

European capital markets: Competition between systems



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1. Introduction

There is an active global debate on corporate governance. A few years ago, there was serious concern about whether US companies would be able to compete against the powerful corporate groupings supported by closely involved banks in the Far East. Now, following the collapse of the East Asian economies, and in particular Japan, "shareholder value" oriented companies, operating in the stock market-dominated financial system of the US, are increasingly seen to be enjoying a competitive advantage over their foreign rivals. The corporate and financial systems of the Far East are currently believed to have resulted in serious misallocation of resources, while US companies and institutions have backed high tech, fast growth industries.

In Europe, the main contrast is between UK and Continental European financial markets. Until recently, there was considerable concern that UK companies were disadvantaged by a pre-occupation with short-term returns for shareholders while Continental European companies could enjoy longer term support from their banks and corporate allies. Now, the prevailing view is that Continental systems will have to adapt to market-oriented conditions and that lack of transparency, illiquidity of shares and poorly functioning financial markets have impeded the growth and restructuring of European industry. This is most clearly reflected in the immature state of the European venture capital industry. While the UK and US financial systems were until recently regarded as being seriously deficient in promoting corporate activity, they are now viewed as being in the vanguard of corporate development.

This article will argue that this debate will bear crucially on the way in which financial markets will develop in Europe. It begins in Section 2 by summarising the pronounced differences that exist in the structure of financial systems, corporate sectors and legal systems across Europe. In Section 3, it will consider the implications of these differences for the performance and activities of European industries. Section 4 will consider the pressures for change and the way in which they are affecting integration of and competition between financial systems, corporate structures and legal systems. Section 5 will discuss the implications of these developments for policy and the roles that different financial institutions will play in the newly emerging European system.

2. Differences between systems

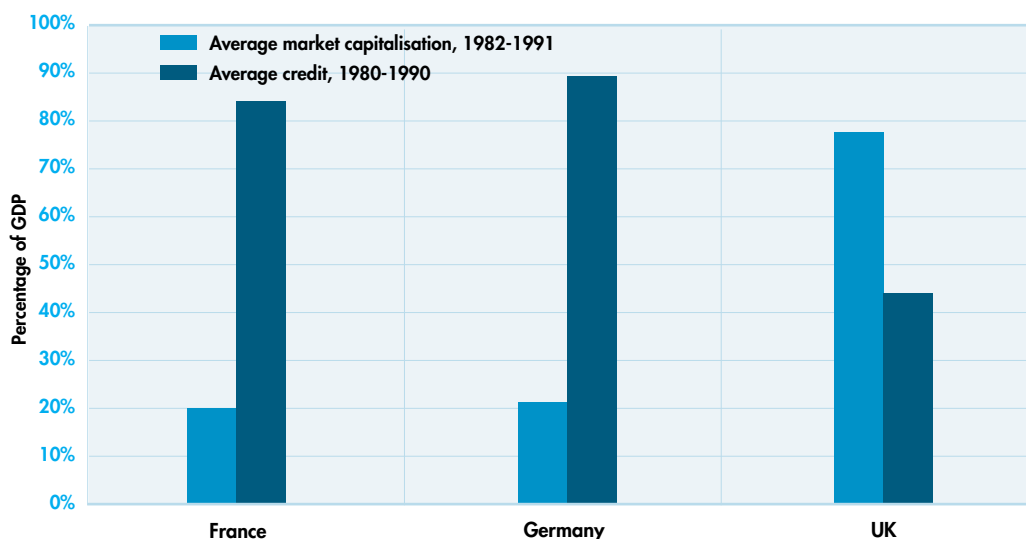
Figure 1 shows the size of stock markets and banking systems in three European countries. It records the ratio of market capitalisation to GDP averaged over the period 1982 to 1991. In the UK the ratio was 76% while in France and Germany it was approximately 20%. The average for OECD countries as a whole was 30%. In Japan it was 85% and in the USA 56%. Stock markets in the UK, USA and Japan were appreciably larger over this period than in most OECD countries. On the

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other hand, bank lending during the 1980s was significantly higher in France and Germany than in the UK. The ratio of credit to GDP averaged around 80% in France and Germany, whereas it was approximately 40% in the UK. The figure for Japan was 102% while in the US it was 69%.

Figure 1. Size of stock markets and bank lending



Source: IFC Emerging Stock Market Factbook

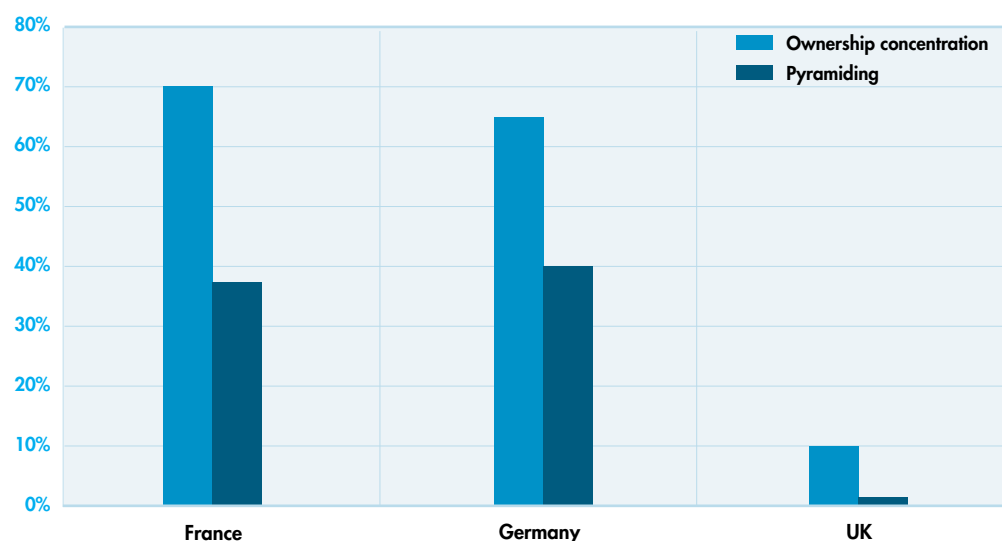
The distinction between market- and bank-based systems does not only concern the size of markets but also the relationship between financial institutions and firms. Financial institutions are viewed as having "arms-length" relations with firms in the UK and US but close relations in many Continental European and Far Eastern economies. There are several ways in which this can be measured but one that is frequently discussed is bank ownership of corporate equity. In the UK, the proportion of corporate equity owned by banks averaged 2% over the period 1980 to 1990. In the US, the figure was close to 0%. In France, it was over 6% and in Germany over 13%. The equivalent figure in Japan was 23%.

There are, therefore, large stock markets in the UK and US and relatively high levels of bank lending on the Continent and in Japan. There are closer relations between financial institutions and firms on the Continent and in Japan, as reflected in higher levels of bank ownership of corporate equity than in the UK and US.

While there are appreciable differences in financial systems across countries, there are still more striking variations in the ownership of corporate sectors. Figure 2 reports data on ownership concentration in France Germany and the UK, measured by the proportion of the 20 largest firms in each country with a single shareholder owning more than 10% of shares. It shows that in almost 70% of the largest companies in France and Germany, there is a single shareholder owning more than 10% of shares. In the UK, the equivalent figure is 10%. In the US, it is around 20% and in Japan, 50%. Concentration of ownership is therefore appreciably higher on the Continent and in Japan than it is in the UK and US. Families and other companies hold many of these large share blocks. Inter-corporate holdings are commonplace on the Continent but rare in the UK and US.

Furthermore, inter-corporate holdings frequently take the form of pyramids. Figure 2 also shows that around 40% of the largest 20 companies in France and Germany are held in pyramids, whereas in the UK there are virtually no pyramid holdings. Pyramids allow shareholders at the top of the pyramid to exert control disproportionate to the size of their share holdings by bringing in outside equity lower down in the pyramid.

Figure 2. Ownership concentration and pyramiding of the 20 largest firms



Source: La Porta *et al.*, (1998).

The UK and the US have large stock markets in which ownership is dispersed amongst many investors. Elsewhere there is more bank lending and bank ownership of equity. Ownership is appreciably more concentrated, frequently with pyramid structures.

To summarise, the UK and US have large stock markets in which ownership is dispersed amongst a large number of frequently institutional investors. There is little bank ownership of corporate equity and few inter-corporate holdings. Stock markets are much smaller in most other countries. There is more bank lending and more bank ownership of corporate equity. Ownership is appreciably more concentrated than it is in the UK and US, frequently in the form of pyramid structures.

3. Implications of differences for performance

Over the last few years, a literature has emerged which has looked at the influence of financial development on economic growth. A strong relation between the size of financial systems, as measured for example by bank credit and stock market capitalisation to GDP ratios, and economic growth has been found across a large number of countries. There therefore appears to be a clear association between financial and economic development (1).

A second strand of literature focuses on differences in developed countries' financial systems. The debate over financial systems dates back to the turn of the century when comparisons were drawn between the success of the German banking system in supporting German manufacturing industry with the apparent failure of the UK financial system to do likewise. Similar contrasts have been drawn between the Japanese and US financial systems. In a much cited analysis of industrial groups

1) See, for example, King and Levine (1993a, b, c), Levine (1997), Levine and Zervos (1998) and Rajan and Zingales (1998).

The debate over financial systems dates back to the turn of the century and the relative success of the German banking system in supporting German manufacturing industry.

in Japan, Hoshi *et al.*, (1990) argue that members of groups encounter fewer financial constraints during periods of financial distress than other firms. But this view has been challenged by Weinstein and Yafeh (1998) who find that "even prior to the liberalisation of financial markets in Japan, main bank clients did not exhibit high profitability or grow faster than their industry peers, even though their superior access to capital resources was evident in their production techniques.... The low growth rates of main bank clients and the relatively high interest they have been paying on their bank loans suggest that the banks could use their monopoly power both to squeeze their clients' profits through interest payments, and to inhibit their growth through conservative investment policies" (p. 671). In other words, Japanese banks have used their close relationships to exploit monopoly power and impose their conservative judgements on companies.

The role of German banks in German industry has also been questioned. Edwards and Fischer (1994, p. 240) find that "the commonly-held view of the merits of the German system of finance for investment, in terms of the supply of external finance to firms and corporate control, receives no support from the analysis of the available evidence". Edwards and Ogilvie (1996) go on to argue that, not only is the current role of German universal banking overstated, it probably never was as significant as suggested, even at its zenith at the turn of the century: "The picture which emerges is not consistent with the claim that German universal banks exerted substantial control over industrial companies and provided significant amounts of finance. Although there were some cases of this, these were the exceptions to the general rule, which was for companies to finance themselves internally to very great extent" (p. 441).

More recently the comparative systems debate has moved on to corporate governance and control. The dispersed nature of corporate ownership in the UK and US allows markets for corporate control to operate in a way in which concentrated ownership in most other countries prevents. The UK and US are therefore distinguished from most other economies in having active markets in corporate control. These are associated with the disciplining of bad management and are supposed to allow the replacement of poor by superior management. However, the evidence in support of this proposition is limited. "Using a number of different benchmarks", Franks and Mayer (1996, p. 164) "find little evidence that hostile take-overs are motivated by poor performance prior to bids. We therefore reject the view that hostile take-overs perform a disciplinary role".

In place of tender offers, countries with concentrated ownership have markets in share blocks. Franks and Mayer (1998a), for example, report "a high incidence of control changes through sales of large share stakes" (p. 1) in Germany. In addition, there is a more direct association of ownership with board representation than in the UK and US: Supervisory board "representation goes hand in hand with ownership. Where the major shareholder is another company, the shareholder appoints the chairman of the board in more than three quarters of the sample; in addition, about one quarter of all remaining members of the board are appointed by the largest shareholder" (p. 10). The German corporate system might therefore be expected to display more active corporate governance than exists in the UK or US. However, in an examination of board turnover and performance in different types of German firms, Franks and Mayer conclude that there is "little relation between concentration of ownership and the disciplining of management of poorly performing firms and little relation between the type of concentrated owner and board turnover. The pronounced influence which might have been expected from the very high levels of concentration

of ownership in Germany and the distinctive forms in which shares are held through banks and pyramids is not in evidence" (p. 28).

While there is a strong relation between financial and economic development, the relation between types of financial and corporate systems in developed countries and economic performance is unclear. Recently it has been suggested that financial and corporate systems may have more relevance to the composition rather than the overall level of economic activity in developed countries (see Carlin and Mayer (1999a, b). There are several possible reasons for this. The first relates to monitoring by investors. Stock markets provide a mechanism of aggregating together the diverse views of a large number of investors about future performance of firms and investments. This is particularly relevant to high technology investments where divergences of views amongst investors are justified by uncertainty about the likely success of new technologies. In contrast, more traditional activities benefit from the economies of scale in monitoring quality of management and investments that financial intermediaries can provide. Allen (1993) therefore argues that different types of financial systems will be suited to different types of activities. This raises questions of the form whether Oracle, Microsoft and Sun would have flourished under bank oriented financial systems and, conversely, whether the huge level of manufacturing investment observed in the Far East, in particular in Korea, could have been sustained in the absence of large banking systems.

The literature on corporate governance has pointed to the trade-off between the control benefits of concentration of ownership and the potential conflicts that arise between minority and majority shareholders. Shleifer and Vishny (1986) argue that concentrations of ownership overcome free-rider problems of corporate control that afflict dispersed ownership markets. However, Shleifer and Vishny (1997) point to the potential abuses that concentrations can encourage. Franks and Mayer (1998b) suggest that concentrated owners are able to provide greater degrees of commitment to stakeholders, such as employees and suppliers, than dispersed anonymous owners. They can therefore encourage stakeholders to make more firm specific investments in, for example, training and dedicated capital expenditures. On the other hand, the anonymity of market ownership provides companies with greater flexibility in implementing policies without being deflected by special pleading and bargaining of interested parties. Concentrated ownership would therefore be expected where activities require firm specific investments by several parties, whereas dispersed ownership will be observed in activities that require flexibility in implementing and changing policy. For example, could the massive restructuring of AEG over a period of 10 years through the 1970s and 1980s with the payment of little or no dividend have been achieved with dispersed shareholders? On the other hand, the restructuring of both the German steel and tyre industries has been seriously impeded by reliance on negotiated mergers and the absence of a market for corporate control.

There may be a close association between different financial and corporate structures and the nature of commercial and industrial activities that are undertaken in different systems.

Monitoring, control and commitment considerations therefore suggest that different types of financial systems and governance arrangements are best designed to support different types of activities. They have comparative advantages in promoting certain types of activities but not absolute advantage over all. There is some evidence in support of this. Carlin and Mayer (1999a) examine the extent to which interactions of country structures (2) relate to the growth rates of 27 industries in 14 countries over the period 1970 to 1995. They find that the interaction effects play

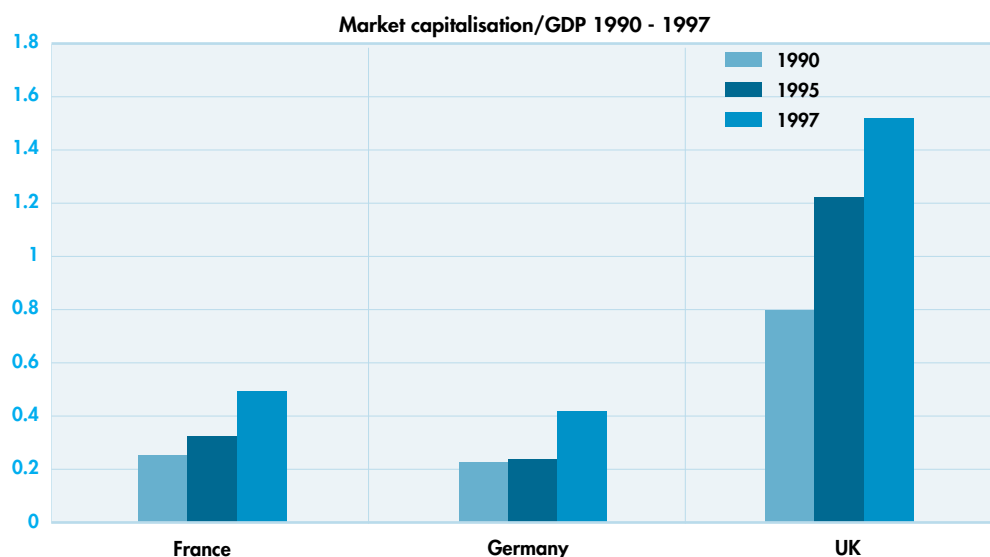
2) *That is the nature of their financial and corporate systems, industry characteristics, their dependence on external finance and inputs of skilled labour.*

an important role in explaining differences in growth rates across industries and countries. The implication of this is that there may be a close association between different financial and corporate structures and the nature of commercial and industrial activities that are undertaken in different countries. This has important consequences for the way in which financial systems are likely to evolve in response to the internationalisation and integration of markets.

4. Pressures for change

Figure 3 reports the size of stock markets as a proportion of GDP in France, Germany and the UK in 1990, 1995 and 1997. The size of markets has increased appreciably in all three countries. In large part, this reflects share price gains that occurred in most markets during the 1990s. However, as Figure 4 records, it is not entirely due to that. Initial Public Offerings (IPOs) nearly doubled in France between 1995 and 1997 from 26 to 49. They went up by a factor of more than 3 over the same period in Germany and they increased by around 30% in the UK.

Figure 3. Pressures for change - Size of markets



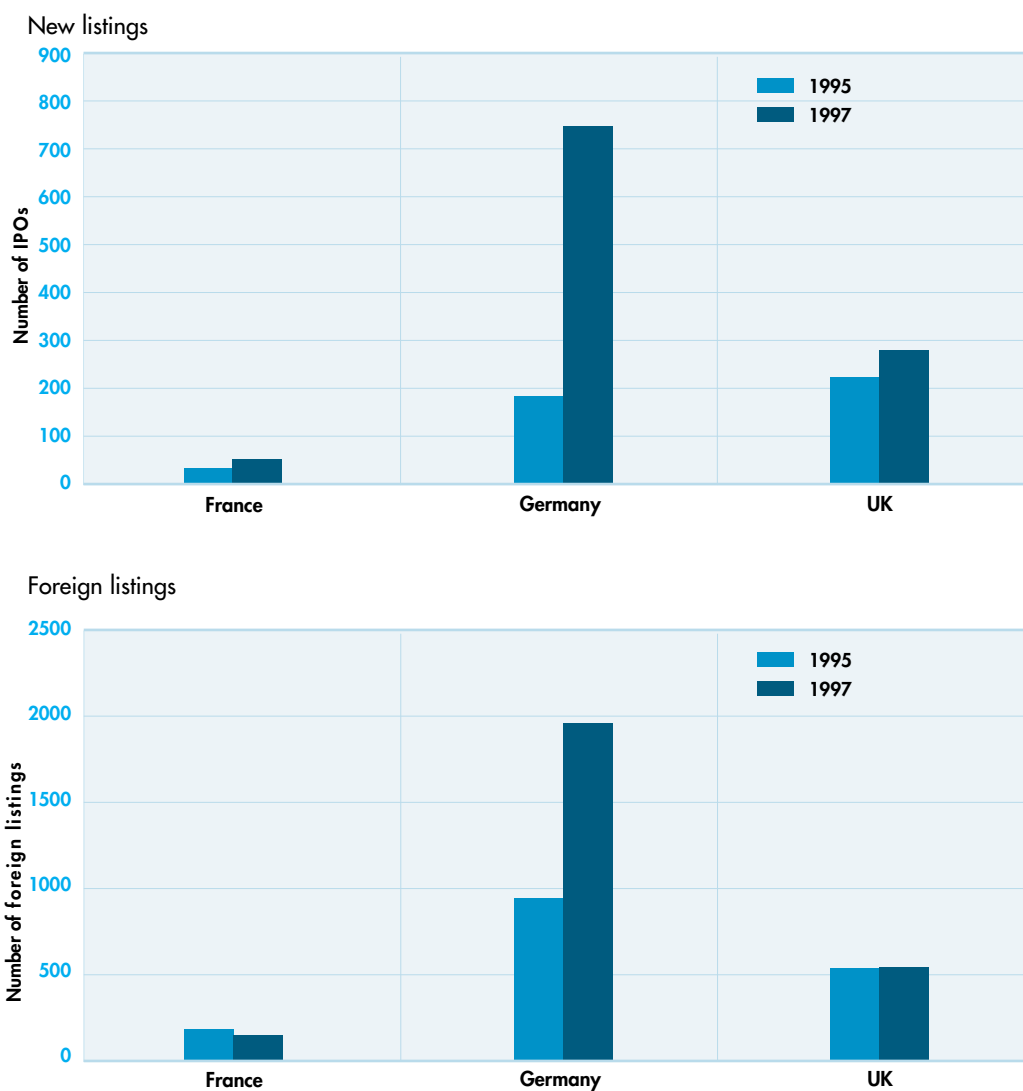
Source: European Stock Exchange Statistics

Many of these new listings are associated with foreign firms. Figure 4 also shows the number of foreign listings on the French, German and UK stock markets in 1995 and 1997. In the UK, there are around 520 foreign listings. In Germany, foreign listings have more than doubled from 940 to nearly 2000 companies.

Greater international mobility of corporations is giving rise to competition between countries in incorporation law.

In summary, stock markets are growing not only because of rising share prices but also because of new listings, in particular across borders. These developments have significant implications for structures of markets and corporations discussed in Section 2. Firstly, greater international mobility of corporations is giving rise to competition between countries in incorporation. In the United States, competition for incorporation between states has been a dominant influence on corporate law. Unlike bankruptcy law, corporate law is formulated at the level of individual states. The states therefore compete amongst themselves to attract firms to incorporate within their jurisdiction.

Figure 4. Listings on European stock markets



Source: Fédération internationale des bourses de valeurs

In Europe, cross-border mobility of companies regarding country of incorporation has been limited primarily to large multinational corporations. But now with the integration of financial and product markets, and the emergence of a common currency, similar mobility will begin to be observed.

Secondly, competition between stock exchanges is intensifying. New markets are emerging, some specialising in particular types of securities, such as high tech, high growth or speculative investments. Alliances are being formed between markets, such as between Frankfurt and London, and both Paris and Frankfurt are pressing to attract business away from London. Geographical location will diminish in significance as a determinant of where companies choose to list and firms will increasingly list their securities on more than one market. These tendencies are already reflected in the growth of cross-border listings to which reference was made above.

Thirdly, minority shareholders are becoming increasingly vocal. In Germany they have successfully pressed for increased disclosure of information and questioned low dividend distributions. The desire on the part of exchanges to enhance liquidity of markets will intensify pressure in this direction.

Fourthly, there have been repeated attempts on the part of the European Commission to harmonise governance, information disclosure, investor protection and take-over rules. To date, these have met with limited success in particular in relation to governance and take-overs but there will be continuing attempts to secure agreement as part of the creation of the Single Market.

All these factors clearly raise fundamental questions about whether the differences between financial and corporate systems described in Section 2 can persist. If companies can choose their legal system of incorporation and market for listing and if both investors and regulators are attempting to secure harmonisation of corporate law and investor protection then there are strong market and political forces pushing towards convergence. Just as competition between firms can create back-to-back rivalry with firms supplying identical products to consumers, so competition between systems may give rise to the emergence of global uniformity.

If systems have comparative advantages in the promotion of different types of activities, then instead of convergence, different systems will be able to specialise.

But these are not the only factors at work. As noted in the previous section, differences across systems are deep-rooted. They are linked to fundamental features regarding countries' industrial structures. If, as suggested in the previous section, systems have comparative advantages in the promotion of different types of activities then financial and corporate systems will be closely linked to their industrial composition. Instead of there being pressure for convergence, different systems will be able to specialise in the promotion of different types of activities. Some will be suited to small-scale service industries, some to high growth, high tech firms, some to large manufacturing firms and others to large R&D activities. The requirements of firms for access to markets as against bank finance and to large long-term as against dispersed shareholders vary appreciably depending on the nature of their activities.

What this suggests is that far from there being an inevitable process of convergence, the integration of financial and product markets will give rise to enhanced opportunities for specialisation and differentiation. Given the fundamental variety of needs of firms for different types of finance and corporate control, internationalisation will offer greater opportunity for countries to specialise in the provision of financial services for particular types of firms and for companies to move freely between different legal and financial systems. However, cultural and language barriers will restrict mobility of European firms in relation to their North American counterparts for several years to come. To the extent that bank-firm relations require geographical proximity then complementarity between financial systems and corporate activities will reinforce the fragmentation of European markets.

5. Policy implications

This paper has painted two possible scenarios for the development of financial markets and corporate systems in Europe. The first is for a steady process of convergence towards market-based systems with greater accountability, disclosure and transparency. The second is a persistence and intensification of systemic differences with companies shopping around for appropriate financial and legal arrangements.

The most likely outcome is a mixture of the two. In some areas, most notably securities markets, there are strong pressures for convergence and integration. Liquidity benefits encourage centralisation of market activities in a small number of locations. But elsewhere, in terms of corporate structures and relations between financial systems, there are benefits to diversity. There will be a continuing need for some banks to have close relations with small growing firms. There will be a need elsewhere for venture capital partnerships to be able to secure large amounts of funding from financial institutions and take firms to liquid stock markets. In some markets, there will be benefits to complex webs of interconnected holdings with large blocks of shares held in pyramids and holding companies. Other markets will benefit from dispersed shareholdings and governance by financial institutions. There will therefore be a role for a diverse range of financial institutions with the potential for greater degrees of specialisation in some areas at the same time as there are pressures for convergence elsewhere.

This diversity will be of considerable benefit to corporations. Instead of being tied to one particular type of financial and legal system, established for cultural, historical as well as commercial reasons, they will be able to move freely around. Notwithstanding the barriers created by culture and language, competition will encourage the emergence of the most suitable forms of arrangements. At the moment we simply do not know what is the most appropriate structure of corporate and financial systems. As noted above, the most likely answer is that it depends on the industrial structure of countries. But if indeed there is a dominant arrangement then it will emerge from competition between systems.

A crucial influence on the process will be the response of the regulatory authorities. As noted above, there is a strong tendency on the part of authorities, and in particular the European Commission, to press for harmonisation. At first sight harmonisation appears to be a necessary precondition for the successful operation of financial markets. After all level playing field considerations would appear to argue for equal access to ownership of companies through acquisition. Absence of harmonisation creates fears of runs to the bottom with national authorities being forced to impose lowest common denominator systems in the process of trying to encourage companies to incorporate and list within their jurisdiction. But in regard to corporate law in the United States, this has not been the experience. On the contrary, there have been considerable benefits to corporations being able to select across a diverse range of systems. This has been most noticeable in relation to the degree of protection that the different states offer to incumbent management. Some have banned hostile bids, some make protection through such anti-take-over devices as poison pills commonplace, others have liberal systems of acquisition that provide little protection to management. Those companies that benefit from the discipline that markets for take-overs impose can select relatively liberal systems whereas those that wish to protect the firms' stakeholders against threats of take-overs can choose to incorporate elsewhere. Competition avoids excessive regulatory tendencies that centralised systems encourage and provides for diversity in arrangements.

Corporate and financial regulation should promote competition between systems by establishing a framework within which diversity and experimentation can be encouraged.

Corporate and financial regulation should therefore be enabling rather than restrictive. It should promote competition between systems by establishing the framework within which diversity and experimentation can be encouraged. The Commission should not be attempting to pick winners. The Anglo-American system might look to be today's winner, but tomorrow's might be quite different.

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