Corporate governance and trust : an international comparison

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Abstract : The referring corporate governance approach considers that the firm manager has a central position towards the other stakeholders (SH) : shareholders, employees, financial creditors. These SH invest specific capital into the firm. The mechanisms protecting each SH's investment are compared within an international perspective. Trust exists when these mechanisms are incomplete. The American and German models are dominant. In Germany, the shareholders must grant an important trust to the firm manager whereas the financial creditors and the employees enjoy important protection mechanisms. In the US, the protection mechanisms play inverse roles.

Recent studies try to explain countries economic performance by their level of social capital and trust[1]. These researches suggest a strong interaction between trust and corporate governance systems[2]. More precisely, trust plays a complementary role in the other governance mechanisms. The stakeholders invest in the firm. We are presenting a table to make an international comparison of the mechanisms protecting investments. This table enables to understand the degree and the nature of the investors protection. Besides, it offers the possibility to estimate the importance and the room left to trust in the governance systems.

1. The room for trust in the governance structures

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[1] Fukuyama F., *Trust : The social virtues and the creation of prosperity*, Free Press, 1994. La Porta R., Lopez-de-Silvanes F., Shleifer A., Vishny R. W. (1997), « Trust in large organizations », *American Economic Review*, 87(1).

[2] Charreaux G. (1998), « Le rôle de la confiance dans le système de gouvernance des entreprises », *Economies et sociétés, Sciences de gestion*, 8-9.

a. The different stakeholders and the nature of the invested capitals

In the classical Anglo-Saxon approach, the corporate governance deals with the mechanisms protecting the financial investments and especially those of the shareholders because they are supposed to assume the residual risk[3]. However each stakeholder (SH) takes on a risk. This risk is run either on a voluntary basis because of the firm activities. Therefore a SH approach seems necessary in order to compare different national governance systems as the value creation and sharing schemes differ. Four SH can be distinguished in the general framework of a listed company: the executive, the shareholders, the employees, the financial creditors. The executive has a coordinating role and takes position as regards the often opposing SH interests. On the one hand, the governance system determines the executive discretionary power and on the other hand, the executive tries to act on the same mechanisms to preserve its investment in human capital. The governance mechanisms must then be studied considering the executive discretionary power.

b. The invested capital and the protection mechanisms

The SH engage either financial or human capital in the firm. They expect to at least get it back or even to add value to it. Capital invested in a firm can become specific. A specific capital is valuable only in the firm where it has been accumulated. A specific investment leads to a relation of interdependance between the SH and the chief executive officer. Besides the SH can not exit the relation without loss.

An investor has some protection mechanisms to add value to its capital and also to get it back with more or less costs. The protection mechanisms consist in legal rules but also in practices linked to contract or to customs. It is useful to distinguish between ex ante mechanisms, passive monitoring, active monitoring and ex post or exit mechanisms. Generally, the capital

[3] Shleifer A., Vishny R. W. (1997), « A survey of corporate governance », *The Journal of Finance*, 52(2).

recovery at the least cost is made possible by the exit possibilities. Those are linked to the market liquidity and to the existing guaranties (exit and ex ante mechanisms). The SH can add value to its capital when he can play a role in the process of value creation and sharing in the firm. This means that the SH has the power to intervene in the firm decision process (monitoring mechanisms).

Ex ante mechanisms are special. With such mechanisms the SH can be sure to have some control over the firm in the case of threat as regards the relation. The firm liquidation is the extreme case of the relation threat. The ex ante mechanisms improve the specific part of the investment. For example, if the employee training is more internal than generic, a large part of his human capital has no value outside the firm. To protect this specific capital, legal or contractual protections exists as protection against lay-offs. Ex ante mechanisms are formal and known by the parties when the relation is established.

The exit mechanisms make the transfer of generic capital possible. A liquid financial market with no legal barriers make the securities transfers easier. The barriers often intend to protect the specific part of the invested capital. For example the social laws takes the employees seniority into account. The ex ante and exit mechanisms appear to be complementary.

If the SH has passive monitoring mechanisms, he receives information on the contract execution. But he can not influence this execution. If he has active monitoring mechanisms, the SH also receives information on the contract execution. But he can influence its execution and play a role in the decision-making process, especially if he participates in the decision-making process.

In order to maintain his discretionary power, the executive can act on the different protection mechanisms. For example, he can create a specific relation between himself and the employees thanks to an appropriate training and promotion politics. This leads to an interdependance situation. The executive can also manipulate the board to control the monitoring mechanisms.

c. The room for trust in the set of protection mechanisms

The study of the protection mechanisms reveals the room left for trust. The English language enables one to distinguish between trust and confidence[4]. The word trust seems appropriate within the framework of actors strategy. Thus trust can be defined as " the deliberate willingness to be vulnerable to the actions of the other party, based on the hope that the latter will undertake an important action for the party giving his trust who can or can not watch or control the other party"[5]. The notion of trust implies to take risk and to have interdependance relations with other actors[6]. In a situation with a corporate governance problem, contracts are incomplete and the parties run a risk. Theoretically there is room for trust. The trust problems are more important if the parties are making specific investments because those are creating interdependances.

In this framework, trust exists when protection mechanisms are incomplete and do not prevent the parties investments. Trust can result from the choice of saving transaction costs or of estimating the risk run as low. More precisely the type of mechanisms identified leave more or less room for trust:

- the absence of exit mechanisms reveals an interdependance between the executive and the concerned SH. Thus the room left for trust is larger.
- When there is interdependance, the absence of exit mechanisms leads to a lock-in position for the SH in front of the executive. The SH tends then to trust the executive.

[4] Luhmann N. (1988), « Familiarity, confidence, trust : problems and alternatives », in Gambetta D. (ed.) *Trust, making and breaking cooperative relations*, Oxford, Basil Blackwell.
[5] Mayer R. C., Davis J. H., Shoorman F. D. (1995), « An integrative model of organizational trust », *Academy of management review*, 20(3).
[6] Rousseau D., Sitkin S. B., Burt R. S., Camerer C. (1998), « Not so different after all : a cross-discipline view of trust », *Academy of management review*, 20(3).

- The monitoring mechanisms compensate for the eventual absence of ex ante mechanisms. The control takes place at the decision-making process level. In this case, the SH has no mechanisms to get the accumulated capital back at the least cost, but he can go on and put the capital to work.

2. A typology of the main corporate governance systems in the trust perspective: some features in the 1990's

The 1990's international studies enable one to evaluate the three SH position in front of the executive in the trust perspective[7]. If the law grants a given mechanism to the SH, "yes" is written in the table and "no" in the contrary case. Other mechanisms are statistics.

a. The shareholders position

The shareholders position appears as strong in the USA and UK whatever the studied mechanisms. The protection is the higher in the UK with a large number of ex ante guaranties and monitoring mechanisms. This situation reveals a low level of trust in the shareholder – executive relation.

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[7] For shareholders and financial creditors position : Demirgüç-Kunt A., Levine R. (1999), « Bank-based and market-based financial systems : cross-country comparisons », *World Bank Policy Research Working Paper 2146*. La porta R., Lopez-de-Silvanes F., Shleifer A. (1999), « Corporate ownership around the world », *Journal of finance*, p. 417-517. La porta R., Lopez-de-Silvanes F., Shleifer A., Vishny R. (1998), « Law and Finance », *Journal of political Economy*, 106(6).
For employees position : OECD (1999), *Perspectives de l'emploi de l'OCDE*, juin. Begin J. P. (1997), *Dynamic human resource systems : cross-national comparisons*, De Gruyter. Poole M., Warner M. (1998), *Handbook of human resource management*, International Thomson Business Press.

Table 1: Shareholders protection mechanisms in the USA, Japan, France, Germany and the U.K.

SH and type of mechanisms	Description of the mechanisms	USA	J	F	A	UK
Shareholder						
Ex ante	Preemptive rights when new issues of stock	No	No	Yes	No	Yes
	Judicial mechanisms to contest the executives or shareholders meeting decision	Yes	Yes	No	No	Yes
	Mandatory dividends	No	No	No	No	No
	Principle "one share – one vote"	No	Yes	No	No	No
Exit	Stock exchange capitalization / GNP (1996)	1.14	0.66	0.38	0.28	1.42
	Number of listed firms on the stock market / population in millions (1996)	28.8	14.1	11.8	7.1	40.3
	Percentage of shareholders diffusion	0.83	0.7	0.4	0.36	0.86
	Shares not blocked before general shareholders meeting	Yes	Yes	No	No	Yes
Active monitoring	Compulsory separation between control and decision	No	No	No	Yes	Yes
	Proxy by mail	Yes	No	Yes	No	Yes
	Percentage of share capital to call an extraordinary shareholders' meeting	0.10	0.03	0.10	0.05	0.10
Passive monitoring	Financial information quality (index with 90 indicators)	71	65	69	62	78

On the contrary, the French and German shareholders rely a lot more on trust. The exist possibilities are less important then in the Anglo-Saxon countries. The shareholding is more concentrated. This leads to an interdependance phenomena between the shareholders and the executive. Besides, the absence of ex ante guaranties generates lock-in situations. Finally, this phenomenon seems more significant in Germany despite some monitoring possibilities.

Japan is in an intermediary situation. The financial markets are less liquid in the Anglo-Saxon countries, but less closed then the continental European countries. In addition, some ex ante mechanisms bring some guaranties to the investors.

b. The employees position

Once more, the USA and the U.K. are in an identical situation. The employees protection is better collectively than individually. However, the absence of monitoring mechanisms makes the employees situation fragile. The relation between the executives and the employees imply to use trust.

Table 2: Employees protection mechanisms in the USA, Japan, France, Germany and the U.K.

SH and type of mechanisms	Description of the mechanisms	USA	J	F	A	UK
Employees						
Ex ante	Degree of law stricness in the case of individual lay-offs (OCDE index with 12 indicators)	0.2	2.7	2.3	2.8	0.8
	Degree of law stricness in the case of collective lay-offs (OCDE index with 4 indicators)	2.9	1.5	2.1	3.1	2.9
Exit	Percentage of the work force receiving a professional training provided by the employer	ND	ND	37	24	39
	Volume in number of hours of professional training provided by the employer	ND	ND	20.1	8.2	15.8
	Unemployment rate in the active population (average 1986-96)	6.2	2.6	10.6	8	8.8
	Percentage of employees working full time and having 5 years or more seniority	ND	ND	65	59	53
Active monitoring	Works council or internal consultative groups	No	Yes	Yes	Yes	No
	Participation plans	Yes	Yes	Yes	No	Yes
	Employees representation at the board	No	No	No	Yes	No
Passive monitoring	Low hierarchical distance improving internal communication	No	Yes	No	Yes	No

In Japan, Germany and France, the employees position is similar. There are no lock-in phenomena except in Japan, where the ex ante protection is weak. Besides monitoring mechanisms help employees to take part to human capital rise in value. However only the German employees benefit from active monitoring possibilities upstream of the decision-making process. Consequently the relations between the executive and the German employees are less based on trust.

c. The financial creditors position

The financial creditors position is strong in Germany and in the U.K. (active banking market, ex ante guaranties, active monitoring). The relations between the executive and the financial creditors is based on low trust.

With a less active banking market, no ex ante guaranties and no monitoring possibilities, the financial creditors in France and in the USA are using mechanisms of trust.

In Japan, the financial creditors are in an intermediary position. The banking market is more active, there are some ex ante guaranties despite the absence of monitoring mechanisms.

If we consider the complementarity of SH positions, this analysis reveals two principal models: the USA model and the German one. In the German model the shareholders have no protection ant then rely on the position of financial creditors. This situation explains the banks power in Germany. In the USA, for similar reasons, the employees will use a shareholder position to benefit from a more complete protection system.

The French and British models come from those two models. The British model is close to the American one considering the shareholders and the employees position. But it is close to the German model as regards the financial creditors. The French model is close to the German model for the shareholders and the employees. But it is similar to the American one from the financial creditors point of view. We have to remember that the French banking system had the benefit of the State guaranty due to the public implication in the financial sector.

The Japan position is unique. The employees situation looks close to the German employees. But the position of Japan financial creditors is less clear.

Finally the SH invest in each country but the power left to the executive is located differently. There is a room for trust in each country but in different relations between SH and the executive.

Table 3: Protection mechanisms for financial creditors in the USA, in Japan, in France, in Germany and in the U.K.

SH and type of mechanisms	Description of the mechanisms	USA	J	F	A	UK
Financial creditors						
Ex ante	Reorganisation restrictions linked to a creditors agreement	No	No	No	Yes	Yes
	The financial creditors can gain possession of their claims, no automatic stay in the bankruptcy and reorganisation laws	No	No	No	Yes	Yes
	Absence of privileges in favor of some creditors as the State or employees	Yes	Yes	No	Yes	Yes
	Management does not stay during reorganisation	No	Yes	No	No	Yes
Exit	Banking debts in the private sector / GNP	0.64	1.17	0.89	0.94	1.14
	Part of the three first banks in the assets total	0.19	0.22	0.41	0.45	0.56
Active monitoring	Legal separation of control and decision functions	No	No	No	Yes	Yes
	Percentage of firms having relations with only one bank	ND	ND	4	14.9	22.5
Passive monitoring	Financial information quality (index with 90 indicators)	71	65	69	62	78