared to the differences between the United States and United Kingdom on the one hand and Japan and Germany on the other.

United States and United Kingdom, while securities markets for debt instruments are about as developed as those in the United Kingdom, but well behind those in the United States. Finally, Australian banks' ties to their borrowers are more of the arm's-length variety observed in the United States and United Kingdom than the 'insider' variety observed in Japan and Germany.

3.1 Securities Markets and External Financing

The relative importance of corporate securities markets across industrialised countries differs dramatically, both in terms of size and liquidity. Table 1 shows stock market capitalisation as a proportion of GDP in 1994 for the five countries under study. Comparing stock market capitalisation can be misleading if there is a high degree of inter-corporate shareholding in one country, because these shares are double-counted.

Table 1: Stockmarket Capitalisation, 1994

As a percentage of GDP

	United States	United Kingdom	Japan	Germany	Australia
Unadjusted	75	112	78	24	68
Adjusted	70	95	40	11	64

Note: Adjusted figures are corrected for the double-counting of shares associated with inter-corporate shareholdings.

Source: Edey and Hviding (1995).

Table 1 adjusts for this bias by removing these shares from the calculation. Stock markets in the Anglo-Saxon countries are clearly larger than those in either Japan or Germany once a correction is made for the double-counting associated with inter-corporate shareholding. Note in particular that the size of the Australian stock market as a percentage of GDP is very close to that of the United States and much larger than that of either Japan or Germany. This pattern is also revealed by data on public equity issues over the past five years, shown in Table 2. Annual average public equity issuance (as a

Table 2: Gross Public Issuance of Equity

Annual average 1991-1995, as a per cent of 1993 GDP

United States	United Kingdom	Japan	Germany	Australia
1.2	2.1	0.65	0.04	1.6

Sources: US, Federal Reserve Board *Flow of Funds Accounts*.

UK, Central Statistical Office *Financial Statistics*.

Japan, Bank of Japan *Quarterly Bulletin*.

Germany, Deutsche Bundesbank *Monthly Report*.

Australia, Australian Stock Exchange *Monthly Index Analysis*.

percentage of GDP) is much higher in the United States, United Kingdom and Australia than it is in Japan or Germany.

Corporate securities markets for *debt instruments* (bonds, debentures and commercial paper) also differ dramatically in size across countries. Table 3 illustrates that the corporate bond market is by far the most developed in the United States, with Japan a distant second. The Australian and UK corporate bond markets are of equivalent relative size, while the German market is almost non-existent. The US and Australian commercial paper markets are the most active, reflecting the fact that these countries were among the first to allow its development.

Table 3: Corporate Bond and Commercial Paper Markets

Outstanding amounts of corporate bonds of non-financial corporations, 1993

Country	Per cent of GDP
United States	19.1
United Kingdom	2.7
Japan	5.1
Germany	0.1
Australia ^(a)	2.6

Outstanding amounts of commercial paper, 1992

Country	Per cent of GDP	
	All firms	Non-financial corporations
United States	9.1	2.0
United Kingdom	0.7	n.a.
Japan	1.8	n.a.
Germany	0.6	n.a.
Australia ^(a)	6.8	3.4

Note: (a) Australia is 1994.

Sources: Edey and Hviding (1995) and Australian Bureau of Statistics *Financial Accounts*.

The debt financing patterns of non-financial firms across countries is shown in Table 4. The table illustrates that in the United States almost 50 per cent of non-financial firms' credit market debt was in the form of securities in 1994, compared to less than 15 per cent in Japan, Germany and Australia, and about a quarter in the United Kingdom. In this respect, the United States is the clear outlier among the countries under study, by virtue of its extremely well-developed corporate bond market.

Table 4: Composition of Companies' Credit Market Debt, 1994

As a percentage of total credit market debt

	United States	United Kingdom	Japan	Germany	Australia
Intermediated debt	51	76	84	90	90
<i>of which: from banks</i>	16	45	n.a.	80	n.a.
Securities	49	24	16	10	10

Note: Credit market debt excludes trade debt. Intermediated debt refers to loans from financial intermediaries. Securities includes commercial paper and long-term bonds and debentures.

Sources: Edey and Hviding (1995); for Australia, Australian Bureau of Statistics *Financial Accounts*; for the UK, Central Statistical Office *Financial Statistics*.

3.2 The Structure of Corporate Ownership

The ownership structure of the corporate sector also differs dramatically across the five countries under study, especially with respect to the importance of banks as shareholders of firms. These differences are partially illustrated by simple inspection of the aggregate statistics on the ownership of listed companies in Table 5. This table reveals the heavier weight of banks in corporate ownership in Japan and Germany compared to the United States, United Kingdom and Australia. Unlike in Anglo-Saxon countries, banks are the most important large shareholders in firms in Japan and Germany. In Japan they own over 20 per cent of the outstanding common stock of

Table 5: Ownership of Common Stock of Listed Companies

Percentage of outstanding shares owned

	United States	United Kingdom	Japan	Germany	Australia
All corporations	44.5	62.9	72.9	64.0	38.9
Financial institutions	30.4	52.8	48.0	22.0	26.0
– Banks	0.0	4.3	18.9	10.0	1.2
– Insurance companies	4.6	—	19.6	—	18.1
– Pension funds	20.1	48.5	9.5	12.0	1.6
– Other	5.7	—	—	—	5.2
Non-financial corporations	14.1	10.1	24.9	42.0	12.8
Individuals	50.2	28.0	22.4	17.0	19.9
Foreign	5.4	6.5	4.0	14.0	41.2
Government	0.0	2.5	0.7	5.0	0.1

Sources: For Australia, Reserve Bank of Australia; for other countries, Prowse (1995a).

non-financial firms. In Germany, they own 10 per cent, but under current law they have great flexibility to vote, according to their own wishes, the additional 14 per cent of common stock owned by individuals but held by banks in trust for them. In contrast, banks in Anglo-Saxon countries own negligible amounts of the stock in non-financial firms. Also notable is the greater importance of non-financial firm holdings in Japan and Germany compared to the other three countries.

While the pattern of share ownership in Australia is broadly consistent with that of its Anglo-Saxon cousins in terms of the relatively low level of bank holdings and holdings by non-financial corporations, it differs from all the other countries under study in the very large share of outstanding stock owned by foreign entities. This clearly reflects the relative openness of the Australian economy as well as its traditional economic ties to the United Kingdom.

Some aspects of the aggregate shareholding pattern however do not seem to bear out the traditional distinction often made between the Anglo-Saxon countries and Japan/Germany. For example, the United Kingdom is closer to Japan in terms of the weight of the financial sector in aggregate holdings, while Germany is closer to the United States in this respect. Similarly, individual ownership in the United Kingdom and Australia is closer to that exhibited in Japan and Germany than in the United States. These aggregate figures however, reveal nothing about the *concentration* of ownership which is important from a corporate governance perspective. What is required is an analysis of the ownership patterns of a sample of firms in each country. This is illustrated in Table 6, which presents data on ownership concentration in a sample of US, UK, Japanese, German and Australian non-financial firms. Ownership concentration is significantly higher in Japan and Germany than in the United States and United Kingdom. The holdings of the largest five shareholders average over 40 per cent in Germany, 60 per cent more than in the United States, and almost double that in the United Kingdom. Japanese ownership is about one-third more concentrated than in the United States, and 60 per cent more so than in the United Kingdom.

Table 6 also illustrates that Australian ownership concentration is quite similar to that of its Anglo-Saxon cousins. The largest five shareholders hold on average 23.4 per cent of the outstanding shares in the largest ten non-financial firms in Australia, slightly higher than in the United Kingdom, but slightly lower than in the United States.⁴

4. Some caution should be used in comparing the ownership concentration numbers for Australia. Ownership concentration tends to vary inversely with the size of the firm. Since only a very small sample of Australian firms is employed here – the largest ten non-financial firms as measured by market capitalisation – measured ownership concentration might be somewhat higher if a larger sample was used that included smaller firms. In addition, the company reports on The Bloomberg Financial Network report custodian holdings in aggregate and do not report them on an individual beneficial basis. If one of the five largest beneficial holders' holdings are reported in the aggregate holdings of a custodian account, they would be missed in the ownership concentration measure reported here. However this may not be a source of great bias in the numbers shown here since most large Australian shareholders have their own in-house custodial services and do not use an outside custodian to manage their holdings.

Table 6: Summary Statistics of Ownership Concentration of Large Non-Financial Corporations

Percentage of outstanding shares owned by the largest five shareholders

	United States	United Kingdom	Japan	Germany	Australia
Mean	25.4	20.9	33.1	41.5	23.4
Median	20.9	15.1	29.7	37.0	18.5
Standard deviation	16.0	16.0	13.8	14.5	16.0
Minimum	1.3	5.0	10.9	15.0	10.0
Maximum	87.1	87.7	85.0	89.6	52.0

Samples: United States, 457 non-financial corporations in 1980.

United Kingdom, 85 manufacturing corporations in 1970.

Japan, 143 mining and manufacturing corporations in 1984.

Germany, 41 non-financial corporations in 1990.

Australia, largest 10 non-financial corporations in 1996.

Sources: For the United States and Japan, Prowse (1992); for the United Kingdom, author's estimates from data in Collett and Yarrow (1976); for Germany, Prowse (1993) and for Australia, author's calculations from company reports.

3.3 Merger and Acquisition Activity

One of the starkest differences between the Anglo-Saxon financial systems and those of Germany and Japan is the frequency of corporate takeovers. Table 7 illustrates that the market for corporate control appears much less active in Japan and Germany than in the Anglo-Saxon countries. Part of the reason for the much greater merger and acquisition activity in these countries is of course the larger number of companies listed on the stock market in the United States and United Kingdom. However, even normalising the dollar value of mergers and acquisitions by stock market capitalisation fails to alter the

Table 7: Average Annual Volume of Completed Domestic Mergers and Corporate Transactions with Disclosed Values, 1985-1989

	United States	United Kingdom	Japan	Germany	Australia
Volume (US\$ billion)	1,070	107.6	61.3	4.2	9.1
As a percentage of total market capitalisation	41.1	18.7	3.1	2.3	10.3

Notes: Dollar values calculated at current exchange rates for each of the five years covered. Market capitalisation figures are for 1987. Australia is 1985 only.

Sources: For the United States, the United Kingdom and Germany, Securities Data Corporation, Mergers and Corporate Transactions database; for Japan, Yamaichi Securities Corporation, as reported in Beiter (1991). For Australia, Bureau of Industry Economics (1990).

impression that the merger market is much more active in the United States and United Kingdom – 15 to 20 times more so in the United States and 5 to 10 times more so in the United Kingdom.

Data on the frequency of merger and acquisition activity in Australia are hard to come by. What data are available suggest that Australia is closer to its Anglo-Saxon cousins in this regard than to Japan or Germany. Data from the Bureau of Industry Economics for 1985 reveal that, normalised for stock market capitalisation, merger and acquisition activity is about three to four times greater than in Japan or Germany, and a little over half as great as in the United Kingdom.

Table 8 shows the percentage of hostile offers (whether ultimately successful or not) made for firms as a percentage of all attempted transactions for the United States and continental Europe. The data reveal the much lower incidence of hostile takeover activity in continental European countries compared to the United States (data for Japan are unavailable). The differences in *actual, completed* hostile takeovers are even more striking. In the postwar period there have only been four successful hostile takeovers in Germany (Franks and Mayer 1993). Kester (1991) claims that the use of takeovers in large Japanese firms is very infrequent. Conversely, in the United States almost 10 per cent of the Fortune 500 in 1980 has since been acquired in a transaction that was hostile or started off as hostile.⁵ While data are unavailable on the frequency of hostile takeovers in Australia, unlike in Japan and Germany, hostile takeovers do occur.

**Table 8: Hostile Takeovers and Leveraged Buyouts
as a Percentage of all Attempted Transactions, 1985-1989**

	United States	United Kingdom	Rest of Europe
Hostile takeovers	17.8	37.1	9.6
Leveraged buyouts	20.0	5.9	2.7

Notes: Hostile offers are defined as those transactions in which the acquiring company proceeds with its offer against the wishes of the target company's management. Data include both completed and withdrawn transactions.

Source: Securities Data Corporation, Mergers and Corporate Transactions database.

3.4 Corporate Finance in the Anglo-Saxon Countries

These dramatic differences are indicative of the different ways in which the US and UK financial systems on the one hand, and the German and Japanese systems on the other, have addressed the problems of corporate finance and governance. In the United States and United Kingdom, there are firstly a host of stock and bond analysts, ratings agencies, and other advisors which analyse the operations and reports of large firms and offer opinions about whether the firm is worthy of new capital. Secondly, liquid

5. See Morck, Shleifer and Vishny (1989).

equity markets make credible the threat of a takeover of a poorly performing firm, helping to discipline management to act in shareholders' interests.

Thirdly, American and British firms have a large number of potential sources of external finance from which to choose, from banks to non-banks, intermediated sources and non-intermediated sources. Research on these markets in the United States has demonstrated that, just as firms vary in the degree to which they suffer from sorting and incentive problems, US corporate finance markets differ in the extent to which they are designed to mitigate these problems.⁶ This provides a natural selection mechanism as to which firms use which markets. Thus, small firms – which suffer most from the information problems related to external finance and governance – are forced to raise funds in markets that have developed the greatest safeguards to mitigate such problems, such as the markets for private equity and bank loans. Medium-sized firms may be able to tap the private bond market, while some of the larger or more promising middle-market firms may also be able to issue public equity. Large firms that suffer least from information problems gravitate toward markets that have the fewest safeguards and where capital is the cheapest, such as the public bond and commercial paper markets.

The Australian financial system appears broadly similar to the systems of the United States and United Kingdom. There is a large sector devoted to analysing the operations of firms and making decisions about their worth. Liquid equity markets make mergers and acquisitions feasible. Equity markets are relatively active and an important source of finance, meaning that Australian firms have not been limited in their external financing options to banks. Finally, as in the United States and United Kingdom, ownership concentration is relatively dispersed.

3.5 Corporate Finance in Japan and Germany

Japanese and German firms, regardless of their size or the severity of their information problems, have traditionally relied much more on bank financing than have Anglo-Saxon firms, while securities markets have been much less important.

Banks consequently have a potentially powerful position as active monitors in both Germany and Japan. First, they have typically comprised the lion's share of external finance to firms and may therefore exercise influence through their control of the firm's access to external funds. Second, the loans they make are often short-term in nature. In normal times they would be rolled over on an almost automatic basis, but should questions arise about management strategy or quality, the bank always has the option of not renewing the loan at a fairly frequent interval. Finally, their large shareholder status means that they have both the incentive and ability to directly monitor management through their presence on the board and the votes they can exercise at the shareholders meeting.

Unlike in Anglo-Saxon countries, banks in Germany and Japan act as insiders to firms. One aspect of this relationship is bank ownership of equity of non-financial firms. They typically have great access to information about the firm's operations, and have the

6. See Prowse (1996).

ability to engage in monitoring and influencing management. Banks' dual role as important lenders and shareholders has given them a primary role in the financing and governing of firms.

4. Legal and Regulatory Determinants of Corporate Financial Systems

Why should corporate finance and governance systems differ so dramatically across countries? This fact poses a problem for the theory of corporate finance and governance. According to theory, there is a best way to organise and finance large firms, and so we should observe similar mechanisms of finance and governance in the large industrialised countries. The fact that we do not suggests that we should either attribute differences simply to accidents of history or culture or look to other factors which theory ignores – such as the laws, rules and regulations which govern the financial systems of industrialised countries.

In fact there are large legal and regulatory differences between the countries under study that affect the corporate financial systems in place. The differences are essentially of three kinds. First is the severity of the legal and regulatory restraints on large investors being 'active' investors in firms. These are affected by differences in the portfolio regulation of financial institutions, tax laws, insider trading laws, and antitrust laws. Anglo-Saxon laws are much more hostile to investors taking large influential stakes in firms than in Japan and Germany.

Second, there are differences in the degree to which sources of non-bank finance are actively suppressed. For much of the postwar period there has been 'active' suppression of corporate securities markets in Japan and Germany, taking a variety of forms including discriminatory taxation, regulatory fiat and cumbersome mandated issuance procedures.

Finally, there are differences in the degree to which corporate securities markets have been 'passively' suppressed by the absence of any strong mandated, standardised disclosure requirements by firms wishing to issue securities to outside investors. There are large differences in the disclosure requirements of Japanese and German firms on the one hand and Anglo-Saxon firms on the other. These differences may have been important in determining the relative speed of securities markets development in different countries if there is a large public good aspect to the production of information by firms seeking external finance, that only the imposition of government-backed disclosure requirements can solve.

4.1 Legal and Regulatory Restraints on Ownership of Corporate Equity

As Table 9 documents, financial institutions in Japan and Germany are given more latitude to own shares in and exert control over firms than they are in Anglo-Saxon countries.

Table 9: Legal and Regulatory Constraints on Corporate Control

Institution	United States	United Kingdom	Japan	Germany	Australia
<i>Banks</i>	Stock ownership prohibited or requires prior approval of FRB and must be 'passive'. Source: Glass-Steagall and BHC Act.	Bank of England may discourage ownership on prudential grounds. Capital adequacy rules discourage larger stakes.	Prior to 1987 banks could hold up to 10 per cent of a firm's stock. After 1987 can hold up to 5 per cent. Source: <i>Anti-Monopoly Act</i> .	No restrictions, apart from some generous prudential rules.	Prior to 1996 banks discouraged from stock ownership. After 1996, can hold up to 5 per cent of Tier 1 capital in equity, up to 0.25 per cent in any one firm.
<i>Life insurance companies</i>	Can hold up to 2 per cent of assets in a single company's securities. Can hold up to 20 per cent of assets in equities. Source: NY Insurance Law.	Self-imposed limits on fund assets invested in any one company stemming from fiduciary requirement of liquidity.	Can hold up to 10 per cent of a firm's stock. Source: <i>Anti-Monopoly Act</i> .	Can hold up to 20 per cent of total assets in equities. Source: Insurance Law.	Can hold up to 5 per cent of statutory funds in any one firm.
<i>Other insurers</i>	Control of non-insurance company prohibited. Source: NY Insurance Law.	—	Can hold up to 10 per cent of a firm's stock. Source: <i>Anti-Monopoly Act</i> .	No restrictions.	No restrictions.
<i>Mutual funds</i>	Tax penalties and regulatory restrictions if ownership exceeds 10 per cent of a firm's stock. Source: <i>Investment Company Act</i> , 1940, IRS.	Cannot take large stakes in firms. Source: <i>Financial Services Act</i> , 1986.	No restrictions.	No restrictions.	No restrictions.

<i>Pension funds</i>	Must diversify. Source: ERISA.	Self-imposed limits on fund assets invested in one company stemming from fiduciary requirement of liquidity.	No restrictions.	No restrictions.	No restrictions.
<i>General</i>	SEC notification required for 5 per cent ownership. Antitrust laws prohibit vertical restraints. Insider trading laws discouraging active shareholding. Bankruptcy case law makes creditor in control of firm liable to subordination of its loans.	Insider trading laws discourage large stockholders from exerting control. Source: <i>Insider Dealing Act</i> .	—	Regulatory notification required for 25 per cent ownership.	Regulatory notification required for 5 per cent ownership. 25 per cent ownership requires formal takeover bid. Insider trading laws discourage active shareholding.

Sources: For the United States, Roe (1990); for other countries, various national sources.

In the United States, financial institutions face significant constraints on their ability to take large stock positions in firms and use them for control purposes.⁷ Banks are simply prohibited from owning any stock on their own account. Bank holding companies cannot own more than 5 per cent of a firm and their holdings must be passive.⁸ Bank trust departments are allowed to hold equity for beneficial owners, but they cannot invest more than 10 per cent of their trust funds in any one firm, and there are often other trustee laws that encourage further fragmentation of trust holdings.

Other financial institutions also face strict rules governing their equity investments. New York insurance law, which currently governs almost 60 per cent of total life insurance industry assets, places a limit of 20 per cent of a life insurer's assets, or one half of its surplus, that can be invested in equity, and a limit of 2 per cent of its assets that can be invested in the equity of any one firm. Other States have similar rules. Property and casualty insurers are prohibited outright from owning a non-insurer. Mutual funds are subject to tax and regulatory penalties if they own more than 10 per cent of the stock of any one firm. Pension fund investments are governed by the *Employee Retirement Income Security Act* of 1974 (ERISA), which requires all pension funds to be diversified, allowing little room for an influential position in a company.

In addition to institution-specific constraints, US securities laws discourage concentrated, active shareholding by investors in general. First, all entities acquiring 5 per cent or more of a company are required to file with the SEC, outlining the group's plans and revealing its ownership and sources of finance. Second, any stockholder who exercises control over a firm may be liable for the acts of the firm. Third, insider trading rules restrict large active shareholders from short-term trading of stock they own. Thus, Bhidé (1993) reports that pension fund managers are reluctant to own more than 10 per cent of a firm, because this would restrict the liquidity of their stake, which by law they have a fiduciary responsibility to protect. Fourth, SEC regulations have prohibited communication among large shareholders – until 1992 it was a violation of proxy rules for 10 or more equity holders to speak together about a firm's policies or management. Finally, the legal doctrine of equitable subordination discourages all creditors from taking equity positions in the company, since their loans are subject to subordination should they exert control over the firm.

In the United Kingdom, there are fewer formal restrictions on agents' ability to hold concentrated shareholdings in firms, but those that exist still appear substantial. Banks are usually subject to explicit Bank of England approval before they acquire significant shareholdings in non-financial firms. Banks' links with non-financial firms have also been subject to strict prudential rules which appear severe enough to have effectively precluded significant equity investments by deposit banks in the United Kingdom (Santomero and Langhor 1985). Insurance companies and pension funds in the United Kingdom typically operate according to self-imposed limits on their shareholdings in one company, for diversification reasons similar to those that have inspired US pension fund reluctance to take large stakes in individual firms (Minns 1980). And as in the United States, insider trading laws in the United Kingdom discourage investors from holding large equity stakes and using them for the purposes of corporate control since

7. For a detailed description of these restrictions, see Roe (1990) and Prowse (1990, 1995a and 1995b).

8. See Carey, Prowse, Rea and Udell (1993).

doing so makes them insiders and therefore vulnerable to prosecution under the *Insider Dealing Act*.

In Japan, there are far fewer regulations constraining particular financial institutions from holding corporate stock, or from using the stock they own for corporate control purposes. The sole restrictions derive from the *Anti-Monopoly Act*, which until 1987 limited a single bank's holdings of a single firm's shares to 10 per cent (the limit has since been lowered to 5 per cent). Insurance companies are similarly restricted to owning at most 10 per cent of the firm. Antitrust laws and insider trading legislation on paper look similar to those of the United States. However, there is widespread recognition that they are not enforced by the authorities.⁹

The institutional structure of the German financial system is based on the universal banking principle. Universal banks can hold whatever share of equity they like in any non-financial firm, limited only by a number of prudential rules which do not appear to be particularly binding and give banks wide latitude to own equity.¹⁰ There are few other aspects of the legal and regulatory environment that restrict concentrated shareholdings. Antitrust laws have not been used to discourage inter-corporate shareholdings as they have in the United States. There has for a long time been no explicit legislation against insider trading: Germany has only recently adopted EC-mandated standards regarding minimum levels of shareholder protection.

In Australia, banks have traditionally been discouraged by the Reserve Bank of Australia from taking equity stakes in non-financial firms, except in cases where the firm has defaulted on a loan. However, from 1996 banks are permitted to hold up to 5 per cent of their Tier 1 capital in non-financial firms' equity, with individual investment limits of 0.25 per cent of Tier 1 capital. Apart from regulations on banks, there are few restrictions specific to other financial institutions that are meaningful. For example, life insurance companies and superannuation (pension) funds are subject to few limits on their equity investments. Life companies, which manage over 40 per cent of Australian pension-fund assets, are restricted to a limit of 5 per cent of statutory (policyholder) funds invested in any one company, but the size of most statutory funds means that this limit is not often approached.

There are however, a number of general regulations that may discourage active equity investments by financial institutions. The first is the requirement for notification of the Australian Securities Commission for equity investments of 5 per cent or greater in a firm. Ownership of 25 per cent stakes or greater require a formal takeover bid to be launched. Finally, insider trading rules discourage large financial institutions from representing themselves on the boards of corporations in which they own sizeable stakes.

Overall, while the panoply of rules and regulations affecting the role of financial institutions as active investors in firms are not nearly as restrictive as those in the United States, the specific restrictions on banks and the more general restrictions on all financial institutions may effectively prevent any Australian financial institution from becoming as active an investor in the firm as those in Japan and Germany.

9. See *The Economist*, 19 May 1990.

10. The most onerous appears to be the requirement that total qualifying investments in equity and real estate should not exceed the bank's capital. A qualifying investment is one in which the bank takes a greater than 10 per cent share of the enterprise. See Deutsche Bundesbank (1991).

4.2 Suppression of Sources of Non-bank Finance in Japan and Germany

Table 10 documents some of the legal and regulatory restraints on access to external non-bank finance by non-financial firms in Japan and Germany in the postwar period. Unlike in the Anglo-Saxon countries, until the mid 1980s in Japan and until recently in Germany, there have been significant obstacles to firms raising external finance from sources other than banks.

Table 10: Legal and Regulatory Constraints on Non-Financial Firms' Access to Non-Bank Finance

Instrument	Japan	Germany
<i>Commercial paper</i>	Issuance prohibited until November 1987.	Issuance discouraged until 1992 by issue authorisation procedure and securities transfer taxes.
<i>Domestic bonds</i>	Stringent criteria for issuance of straight and convertible bonds until 1987.	Issuance discouraged until 1992 by issue authorisation procedure and securities transfer taxes.
<i>Eurobonds</i>	One-year approval period for foreign bond issuance until 1982. Restrictions on issuance of Euro-yen bonds until 1984. Withholding tax on interest income of non-residents until 1985. Eurobond issuance restrictions eased further in 1992.	Issuance abroad required prior notification of the authorities and was subject to maturity restrictions until 1989. Issuance of foreign currency bonds prohibited until 1990.
<i>Equity</i>	Heavy taxes on transactions in equities until 1988.	New share issues must be offered to existing shareholders first. 1 per cent corporation tax on all equity issues until 1992. Secondary trading in equities subject to securities transfer tax until 1992, ranging from 0.1 to 0.25 per cent. Annual net asset tax of 1 per cent on corporate net assets, payable irrespective of net income position.

Sources: International Financial Law Review (1990), Takeda and Turner (1992).

In Japan, these restrictions were gradually removed over the 1980s, but prior to this were very stringent. Until the early 1980s, the corporate sector had no direct recourse to capital markets for external finance. The domestic bond market was open to only a very few government-owned firms or electric utilities. The Bond Issuance Committee set severe eligibility requirements on issuers of corporate bonds through a detailed set of

accounting criteria that in 1979 permitted only *two* firms to issue unsecured straight and convertible bonds domestically. These requirements were gradually relaxed in the mid 1980s so that by 1989 about 300 firms were eligible to issue unsecured straight bonds.¹¹ Similar restrictions on access to the Eurobond market were relaxed in stages from 1982. Commercial paper issuance was prohibited by the authorities until 1987. While not directly restricted, equity issuance was discouraged by heavy taxes on transactions in equities until 1988.

Restrictions on non-bank finance in Germany have also been significant until even more recently. Issuance of commercial paper and longer-term bonds was hampered by requirements under the issue authorisation procedure and the securities transfer tax (Deutsche Bundesbank 1992). The issue authorisation requirements included obtaining prior approval by the Federal Ministry of Economics. Approval was granted if the credit standing of the issuer was satisfactory and if the application was supported by a bank. While this was little more than a formality for the large German firms, it added to the effective cost of a bond issue relative to a bank loan because firms could not generally issue the bonds at a time of their own choosing but were forced to wait for approval from the Ministry. The securities transfer tax often imposed a considerable burden on the secondary market for corporate securities, particularly at its short end. Foreign issuance of corporate debt has been subject to similar restrictions. Equity issuance and secondary trading of equities have historically been subject to a variety of taxes that have generally made equity uncompetitive with bank loans as a form of external finance (Döser and Brodersen 1990). Most important has been the legal requirements for employee representation on boards of public companies. These have been very important in discouraging the only form of organisation that is legally permitted to raise funds on the public markets (Borio 1990). Overall, these restrictions have made non-bank finance 'not a viable alternative for most German businesses'.¹²

In Australia, as in the United States and United Kingdom, there have been far fewer impediments on the development of corporate securities markets. For example, Australia was one of the first industrialised countries to allow the development of an active commercial paper market in the mid 1970s, compared to the United Kingdom (1986), Japan (1987) and Germany (1991). The issue of securities by corporations in Australia is governed primarily by the Corporations Law,¹³ and, in the case of securities which are traded on a stock market or a securities exchange, the rules of the relevant exchange – in practice, the Australian Stock Exchange (ASX). The only type of security that a company is prohibited from issuing under the Corporations Law is a share warrant or bearer share which is transferable simply by delivery of the document evidencing legal ownership (that is, no requirement for registration by the issuing company).¹⁴ The only possible substantial disincentive to issue securities in Australia would appear to be the stamp duty. Stamp duty is payable on the issue of corporate bonds at a typical rate of

11. See Nomura Securities (1989).

12. See Döser and Brodersen (1990).

13. The Corporations Law is enacted in each State and Territory, but effectively read as one law Australia-wide through mutual recognition of each jurisdiction (International Financial Law Review 1990).

14. This prohibition has its origins in the desire of State governments to protect stamp duty revenue on share transfers, since the instant nature of share warrant transfers would make collection difficult.

0.4 per cent. In addition, existing securities transferred to another party typically incur stamp duty at the rate of 0.06 per cent.

4.3 Fostering Non-Bank Finance through Disclosure Requirements

Quite apart from the active discrimination against non-bank finance for much of the postwar period in Japan and Germany, the lax disclosure requirements in these countries *may* have been an additional (passive) factor in discouraging non-bank sources of corporate finance.

Firms in Anglo-Saxon countries wishing to issue securities to the public have been required to disclose much more information than those in Japan and Germany. Results from a recent OECD survey illustrate this pattern.¹⁵ In a study of multinational firms' consolidated financial statements, the OECD rated their disclosure relative to OECD guidelines as 'full', 'partial', or 'not implemented'. Table 11 illustrates the results for two areas of disclosure – operating results and sales. Two-thirds of the US firms and three-quarters of the UK firms surveyed had fully implemented the OECD disclosure guidelines for operating results; the rest had partially implemented them. In Germany none of the firms surveyed and in Japan less than 10 per cent of those surveyed had fully implemented the guidelines. The results for the disclosure of sales (and other areas not reported here) reveal a similar pattern.

Table 11: Selected Results from a Survey of the Implementation of the OECD Guidelines on the Disclosure of Information by Multinational Enterprises

Number of firms

Country	Implementation of guidelines on disclosure of operating results			Implementation of guidelines on disclosure of sales		
	Full	Partial	Not implemented	Full	Partial	Not implemented
US	34	19	0	35	18	0
UK	19	6	0	18	7	0
Japan	2	21	0	6	17	0
Germany	0	19	0	11	8	0
Australia	11	1	0	11	1	0

Source: OECD (1989).

Table 11 also reveals that disclosure requirements in Australia are as strict if not stricter than those of their Anglo-Saxon cousins, and much stricter than those of Japan or Germany. All but one of the 12 Australian firms surveyed had fully implemented the

15. See OECD (1989).

OECD guidelines on the disclosure of operating results and sales – the other had partially implemented them. Indeed, out of 11 reporting areas surveyed by the OECD, Australia was below average in only one area – the disclosure of the geographical areas where operations are carried out and the principal activities carried on therein by the parent company and affiliates. Overall, Australian company disclosure practices appear on a par with the most demanding in the world.

There is a fairly intense academic debate as to the effects of mandated corporate disclosure requirements, with no conclusive answer. One hypothesis is that mandated disclosure rules help firms make credible commitments to outside investors to provide honest and timely disclosure and protection from market manipulation or insider trading. In this view, for strategic, competitive reasons firms may not have sufficient incentives voluntarily to provide the financial information outside investors would require to consider extending such finance (for example, they may be afraid that competitors could take advantage of such information). Thus, absent a regulatory and legal framework requiring adequate, standardised disclosure to outside investors, the development of a liquid market for corporate securities may be effectively impeded.¹⁶ The alternative hypothesis is that regulation unduly constrains the choices of firms and investors and prevents efficient contracting. In this view, firms have sufficient incentives to provide the optimal amount of disclosure to obtain external financing, and regulations mandating such disclosure are, at best, irrelevant, and at worst, burdensome on both firms and investors.¹⁷

Ultimately, the effect of mandated disclosure requirements is an empirical issue. Unfortunately there is only a limited amount of empirical work that bears on this topic. Stock price studies of firms before and after the US 1933 *Securities Act* suggest that mandated disclosure regulations impose costs on firms (Bentson 1973; Chow 1983). On the other hand, Sylla and Smith (1995) explain the differing speeds of development of stock markets in the United States and United Kingdom since 1800 on differences in mandated disclosure rules. They attribute the faster development of the stock market in the United Kingdom in the 19th and early 20th century to the various Companies Acts between 1844 and 1900 which required substantial disclosure by firms wishing to issue equity. Disclosure requirements were significantly less onerous in the United States until the 1930s, when the *Securities Acts* of 1933 and 1934 went beyond even what the British had put in place. Sylla and Smith claim these disclosure rules were responsible for putting the United States ahead of the United Kingdom in terms of the size and depth of the stock market in the immediate postwar period.

While this debate is far from settled, it is nevertheless possible that the marked differences in disclosure requirements between countries may be in part responsible for the differences in the relative speeds of development of securities versus intermediated markets.

16 Proponents of this view include Dye (1990), Dye and Magee (1991) and Demski and Feltham (1994).

17. Proponents of this view include Bentson (1973), Leftwich (1980), Phillips and Zecher (1981) and Watts and Zimmerman (1986).

5. Costs and Benefits of Different Systems of Finance and Governance

There is much debate about the efficiency of the different systems of corporate finance and governance in the industrialised countries, with no clear conclusion. While much of the academic and policy-related literature finds particular advantages in the financing and governing systems in a particular country, this has not translated into overall demonstrably cheaper capital for firms, nor obviously superior mechanisms of corporate control in any one country.

Without going into the detail of the individual studies on this broad topic, the consensus of the academic literature to date appears to be the following:

- there are a number of advantages to a system that allows large equity and debtholders of the firm to be the same agents, that encourages the concentrated holding of debt and equity claims, and where ties between financial institutions (typically banks) and firms are relatively tight. Cable (1985), Prowse (1990), Hoshi, Kashyap and Scharfstein (1990), Lichtenberg and Pushner (1992) and Elston (1993) all provide evidence suggesting that the concentrated holding of debt and equity claims by financial institutions (typically banks) in Germany and Japan mitigates the information problems of external finance and governance to a greater extent than in the Anglo-Saxon countries where ties between banks and firms are less tight;
- the Japanese and German system *may* be vulnerable to the ‘who monitors the monitor?’ problem. In systems where reliance is on direct shareholder monitoring, the large shareholders (typically the banks) have a particularly important role to play. However, if these institutions themselves are diffusely held there may be a problem in ensuring that they conduct the investment and monitoring function in an efficient manner. Although there is plenty of evidence that Japanese and German banks are diffusely held institutions (Prowse 1995a), there is to date no evidence on whether this has resulted in any problems of corporate control;
- takeovers are a costly and sometimes weak mechanism of corporate control. The cyclical nature of the takeover market means that there are periods when the takeover market literally shuts down, typically in recessions when finance is hard to obtain. In these periods the takeover threat may not be credible. In addition, takeovers are vulnerable to broad political and regulatory forces that have provided a large impediment to the market for corporate control in the United States in the early 1990s. Finally, in industries where for regulatory reasons takeovers are precluded, the corporate control mechanism may be weak (Prowse 1995b);
- countries where securities markets play an important financing role appear to embody some important strengths that the systems of Germany and Japan lack. Sahlman (1990) and Porter (1992) provide evidence that the US system appears better at funding emerging companies and new (often high technology) business activities than the German or Japanese system. Franks and Mayer (1992) argue that such a comparative advantage is the reason for the predominance of high-technology firms in the fields of oil exploration, biotechnology, pharmaceuticals and computer software in the United States. Porter (1992) claims that liquid United States capital

markets are able to reallocate capital from low to high-growth sectors more efficiently than in Japan or Germany; and

- the particular advantages of each system do not appear to translate into overall measurable aggregate differences in either the cost of external financing or the effectiveness of the corporate control mechanism. Both systems appear to have the power to cure the most egregious cases of management indiscipline. Conversely, both systems also have their embarrassing examples of breakdowns in corporate control. Kaplan (1993a, 1993b) reports that top management turnover exhibits *similar* sensitivities to measures of poor firm performance in the United States, Japan and Germany. Similarly, there are legions of cost of capital studies with no consensus as to which system delivers external finance to firms at the lowest cost.¹⁸

6. Pressures for Change in the Existing Systems

Static comparisons of the financial systems as they existed in the early 1990s miss a crucial point: the systems are evolving over time in response to a variety of external pressures. Overall, the legal and regulatory environment of the different countries appears to be converging, but the focal point of this convergence is not one system or another as it currently exists, but a new legal and regulatory environment that allows financial institutions to be active investors in firms *and* allows unfettered access to securities markets by firms seeking external finance. This evolution appears to be occurring most rapidly in Japan and Germany, probably because their traditional systems of finance and governance – which have involved tightly regulated securities markets – are most inconsistent with the emerging pressures for change.

What are the forces behind this evolution? I consider four trends that I believe are common to the major industrialised countries and which I believe will dramatically change systems of corporate finance and governance over the long term. These forces are:

- technology, particularly as it affects financial globalisation and market innovation;
- the changing nature of the firm;
- the growth of the institutional investor; and
- the increasing incentives for institutional investors to be active investors.

6.1 Technology, Financial Globalisation and Market Innovation

The most profound change is probably technology: the rapid growth of computers and telecommunications. Their spread has lowered the cost and broadened the scope of financial services, making possible new product and market development that would have been inconceivable a short time ago, and in the process challenging the institutional and market boundaries that in an earlier day seemed so well-defined. Technological innovation has markedly accelerated the process of financial globalisation. Both developments have expanded cross-border asset holdings, trading and credit flows and in response both securities firms and US and foreign banks have increased their

18. See, for example, Kester and Luerhman (1992).

cross-border locations. Market innovation has been as much of a reaction to technological change and globalisation as an independent factor. Overall, these combined forces have led to the development of global markets for corporate securities (equities, bonds and commercial paper) and intermediated loans, to which the large firms of all the major industrialised countries potentially have access. In particular these developments have made many of the statutes governing corporate finance in Japan and Germany form an increasingly inconsistent patchwork, and have increased the pressure to relax restrictions on access to non-bank finance that have been a major characteristic of the postwar legal and regulatory environment of these two countries.

Japan is the clearest example of the legal and regulatory environment changing in response to these pressures. The regulatory and legal structure of the Japanese financial system has been slowly changing since the 1970s under both domestic and international pressure for reform. From a corporate finance perspective, the most important aspect of Japanese deregulation has been the gradual and continuing removal of restrictions on non-bank finance. Rosenbluth (1989) argues that the regulation of Japanese corporate finance in favour of bank lending proved unsustainable in the face of growing competition from the Euromarkets, and the decline in profitability of bank lending after the removal of interest rate controls.

Ties between banks and large firms in Japan that have easy access to the Euromarkets and the developing domestic bond market are weakening substantially in response to this deregulation (Kester 1991; Hoshi, Kashyap and Scharfstein 1993). This has obvious implications for how corporate financing in Japan will evolve in the future. The deregulation has already increased Japanese firms' access to securities markets, both at home and abroad: while Japanese non-financial corporations obtained only 15 per cent of their total gross external financing from securities markets between the years 1970 and 1985, from 1986 to 1990 they obtained over 30 per cent of their external funds from bond and equity markets.¹⁹

The German legal and regulatory environment has also shown recent signs of changing. As part of the attempt to compete with London as a centre of finance, the authorities have relaxed many of the restrictions on corporate finance in recent years (Deutsche Bundesbank 1992). In addition, other aspects of the German legal and regulatory framework will have to change under the planned EC reforms. As in Japan, this is likely to increase the role of securities markets in the financing of German firms.

Technology, market innovation and globalisation are also adding to the pressure on authorities in the Anglo-Saxon countries to reduce the regulatory restrictions on banks being active investors in firms, particularly in the United States where these restrictions are probably the most severe. American commercial banks have been fierce lobbyists in favour of repealing the Glass-Steagall Act, which prohibits them from engaging in investment banking activities including the underwriting of corporate securities, and the holding of them on their own account. They claim such restrictions preclude them from effectively competing internationally with foreign banks who do have such powers, and domestically with non-banks who are also able to offer one-stop shopping financial services (loans, underwriting services) to firms. While Glass-Steagall has survived

19. See Bank of Japan (1992), Prowse (1995a).

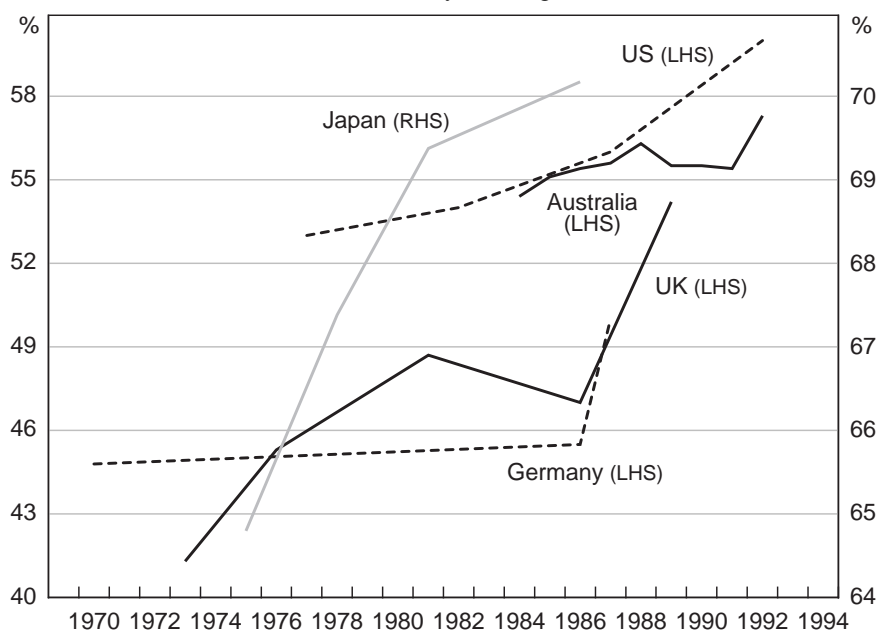
predictions of its demise for almost two decades, it is very likely that it will indeed be repealed before the turn of the century.

Banks in Australia have recently been given expanded powers to invest in the equity of non-financial firms. Last year, the Reserve Bank modified its policy on this issue to allow banks to make equity investments in, as well as providing loans to their business customers, up to certain prudential limits (see Table 9).

6.2 The Changing Nature of the Firm

Another force at work is the changing nature of the firm. Small and medium-sized firms have become increasingly important in the economies of many industrialised countries. Figure 1 shows the employment share of small businesses in the United States, United Kingdom, Japan, Germany and Australia from the early 1960s to recent years. While inconsistencies in the data caution against making comparisons *across* countries, the common trend *over time* for each country is rather more clear: small and medium-sized businesses have been becoming increasingly important in recent years, particularly in the United States, United Kingdom and Japan. In Germany and Australia, the trend does not seem as pronounced. In Germany, this may be because small and medium-sized firms

Figure 1: Employees in Small Enterprises
Per cent of all salary and wage earners



Sources: US, Prowse (1996); other countries, Bureau of Industry Economics (1992).

have historically always been a very important sector in the economy,²⁰ while the short time period for which data is available prevents drawing concrete conclusions for Australia.

The reasons behind this phenomenon are not entirely clear, but are very likely to be at least partly related to the evolution of the developed economies to an information-based structure. This has contributed to small firms' growth since many service and technology based firms tend to be small or medium sized. The increasing tendency for large firms to outsource many of their administrative functions to smaller firms (such as payroll, accounting and personnel) is also a factor in the growing importance of small firms in many countries.

The implications of this phenomenon for the corporate financial systems of these countries are somewhat more obvious: as small and medium-sized firms have increased in importance so has their demand for capital. Thus, there is pressure in many countries for an expansion of financial markets that can cater to the needs of smaller firms – in particular, those markets that can mitigate the information problems that smaller firms pose to investors. In the United States this has manifested itself in the extremely rapid growth of the private placement and private equity markets, which cater primarily to small and medium-sized firms. For example, the private placement market – which caters to medium-sized firms with revenues between about \$100 million to \$500 million – has grown very rapidly over the last decade and is now quite large. Average annual issuance in recent years is almost five times greater than in the early 1980s and in some recent years issuance has actually exceeded that of public bonds, even though individual issue sizes are much smaller than those in the public market.²¹ Similarly, the private equity market – which caters to startup firms seeking venture capital and slower-growing medium-sized firms – has also expanded very rapidly. Indeed, although the private equity market is small compared to others, its growth since 1980 has been astronomic, much faster than other long-term finance markets. The private equity capital stock invested in small and medium-sized private companies in 1994 was about \$40 billion, almost 15 times larger than in 1980.²²

In addition to market-based changes, there have been changes in the legal and regulatory environment designed to reduce the regulatory burden of raising capital for small and medium-sized firms. Of particular note is the SEC's endorsement of the Small Corporate Offering Registration, which by simplifying disclosure requirements, allows small firms to raise equity publicly without incurring the large costs previously involved.

In Australia, there have also been a number of institutional and regulatory changes in the structure of financial markets designed to improve the access of small and medium-sized firms to equity capital. Several private companies are considering a number of proposals which potentially could revolutionise equity trading for medium-sized firms. AUSDAQ, a trading system designed for dealing in equities in small and medium-sized firms, is to

20. Harm (1992) reports that small firms – the so-called 'Mittelstand' – have always been a large share of the economy in Germany. Figure 1 should not be taken to contradict this notion, since comparing levels of importance across countries is extremely problematic owing to different survey techniques and coverage.

21. See Carey *et al.* (1993).

22. See Fenn, Liang and Prowse (1995).

become operational in 1996. In addition, there are proposals to establish a stock exchange catering to startups and other small companies which will have less stringent listing requirements than those currently applying to ASX listings, with no qualifying restrictions on capitalisation, length of trading record or the percentage of shares in public hands. This will be a formal mechanism to tap funds from private equity investors such as business angels and venture-capital companies. The idea behind both of these innovations is to improve the liquidity, efficiency and opportunities for exit in the equity market for small and medium-sized firms, thereby encouraging more investment capital into the market. In addition, like in the United States, consideration is being given to a number of proposals which would lower the costs of raising equity publicly for small firms by relaxing some disclosure and other requirements.²³

Access to the Australian stock market by small companies wishing to make initial public offerings (IPOs or 'floats' in Australia) is also significant. There has been much discussion in the US press about the booming IPO market in the US. But the IPO boom in the United States appears puny in comparison with that in Australia in recent years. Annual average issuance of stock through IPOs over the past five years has been over three times higher (as a percentage of GDP) in Australia than in the United States.

In Japan and Germany, the historical reliance on banks might seem tailor-made for the financing of small and medium-sized firms. But the banks have appeared to be more concerned with lending to their large customers and small firms have consequently been ignored. Combined with the undeveloped nature of their securities markets, this has meant that smaller firms have found it difficult to access growth capital. Many medium-sized European firms now find it easier to do IPOs on the US NASDAQ exchange rather than raise capital domestically. This small-firm finance problem has been an additional factor in the pressures on regulators in Japan and Germany to open up their securities markets to a greater number of firms.

6.3 Increasing Importance of Institutional Investors

An important development in many industrialised countries in recent decades has been the growing importance of long-term institutional investors such as life insurance companies and pension funds. In the Anglo-Saxon countries, these institutional investors have come to dominate the capital markets, and many of the implications of this domination are still playing themselves out in terms of how firms are financed and governed in these countries. Perhaps more importantly, if current trends continue, institutional investors will also come to dominate Japanese and German capital markets. This would be a profound change for the corporate finance systems of Japan and Germany.

Table 12 illustrates the rapid growth of life insurance and pension fund assets in the five economies under study since 1970. Currently, these institutions are the most important institutional investors in the Anglo-Saxon countries, where their assets make up between 13 per cent and 27 per cent of total personal sector assets. In contrast, in Japan and Germany, they make up only 2 per cent of personal sector assets. Such

23. See, for example, The National Investment Council (1995).

Table 12: Life Insurance and Pension Fund Assets

Country	As a percentage of GDP		As a percentage of personal sector assets
	1970	1990	1990
United States	37	59	13
United Kingdom	43	97	27
Japan	8	41	2
Germany	10	22	2
Australia	26	39	16

Source: Davis (1992).

differences in the importance of institutional investors are primarily accounted for by the scope and certainty of the state social security system and the way private pensions are structured in different countries. For example, in Japan and Germany, relatively generous social security provisions have accompanied smaller private pension schemes. In addition, in Germany about two-thirds of the funds earmarked for the payment of private pensions is retained by the company as an unfunded liability. Only the remainder is invested outside the company via private pension funds. The funds retained by the company are used for general corporate purposes. The result is that there is less capital available for the capital markets and less demand for external financing than in Anglo-Saxon countries where the bulk of private pensions are channelled through private pension funds.²⁴

However, given the rapid ageing of the populations of Germany and Japan over the next few decades, their governments are likely to limit social security commitments and stimulate private saving for retirement. This is likely to stimulate rapid growth of private pension funds. Australia provides a good example of this phenomenon already occurring. Currently every employer must contribute at least 6 per cent of their employees' salaries to a pension fund. By the year 2000 this share will rise to 9 per cent. In addition, by 1997 each employee must contribute 3 per cent of their salary to such a fund. This will spur rapid growth of pension fund assets in Australia in the first few decades of the next century.

What are the implications of institutional investors being big players in the corporate capital markets? As Davis (1992) notes, what we observe is that countries with large pension fund sectors tend to have well-developed securities markets, and vice versa. The question is, which is the causal factor? There are those who argue that, other things equal, the presence of large institutional investors in the market should encourage the development of securities markets, since their preferred investments traditionally have been in securities of various types rather than intermediated loans or real estate. However, Jensen (1989) argues that the investment philosophy of US public and private sector pension funds has been evolving recently. Whereas in the past a primary goal of pension

24. See Edwards and Fischer (1994).

funds was diversification, achieved by retaining many different investment managers each of whom traded an array of highly liquid public securities, recently such funds have increasingly participated in a select number of private illiquid investments and private pools of equity capital, making highly liquid public markets less essential to their operations. After all, since pension funds can project their cash needs well into the future based on predictable factors such as employee demographics, life expectancies and health trends, they do not have an inherent need for liquidity as much as the individual investor.

There is very likely some truth in both arguments. Proponents of the first argument can point to the considerable evidence that the presence of large institutional investors has improved the efficiency and degree of innovation in the public securities markets in the United States and United Kingdom (Davis 1992). However, there are signs in the United States that pension funds are beginning to turn to more illiquid investments. Indeed, regardless of their preferences for liquidity, there is considerable evidence that their holdings of public securities are becoming more illiquid simply because of their increasingly large holdings of such securities, and the trading costs involved with selling such holdings. This point is explored more fully in the next section.

6.4 Increasing Attraction of Active Ownership for Institutional Investors²⁵

In recent years there have been signs that US and UK institutional investors are becoming more informed, active monitors of firms than has traditionally been the case. In the past, many institutional investors in the United States and United Kingdom were devotees of the 'Wall Street Walk', which involved selling the stakes of the companies in which the shareholder was unhappy with management behaviour. Recently however, it appears there has been a significant change in the costs and benefits of becoming a more active investor in firms that has led more and more institutional investors to become informed, active monitors of firms rather than simply passive holders of shares. While they have a long way to go before their behaviour can be compared to German and Japanese banks, it does appear that the attractions of becoming active investors will continue to increase in the Anglo-Saxon countries.

The driving force behind this change in the cost-benefit calculus of active monitoring is the increasing concentration of corporate ownership in the hands of the institutional investors, along with (in the United States) the relaxation of regulations that have made active investing by large shareholders difficult. Currently, the largest institutional investors in the United States (mutual funds, pension funds, and life insurance companies) each own over 1 per cent of the largest 1,000 companies listed on US stock exchanges. A 1 per cent investment might appear to be too small to give an institutional owner much incentive to monitor actively the management of the company, but in reality the opposite is the case: a 1 per cent ownership stake in a large US company is a huge investment that gives the institutional investor enormous incentives to act like an owner. For example, consider an institution that holds a 1 per cent stake in the common stock of GM. The market value of this holding is over US\$450 million. Now consider the decision this

25. Much of this section is taken from Pound (1992).

owner faces when voting on a corporate issue. There may be the potential for the company's stock price to gain or lose 20 per cent depending on the initiative's outcome – which amounts to US\$90 million of the 1 per cent owner's investment. Moreover, doing the Wall Street Walk and simply selling the stock could cost the 1 per cent owner as much as \$4 million in trading costs (brokerage fees and the fact that selling such a large stake would probably push the price down). To this extent, the sheer size of this stake and the trading costs associated with selling make the institution 'captive'. The 1 per cent owner of GM thus has an incentive to spend considerable resources if necessary, to analyse the issue and persuade management to follow the preferred course. In many cases it may be cheaper for the institutional investor to do just this rather than to sell.

A large number of institutional investors, all performing the same cost-benefit analysis, creates a large constituency with incentives to press a value-maximising agenda on management. Thirty years ago, appealing to a majority of shareholders meant circulating material to tens or even hundreds of thousands of poorly informed individual owners. Owing to the increasing concentration of ownership in the hands of institutional investors, appealing to shareholders with sizeable voting power is much less costly: a dissident shareholder can reach a shareholder majority by contacting, say, 25 investment professionals all of whom understand the issues and can devote considerable expense to their analysis. This means a dissident investor should be able to press a serious counter-agenda with a controlling fraction of shareholders for much less than the \$4 to \$5 million typically associated with a full-control proxy contest – in some cases for as little as \$250,000 to \$500,000.

In fact, US institutional investors are already using shadow management committees, independent director slates and outside experts to critique management policy. These mechanisms allow investors to exert pressure on management. The increasing motivation for activism has in turn led to institutional investors pressuring the SEC to allow them more freedom to monitor management actively. In recent years SEC regulations precluding large shareholders from communicating with each other have been relaxed. In addition, there is a fierce debate over the degree to which the current restrictions on the ability of financial institutions to be active investors in firms act as impediments to more efficient governance.

In Australia, a similar pattern is emerging although it is as yet probably not as developed as in the United States. Greater-than-1 per cent ownership stakes in major firms are not uncommon. Many such owners may have started to perceive themselves as captive in the sense that simply selling such a large stake on the market in response to dissatisfaction with management policies or performance would involve prohibitive trading costs. Such investors may thus be becoming more interested in investing resources in governance activities rather than in 'wasting' them on trading costs.

7. Implications of Changing Legal and Regulatory Environments

The preceding discussion suggests that current mechanisms of corporate finance and control in all countries may simply not be viable in the long run. There is clearly some long-term convergence going on in the legal and regulatory environments of these

countries, and the focal point of this convergence is not the Japanese/German or US/UK system as it currently exists but an environment where financial institutions (including banks) are free to be active owners *and* where corporate securities markets are unhindered by regulatory and legal obstacles. What will be the primary mechanisms of corporate finance and control in such a system?

This is a difficult question to answer for a number of reasons. First, we do not have models among the developed industrialised countries we can look at where the legal and regulatory environment allows financial intermediaries to be active investors *and* allows firms easy access to securities markets. The closest thing to this model might arguably be the United States in the early 20th century. In the United States in the 1920s, firms had relatively free access to non-bank finance, securities markets were relatively active, and there were few restrictions on the ability of financial institutions to take equity and debt positions of a size to confer some control.²⁶ In this system, there might plausibly be some firms that would be able to solve their financing and governance problems better by using intermediated finance from intermediaries who also take active equity positions in the firm, and conversely, some that may solve their problems better by relying on securities markets for external finance and an active takeover market for corporate control. Just how and why this 'mix' occurs is a subject worthy of further investigation in the form of a more detailed analysis of this period in US financial history.

However, even if we had models that we could look at, they might not be very informative with regards to what would happen in different countries that adopted this freer regulatory environment with respect to corporate capital markets and institutional investors acting as active investors. This is because the starting-point of a system may be important. In particular, a convergence of regulatory environments may not imply a convergence of economic outcomes because institutional history matters. That is why continuing research on the institutional and regulatory differences between financial systems is likely to remain important.

26. See for example De Long (1990).

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