Much debate has been centered on a common definition of corporate governance. However, the existence of different corporate governance systems has made such attempt more or less futile. In a broad sense, corporate governance systems can be classified into at least two categories: market-oriented system and bank-oriented system or otherwise known as relations-based system (Vives, 2000).

The market-oriented system is adopted in the United States and the United Kingdom. Large companies are listed in stock markets with dispersed ownership to individuals or institutions. Due to companies’ reliance on the capital market, threats of hostile takeovers are important mechanisms for gaining control. There is thus a well-developed market for corporate control. Disperse ownership reduces shareholders’ incentives and powers to monitor and control professional management. As a result, conflicts arise from shareholders and management. In addition, largely due to the Glass-Steagall Act promulgated during the Great Depression, the US commercial banks were prohibited from owning equity of other companies so they played a limited role in direct monitoring and controlling company affairs (Vives, 2000). Scholars like Roe argue that Berle and Means models, i.e. dispersed ownership in the hands of small shareholders, are in fact a product of political intervention which restricted banks’ ownership in companies, instead of achieving economic efficiency.
Black and Roe¹ conclude that this ‘over-regulation’ served as impediments to concentrations of ownership as opposed to other countries, such as European countries, where free choice of capital structure is upheld. Nevertheless, countries with more freedom in choosing their ownership structure has led to criticisms in recent years that ‘under-regulation’ indeed undermines investor protection (Becht and Mayer, 2001).

The bank-oriented system is practiced in most continental European countries as well as in Japan, featured by highly concentrated ownership. Commercial banks play an important role of finance provider. Given the concentrated ownership, diluted or restricted voting powers is used to prevent hostile takeovers so that the market for corporate control is not as well developed as that in the US or the UK (Becht and Böhmer, 2001). Taking Germany as an example, corporate governance is described as being less dependent on capital markets and outside investors, but having more reliance on financial institutions and inside investors. Banks are allowed to organize proxy votes to receive general power of attorney from shareholders and subsequently cast those votes in banks’ favor. As a result, banks can exercise their influence by ways of direct ownership of shares, provision of loans, seats in supervisory board and organizing proxy votes (Boehmer, 2001). In addition, by way of pyramid structures

and cross shareholdings, voting powers will exceed equity ownership. Thus, conflicts arise from the controlling and minority shareholders, instead of between professional management and shareholders under the Berle and Means model (La Porta et al., 2000). Although the controlling shareholders are in a good position to monitor company affairs, they often handpick the management team.

2.1 Corporate Governance Models: Keasey, Thompson, and Wright models

In spite of the varieties of corporate governance system set out above, Keasey, Thompson, and Wright (1997) endeavor to introduce four Anglo-American governance models to depict causes for corporate governance problems and solutions thereto.

2.1.1 The Principal-Agent or Finance Model

The principal-agent model is probably the most important model of the corporate governance theory. The underlying premise of this model is that shareholders’ residual voting rights should ultimately commit the corporate resources to value maximization. According to Jensen and Meckling (1976), the relationship between the owners and the management is defined as the principal(s) engage the agent to perform services on behalf of the principals which involves the delegation of some decision-making authority to the agent. Clearly, this model recognizes the agency costs arising from the separation of ownership and control since both parties are committing to maximizing
Jensen and Meckling (1976) define agency costs as the sum of:

a. **The monitoring expenditure incurred by the principal**

In order to prevent the agent’s divergence from the principal’s interest and solve the potential moral hazard problem, the principal has to establish incentives, like stock option, to bring the agent’s action in line with that of the principal. Moreover, the principal inevitably need to incur some monitoring costs to limit the agent’s deviation from the principal’s interest.

b. **The bonding expenditure by the agent**

The principal needs to pay the agent to expend resources to guarantee that the agent will not take certain actions which will harm the principal, or to ensure that the principal will be compensated if the agent does take such actions. This costs is referred to as ‘bonding costs.’

c. **The residual loss**

In spite of the above costs intended to align the principal and the agent’s interest, divergences between the agent’s decision and the maximization of the principal’s welfare may still take place. The reduced welfare of the principal is the residual loss.

Although shareholders seem to have the powers to commit corporate resources via voting rights, in reality they do not loud their *voice* as much as expected in the typical Anglo-American system for two reasons. First, the access to liquid market
reduces incentives of public company shareholders to monitor and check on the board. Instead of opting for voicing their concerns, shareholders choose easy exit in highly liquid markets, namely divesting their equity interest, because this option represents lower opportunity costs. Second, although diffuse ownership is beneficial to shareholders because it achieves the optimal allocation of risk bearing, it nevertheless leads to the lack of interest in monitoring the company on shareholders’ part. Each shareholder relies on others to act diligently to monitor the company, which inevitably leads to the “free-ride” problem (Keasey et al., 1997). Once the checks and balance mechanism malfunctions, corporate governance falls apart.

Advocates of this model offer their solutions to the agency problem. Scholars like Fama and Jensen recommend solutions to prevent corporate governance failures. These recommendations include the removal of restrictions on the market of corporate control to eliminate managements with unsatisfactory performance and the commitment of company resources elsewhere to reduce the agents’ discretionary power, such as debt-financed takeovers and leverage buy-outs (Keasey et al., 1997). However, whether the market of corporate control is an efficient mechanism for disciplining management has been hotly debated. Gugler believes that takeovers are not a complete mechanism for resolving the agency problems. Empirical evidence has showed that hostile takeovers only lead to little positive or even negative change in
firms’ efficiency. Franks and Mayer also argue that the market for corporate control does not function as a disciplinary devise for poorly performing company (Gugler, 2001). According to Ravenscraft and Scherer, there is scant evidence showing improved operating performance after takeovers. The use of debt also attracts mixed views since this may cause debt overhang problem or encourages management to take excessive risks (Vives, 2000).

2.1.2 The Myopic Market Model

Supporters of the myopic model believe that the excessive concern for short-term gains is the consequence of capital failure. This model suggests that maximization of shareholder welfare is not the same as share price maximization because the market system tends to undervalue long-term expenditures. These long-term investments may well lead to the increase of the shareholder welfare. Because of the myopic nature in the corporate structure, managers are forced to take short-term decisions in pumping up share prices, or otherwise risk the company to hostile takeover bid. This in turn will put managers’ private interest at stake. In addition, some supporters argued that this myopic market structure actually increased the cost of capital in the US compared to countries like Japan and Germany which rely on indirect finance from commercial banks.

From the perspective of managers, since their fitness is judged upon short-term
performance, they are forced to take projects with high rate of return or short payback periods in order to survive the highly competitive managerial labor market. By the same token, institutional investors, the most important stock market player, are evaluated against short-term performance so they are like company managers who are forced to overlook long-term benefits. This school argues that excessive attention to short-term performances distorts share prices. Thus, takeover will not be a nature extension of market efficiency since mis-priced share prices fail to reflect companies’ fundamentals (Keasey et al., 1997). As a result, corporate governance problems arise from the excessive attention paid to short-term gains in spite that it means compromise of long-term wealth maximization.

Myopic model advocates propose the creation of an environment wherein shareholders and managers are encouraged to share long-term performance horizons (Keasey et al., 1997). They believe that both managers and shareholders will develop long-term interests with the help of “relationship” investors, namely, investors who are locked into the long-term position. However, to lock in shareholders by increasing their exit cost will make shareholders more vulnerable to poor corporate governance. Furthermore, this measure will certainly impede the market efficiency by preventing takeover attempts, which is supposed to function as a mechanism to eliminate inefficient managers. Consequently, several scholars, such as Blair and Marsh offer
empirical evidence to dismiss the notion of market myopia (Keasey et al., 1997).

2.1.3 **The Abuse of Executive Power**

The fundamental argument of this model rests on the premise that corporate governance problems arise from the excessive powers granted to corporate elites, namely senior management, and as a result they abuse these powers to advance their self-interest. This school of thought rejects the principal-agent model, regarding board of directors as a “self-perpetuating oligarchy.” Moreover, they believe that senior management has written them into contracts in their favor regardless how share price performs.

Supporters of this model dismiss current checks and balance mechanisms, such as outside directors, audit process and takeover bid, as effective mechanisms to control senior management. Mechanisms like fixed-term contract and independent nomination of outside directors are proposed to curb the excessive powers possessed by the senior management (Keasey et al., 1997). However, fixed-term contracts may well force management to overly emphasize short-term gains, which happens to be the situation the myopic model tries to avoid. Moreover, it is hard to find a robust pay-performance relationship in senior manager remuneration.

2.1.4 **The Stakeholder Model**

This model is regarded as the most fundamental challenge to the principal-agent
model since it emphasizes that the purpose of firm should be defined broader than the mere maximization of shareholder welfare. Thus, corporate governance should refer to the design of institutions to make managers internalize all stakeholders’ welfare (Vives, 2000). Other parties who have interests in the firm’s long-term success, should also be taken into account when a firm’s objective function is defined. These stakeholders include employees, suppliers and customers. Supporters of this model believe that this stakeholder approach is more equitable and socially efficient (Keasey et al., 1997).

In terms of economic relations, firms face situations described in the well-known Game Theory, i.e. cooperative games or prisoner’s dilemma. The essence of the theory is that the outcome may not only depend on the choices made by one person, but also on the strategies selected by other participating parties (Pertersen and Lewis, 1999). Game theory concludes that full-cooperation maximizes the participants’ joint payoffs but concedes that cheating remains the dominant strategy in a one-shot game. Advocates of this model believe that ethical treatment of stakeholders will benefit the firm because trust relationships are built with stakeholders. Therefore, in order to achieve the maximum efficiency in the costs of social association the long-term contractual associations between a firm and its stakeholders are necessary.

Blair argues that a firm’s contracts with its stakeholders involve co-specialized
investments, which generate “quasi-rent.” In order to prevent participants from attempting to increase their shares, mechanisms need to be devised to overcome such problem. These mechanisms include interlocking shareholdings as well as directorates, and strategic alliance (Keasey et al., 1997). However, interlocking shareholdings and directorates inevitably lead to complex corporate shareholding structures and may increase the mismatch between ownership and control, which thus become another cause for poor corporate governance.

Supporters of this model use Japan and Germany as examples, illustrating corporate objectives being defined broader than mere shareholders’ interests. Germany has been repeatedly cited as a country where stakeholders model is widely practiced. In Germany, ownership is highly concentrated with important family ownership. A two-tiered board system is adopted with wide representation from employees, customers and suppliers in the supervisory board (Vives, 2000). Commercial banks, the most important external financiers, control companies via proxy votes. However, the design of the proxy rule enables banks to acquire seats in the supervisory boards even though these banks may have only negligible ownership in the company (Boehmer, 2001).

These four models have their own perceived causes of corporate governance problems and solutions thereto. The principal-agent model believes the agency
problems caused by the separation of ownership and control is the reason behind corporate governance problems. The myopic market model believes that the market’s excessive attention to short-term gains leads to corporate governance failures. The abuse of executive power model believes senior management’s excessive powers causes poor corporate governance. The stakeholder model blames narrowly defined corporate objective as the cause for problems. In spite of the differences, it is generally agreed that the principal-agent model is the most important theory in the domain of corporate governance.

2.2 Alignment between Ownership and Control under the Principal-Agent Model

The Principal-Agent model is the most popular view of corporate governance. As the principal-agent model sets out, the separation of ownership and control provides incentives for individuals or groups who have control over corporate decisions to expropriate others although they may not enjoy majority ownership. As a matter of fact, voting rights may not always correspond to cash flow rights, i.e. equity ownership. Berle and Means (1968) suggest that under the corporate system control over industrial wealth can be exercised with a minimum of ownership interest. Control rests with those who have the actual power to select the board of directors. Therefore, the locus of control can be established if people who have the actual voting power to select board of directors can be determined. These individuals or groups are
thus deemed as those who are in control (Berle and Means, 1968).

The degree of control measures the discretion which the controlling group has in order to pursue its own objectives and is ultimately related to the group’s voting power (Cubbin and Leech, 1983). The concentration of voting powers is crucial given that it enables the controlling owner or block to decide important policies, such as dividend payout, personnel appointment and investment projects. The ‘over-regulation’ theory stresses the conflicts between strong managers and dispersed owners while the ‘under-regulating’ literature focuses on the conflicts between controlling block-owners and minority owners (Becht and Mayer, 2001). In spite of this difference, they both encounter the same problem of asymmetric information because the insiders, regardless being the management or the controlling block-holders, possess much more information than those deemed to be outsiders, such as dispersed shareholders or minority shareholders.

Bloch and Kremp (2001) offer three reasons that contribute to the misalignment between ownership and voting powers. First, they believe that the existence of multiple classes of shares can result in mismatched ownership and control. Shares with multiple voting rights will outweigh one-share-one-vote, or one-share-one-vote has greater power than shares accorded with no voting rights at all. Second, the existence of pyramidal structure renders certain shareholders at the top of the pyramid
to possess control disproportionate to their actual ownership. Third, cross-shareholdings transform ownership into disproportionate control.

From the perspective of shareholders, they need to retain important cash flow before they have motivations or incentives to monitor management. Without such incentives, controlling block-holders will seek rent-extraction activities at other shareholders’ expense. Moreover, such expropriation will also create adverse incentive effects under the stakeholder model. Investment in company-specific capital will be reduced which will hurt other stakeholders’ interests (Vives, 2000). For example, funds allocated for employee training programs is used to extract private benefit by the controlling block-holders.

2.2.1 Berle and Means’ Five Control Categories

Berle and Means (1968) categorized control into five categories.

2.2.1(i) Control through almost complete ownership

This type of control is most commonly seen in private companies, whose shares are concentrated in a sole owner, or a small number of individuals or groups. These few owners in essence own almost all of the outstanding shares. They not only have almost complete ownership, but also wield absolute control. They are legal owners of the company, and have the power to dispose of assets and select management. Nevertheless, concentrated ownership prevents the possibilities for diversification and
reduces the liquidity of stocks. Un-diversified risk-averse owners may undertake investment projects that are sub-optimally risky and yield sub-optimal returns (Gugler, 2001). In the long run, this type of company will fail to create risk-sharing opportunities and fail to utilize its resources to achieve the optimal returns. Nonetheless, this form of control is a complete alignment of ownership and control.

2.2.1(ii) **Majority control**

Under this type of control, a small number of individuals or groups own more than 50% of the company’s outstanding shares. Based on this legal ownership, they are able to exercise full control over company affairs in most cases, except in circumstances where greater majority is required.

The majority control is most strikingly disproportionate when the rest of shares are owned by a large number of shareholders given that a large group of individuals cannot combine their capital effectively in a single enterprise without a loss of control by some members of the group (Berle and Means, 1968). Furthermore, majority control in effect gives more than half of the equity interest in the consolidated enterprise with subsidiaries. This type of ownership structure nevertheless overcomes the weaknesses demonstrated in the complete ownership by allowing possibilities for diversification and creating stock liquidity.

2.2.1(iii) **Control through a legal device without majority ownership**
Various legal devices have been created to achieve this form of control. Becht and Mayer (2001) term these devices used by dominant shareholders to exert disproportionate degrees of voting powers as a “private control bias.” Berle and Means (1968) introduce several devises in their research work.

a. Pyramiding

Pyramiding refers to the owning of a majority of stocks of a company which in turn holds a majority ownership of another company. This process can be repeated several times and the number of repetitions determines the final outlook of the pyramidal holding company structure. The main reason for this structure is the possibility of controlling vast resources with a limited amount of capital (Bianchi et al., 2001). By adopting this approach, an ownership interest amounting to a fraction of the total property controlled can actually possess the complete control over a large operating company. Similar to the majority control involving subsidiaries, a majority shareholder of the company at the apex of the pyramidal holding structure can have almost as complete control of the entire property as a sole owner (Berle and Means, 1968).

b. Non-voting stock

By way of issuing non-voting stocks enables the controlling minority to secure their sources of finance without losing control to outsiders. Owners of non-voting stocks
are virtually disfranchised and unable to participate in the determination of board members. By contrast, the controlling minority needs only to secure more than half of the stocks whereto voting rights are attached. The disfranchise of common stocks the voting rights later proved unpopular as far as large-scale stock exchanges were concerned. The New York Stock Exchange refused to list issues of non-voting stocks (Berle and Means, 1968).

c. Shares having excessive voting power

This devise is employed when excessive voting powers attach to certain classes of shares, which in turn reduces the voting powers of other classes of shares. This devise can be regarded as a variant of the non-voting stock since both devises achieve the same end by granting voting powers disproportionate to capital invested to the controlling group.

d. Voting Trust

Voting trust is a legal devise designed to secure legal control through direct and indirect ownership of majority. Voting trust is created with the placement of stocks. Trustees of the voting trust, often part of the management, thus have the total voting powers associated with stocks held by the trustees. As a result, as long as more than half of shares with voting rights are placed in the trust, the trustees can exercise majority control without owning corresponding equity. This separation of ownership
and voting powers aroused regulators’ attention so they initiated restrictions on the duration of such trusts. Given the separation of ownership and control, this arrangement has shunned away investors who desire to take control of the company.

2.2.1(iv) **Minority control**

Minority control refers to the situation where an individual or a block-holder holds sufficient stock interest to be in a position to dominate a company through their equity interest. Such group is often said to have “working control” of the company. As opposed to the three forms of control discussed above, the working control rests on such individual or block-holder to attract scattered owners proxies. These proxies, combined with their substantial minority interest, enable the minority block-holder to control the majority votes at the annual elections. Furthermore, given scattered share ownership, no other shareholder is large enough to act as a nucleus to gather a majority of the votes (Berle and Means, 1968). Under this form of control, direct monitoring is very difficult because no shareholder is large enough to conduct regular monitoring on company operations. Free-ride problem inevitably arises since each shareholder relies on others to do direct monitoring, which subsequently leads to a checks-and-balances vacuum.

Berle and Means argue that it is very hard for outsiders to acquire majority interest under this circumstance because the costs will be high. The controlling
block-holder will use company resources to fend off take-over attempts by outsiders while the outsiders have to use their own resources to fight for majority interest. For example, the company may buy back company shares to reduce the number of outstanding shares and increase the voting power of the existing controlling bloc. This type of control runs well when company runs well, but may lead to proxy war when company is in crisis.

2.2.1(v) Management control

This type of control exists when share ownership is so dispersed that no single individual or block-holder has sufficient ownership interest to dominate company affairs. The election of the board of directors thus determines the locus of control. Berle and Means argue that control tended to be exercised by those who selected the proxy committee, by which the election of directors for the ensuring period may be made. The proxy committee is appointed by the management so the management can become a self-perpetuating body by controlling the proxy committee. The striking feature of this form of control is the complete derailment of ownership and control.

2.2.3 ECGN Theoretical Framework

European Corporate Governance Network (hereinafter referred to as “ECGN”) provides a theoretical framework on the separation of ownership and voting power to
outline advantages, disadvantages and implications for dispersion versus concentration of cash flow and voting power (see Table 2.1). The framework is divided into four Quadrants: Quadrant I represents both dispersed ownership and voting power; Quadrant II represents dispersed ownership but concentrated voting power; Quadrant III represents concentrated ownership but dispersed voting power; Quadrant IV represents both concentrated ownership and voting power.

2.2.3(i) **Quadrant I: dispersed ownership and dispersed voting power**

Quadrant I situation more or less resembles the management control category proposed by Berle and Means. Dispersed ownership creates liquidity of stocks, provides risk-sharing opportunities with others and thus reduces cost of capital. Nevertheless, Jensen and Meckling\(^2\) once commented that agency costs would be generated by the divergence between an owner-manager and outside shareholders if the owner-manager sells equity claim to outsiders because he will bear only a fraction of costs of any non-pecuniary benefits he takes out in maximizing his own utilities. As a result, the management or the controlling block-holder may advance their own interests while having other shareholders bear the risks associated with those self-interest maximization activities. Moreover, dispersed ownership implies ineffective direct monitoring. As discussed above, each shareholder counts on others

to do the monitoring which inevitably leads to ‘free-ride’ problem. The dispersed ownership also serves as a two-edged sword. On the one hand, dispersed ownership creates liquidity but, on the other hand, it reduces shareholders’ incentives to voice their concerns. Instead, shareholders opt for easy exit. Nevertheless, disperse and liquid stocks give outsiders the opportunities to take control of the company.

According to the ECGN theoretic framework of the separation of ownership and voting power, Quadrant I situation is likely to lead to the phenomenon of ‘strong managers, weak owners’ given the lack of direct monitoring control. However, some scholars believe the existence of alternative disciplining mechanisms, such as the board of directors, the threat of takeover, the managerial labor market, helps bring managerial behaviors in line with shareholders’ interests.

2.2.3(ii) **Quadrant II: dispersed ownership and concentrated voting power**

Quadrant II situation may fit into the minority control categories by Berle and Means. Quadrant II situation enjoys the advantages witnessed in Quadrant I situation, such as liquidity, risk-sharing opportunities with outsiders and lower cost of capital compared to owner-manager company. Beyond these advantages, direct monitoring may take place in Quadrant II situation if the block-holders do not collude with the management.

Disperse ownership with concentrated voting power gives the block-holders
secured control excessively disproportionate to their ownership stake. Due to the
misalignment of ownership and control, conflicts may take place between the
controlling block-holders, i.e. block-holders having working control over the company,
and outside small shareholders. Dispersed ownership renders the large number of
outside small shareholders unable to combine their ownership effectively to undertake
direct monitoring on company affairs whereas the controlling block-holders possess
enough voting powers in shareholders’ meetings, and thus dominates company affairs.
In the case where the block-holders are external to management, increasing dispersion
will make the control more secure and the company will behave less ‘managerially.’
By contrast, if the controlling group is management through ownership, increasing
dispersion will have the effect of making management’s position more secure and the
company’s behavior more managerial. The management will thus have more
discretion to pursue its own objectives (Cubbin and Leech, 1983).

The recommended alternative monitoring mechanisms in Quadrant I may not be
equally applicable here. The controlling block-holders with their disproportionate
voting power are able to select the board of directors in their favor. Therefore,
monitoring by the board does not warrant effectiveness. Takeovers prove very
difficult under the dispersed ownership and concentrated voting power structure. The
controlling block-holders will fend off takeover attempts by utilizing internal
resources while the outsider bidders need to incur high costs to acquire the company. These costs include: small shareholders have an incentive not to tender to the bidder because they may envisage greater gains from the post-takeover company value; the bidder may face competitions from other bidders, which inevitably raises the takeover price; the bidder has to fight off the incumbent management’s defensive actions (Guglar, 2001).

2.2.3(iii) Quadrant III: Concentrated ownership and dispersed voting power

Quadrant III situation is described as having the mostly disadvantages (Guglar, 2001). Concentrated ownership reduces liquidity and risk-sharing opportunities with outsiders. As a matter of fact, the cost of capital is higher than dispersed ownership. The ownership and control are seriously misaligned so the agency problems are potentially more serious than other situations. Outside interventions like hostile takeovers have little chance of success given that concentrated ownership cannot be converted into meaningful control via voting power. Voting power of concentrated owners is largely limited so direct monitoring by large block-holders is virtually impossible.

Nevertheless, the concentrated ownership and dispersed voting power does work in controlling minority shareholders’ favor if they have disproportionately greater voting powers. The controlling minority shareholder can secure outside finance
without losing control by disfranchising other shareholders. This situation is clearly the least popular approach as far as corporate governance advocates are concerned.

### 2.2.3(iv) Quadrant IV: Concentrated ownership and voting power

Quadrant IV situation is similar to the control through almost complete ownership and majority control categories. The alignment of ownership and control provides majority shareholders with the incentives to direct monitor company affairs, thus avoiding the free-ride problem. As stated above, concentrated ownership leads to liquidity and diversification problems, which in turn contribute to higher cost of capital.

Jensen and Meckling (1976) comment that as the owner-manager’s equity ownership falls, his fractional claim on the outcome falls so he is encouraged to appropriate larger amounts of the company resources in the form of perquisites. As a logic extension, if ownership and control are concentrated in the hands of the majority shareholder, it is likely that the majority shareholder will conduct rent extraction activities at minority shareholders’ expense. Therefore, conflict may well take place between majority and minority shareholders.
Table 2.1: Dispersion – Concentration tradeoffs for investors

<table>
<thead>
<tr>
<th>Quadrant I</th>
<th>Quadrant II</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dispersed Ownership</strong></td>
<td><strong>Concentrated Ownership</strong></td>
</tr>
<tr>
<td><strong>Dispersed voting power</strong></td>
<td><strong>Concentrated voting power</strong></td>
</tr>
<tr>
<td><strong>Advantages:</strong></td>
<td><strong>Advantages:</strong></td>
</tr>
<tr>
<td>Liquidity</td>
<td>Direct monitoring</td>
</tr>
<tr>
<td>Diversification opportunities (risk sharing)</td>
<td>Liquidity</td>
</tr>
<tr>
<td>Low cost of capital</td>
<td>Diversification opportunities</td>
</tr>
<tr>
<td><strong>Disadvantages:</strong></td>
<td>Lower cost of capital than IV</td>
</tr>
<tr>
<td>Lack of direct monitoring (free-riding problem, absenteeism)</td>
<td>Disadvantages:</td>
</tr>
<tr>
<td><strong>Implications:</strong></td>
<td>Cash-flow and control incentives misaligned</td>
</tr>
<tr>
<td>Strong managers, Weak owners</td>
<td>Potential collusion (manager-block-holder)</td>
</tr>
<tr>
<td>Takeovers are possible</td>
<td>Extraction of private benefits</td>
</tr>
<tr>
<td>Management control or market control</td>
<td><strong>Implications:</strong></td>
</tr>
<tr>
<td></td>
<td>‘Strong Voting Block-holders, Weak Minority Owners’</td>
</tr>
<tr>
<td></td>
<td>Takeovers impossible/unlikely</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Quadrant III</th>
<th>Quadrant IV</th>
</tr>
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<tbody>
<tr>
<td><strong>Dispersed voting power</strong></td>
<td><strong>Concentrated voting power</strong></td>
</tr>
<tr>
<td><strong>Advantages:</strong></td>
<td><strong>Advantages:</strong></td>
</tr>
<tr>
<td>Some protection of small shareholders from voting right restrictions</td>
<td>Direct monitoring</td>
</tr>
<tr>
<td><strong>Disadvantages:</strong></td>
<td>Cash-flow and control interests aligned</td>
</tr>
<tr>
<td>Cash-flow and control incentives misaligned</td>
<td><strong>Disadvantages:</strong></td>
</tr>
<tr>
<td>Few means of intervention</td>
<td>Low liquidity</td>
</tr>
<tr>
<td>Low liquidity’</td>
<td>Low diversification opportunities</td>
</tr>
<tr>
<td>Low diversification opportunities</td>
<td>High cost of capital</td>
</tr>
<tr>
<td>High cost of capital</td>
<td>Potential rent extraction by majority-owner</td>
</tr>
<tr>
<td><strong>Implications:</strong></td>
<td><strong>Implications:</strong></td>
</tr>
<tr>
<td>Mostly disadvantages</td>
<td>‘Weak Managers, Weak Minority Owners’</td>
</tr>
<tr>
<td>‘Strong Managers, Weak Owners’</td>
<td>‘Strong Majority Owners’</td>
</tr>
<tr>
<td>Takeovers difficult</td>
<td></td>
</tr>
</tbody>
</table>

Source: Corporate Governance and Economic Performance
2.2.3 Becht and Mayer’s Five Stylized Path

Becht and Mayer (2001) introduce a five-path framework to categorize the combinations of ownership and control. This framework is based on the premise that the founder of a company faces three choices in choosing the capital structure. First, neutrality, meaning ‘one-share-one-vote’ without pre- or post-bid anti-takeover defenses. Second, control is locked in through voting rights or transfer restriction. Third, voting rights are leveraged with cash flow rights.

2.2.3(i) Path One: Little equity is sold

The owner-manager adopts the neutrality approach by selling only required equity on ‘one-share-one-vote’ basis to outsiders to fulfill the listing requirements. Yet the owner-manager does not have intention to further sell the remaining equity, and therefore retains the majority of equity that confers majority control. Although the company becomes a public company, the owner-manager’s control is uncontestable. Conflicts thus may well arise between the controlling shareholder and other minority shareholders since the controlling block-holder may extract private benefits at other shareholders’ expense. By way of this path, liquidity is largely reduced. This situation resembles Quadrant II of the ECGN model.

2.2.3(ii) Path Two: Control is locked in and further equity is sold in blocks
Path two depicts the situation where the owner-manager sells equity to outside block-holders and retains less than half of cash flow rights. However, the owner-manager still retains the control by preventing outside block-holders from acquiring voting powers, or by restricting outside block-holders’ voting powers. Flat and scaled voting caps are used to achieve this end. Therefore, this arrangement is more similar to ‘one-member-one-vote’ where voting rights are based on membership instead of ownership. For example, Royal Dutch Shell has a voting right limit of 48,000 votes, equivalent to 0.002% of the total voting rights (Becht and Mayer, 2001). Thus, this leads to the combination of dispersed voting power and concentrated ownership. Although this path can prevent majority shareholders from exercising control over small shareholder, the funding owner-manager is able to lock in its control independent from its cash flow rights so that outside concentrated owners can hardly contest such control.

2.2.3(iii) Path Three: Cash flow rights are sold in excess of voting rights

This path is based on voting rights leveraged over cash flow rights. Cash flow rights are sold independently from voting rights by way of legal devises. As suggested by Berle and Means, these devises include dual-class voting rights, non-voting stocks and voting trusts. Under this path, ownership is dispersed while control is concentrated. This is similar to Berle and Means’ control through a legal device
without majority ownership model.

2.2.3(iv) **Path Four: Control is locked in and further equity is sold in disperse**

Similar to path two, although the owner-manager sells majority ownership to outsiders, the owner-manager is able to retain the control by preventing outside shareholders from exercising voting powers, or by restricting outside shareholders’ voting powers. Unlike path two, company equity is sold to dispersed owners rather than block holders. Nevertheless, control cannot be contested with the help of lock-in the incumbent.

2.2.3(v) **Path Five: Cash flow rights and control are sold in the market**

Path five refers to the situation where shares are sold to the public in accordance with the principle of ‘one-share-one-vote.’ This results in dispersed ownership which inevitably leads to disperse control. Thus, control is transferred to management, similar to the management control model proposed by Berle and Means.

These three models or frameworks illustrate the interrelations between cash flow and voting rights. They pretty much lay down similar combinations of cash flow rights and voting power although they are built upon different frameworks. As all these models illustrate, the misalignment of ownership and control creates corporate governance problems since the party in control has incentives to undertake rent-seeking activities in one way or another to compromise other parties’ interest. As
a consequence, conflicts are inevitable.

2.3 Corporate Governance in Banking and Financial Sector

Banks are of unique nature and are key players in an economy since they have great influence on macro-economic and monetary policies. However, banks face various risks ranging from business, finance, operation and event so inappropriate handling of these risks may impact negatively to the economy. Furthermore, the development and innovation of financial instruments largely reduce the traditional role of banks as financial intermediaries, namely, receipt of deposits and the granting of loans. Newly developed information-based activities, such as trading in financial markets and income generation through fees, are now the major sources of banks’ profitability (Canals, 1997). These innovated financial products do not necessarily appear in banks’ balance sheets. They nevertheless expose banks to higher degree of risks which regulators and shareholders may not take notice. As a matter of fact, a sound corporate governance constructs a disciplined environment whereunder banks set their objectives and the means of attaining them, as well as monitoring the performance of those objectives (Greuning and Brajovic-Bratanovic, 2003).

Greuning and Brajovic-Bratanovic (2003) define corporate governance in the banking and financial sector as a set of relationships, between management, the board of directors, shareholders and other stakeholders, to determine how the bank is
governed, ranging from setting corporate objective and risk profile, aligning management’s activities, running day-to-day operations within risk profile to protecting the interest of depositors and other stakeholders. They recommend a “partnership” among key players to strengthen corporate governance in banking sector within the context of financial risk management and market-based approach.

Eight key players are identified for this purpose: regulators authorities; supervisory authorities; shareholders; board of directors; management, audit committee and internal auditors; external auditors; the general public. Their key responsibilities and functions are illustrated in Table 2.2.
Table 2.2: Key players and their responsibilities in bank corporate governance and risk management

<table>
<thead>
<tr>
<th>Key Players</th>
<th>Responsibility for Risk Management</th>
<th>Importance</th>
<th>Policy Level</th>
<th>Operational Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>System</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal and Regulatory Authorities</td>
<td>Optimize</td>
<td>Critical</td>
<td></td>
<td>N/A</td>
</tr>
<tr>
<td>Bank Supervisors</td>
<td>Monitor</td>
<td>Indirect</td>
<td></td>
<td>Indirect</td>
</tr>
<tr>
<td>Institutional</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders</td>
<td>Appoint key players</td>
<td>Indirect</td>
<td></td>
<td>Indirect</td>
</tr>
<tr>
<td>Board of Directors</td>
<td>Set policy</td>
<td>Critical</td>
<td></td>
<td>Indirect</td>
</tr>
<tr>
<td>Executive Management</td>
<td>Implement policy</td>
<td>Critical (Implementation)</td>
<td></td>
<td>Critical</td>
</tr>
<tr>
<td>Audit Committee/</td>
<td>Test compliance with board policies and provide assurance regarding corporate governance, control</td>
<td>Indirect (Compliance)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internal Auditors</td>
<td>systems and risk management processes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>External Auditors</td>
<td>Evaluate and express opinion</td>
<td>Indirect (evaluation)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outside Stakeholders/Public</td>
<td>Act responsibly</td>
<td>N/A</td>
<td></td>
<td>Indirect</td>
</tr>
</tbody>
</table>

Source: Analyzing and managing banking risk: a framework for assessing corporate governance and financial risk management