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A Critical Review of the Different Models of Corporate Governance

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Abstract: The Corporate Governance (CG) structure of joint-stock companies in a given country is determined by several factors: the *de facto* realities of the corporate environment in the country; each corporation's Articles of Association (AoA); and the regulatory and legal framework outlining the responsibilities and rights of all parties involved in CG. While CG provisions differ from corporation to corporation many *de jure* and *de facto* factors affect corporations in a similar way. Hence, it is possible to outline a *'model'* of CG for a given country [1]. CG models vary from country to country. This paper critically analyses the different models of CG namely the Anglo-Saxon Model (followed in U.K., U.S.A.), the German Model and the Japanese Model in order to understand how companies operate and consequently to find out those elements that are external and internal to the productive combination that influence the performance of the companies. It also makes a comparative analysis between Indian Model of CG and these models. In other words, the paper explains in detail as to how there is a relationship between the Indian Model of CG and the Anglo-Saxon and the German Model.

Keywords: Corporate Governance, Anglo-Saxon Model, German Model, Indian Model, Japanese Model, Outsider-based system.

I. INTRODUCTION

CG has been a topic of hot debate in developed countries like U.K. and U.S.A. for the last few decades. With the opening up of economies it has also been a concern for a developing country like India. The issue is particularly important for India since it is central to its financial and economic development.

The CG structure of joint-stock companies in a given country is determined by several factors: the de facto realities of the corporate environment in the country; each corporation's AoA; and the regulatory and legal framework outlining the responsibilities and rights of all parties involved in CG. While CG provisions differ from corporation to corporation many de jure and de facto factors affect corporations in a similar way. Hence, it is possible to outline a 'model' of CG for a given country [1].

Models are the result of the presence of different interest and power equilibrium in the corporate which have to shack up with social and economic forces with different economics and legal traditions. It is very important to analyse the models of CG in order to understand how companies operate and consequently to find out those elements that are external and internal to the productive combination that influence the performance of the companies [2].

CG models vary from country to country. However, the main principles of every CG model are derived from fundamental mechanisms of governance as outsider (shareholder model) and insider (stakeholder model) systems. Outsider model has dispersed ownership (shares owned by individuals in stock markets) and the aim is to reach fast short-term goals for wealth maximisation of shareholders. While the insider model is based on interests of stakeholders and the ownership is concentrated (shares owned by banks, family or institutions) and the aim is to reach long term goals [3]. This is depicted in the diagram below:

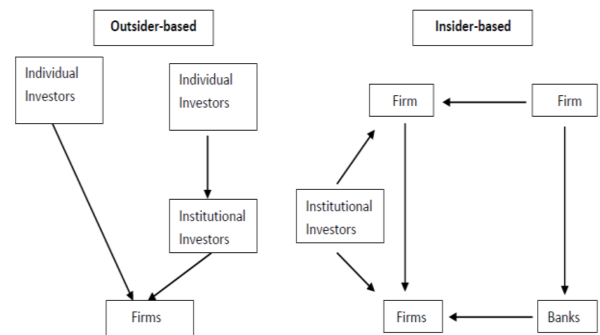

Fig. 1: Outsider and Insider CG Models Source: Adapted from [4]

Based on the above, three different types of CG models exists worldwide. These are:

- Anglo-Saxon Model (Outsider-based system)
- German Model (Insider–based system)
- Japanese Model (Insider–based system)

II. ANGLO-SAXON MODEL

The Anglo-Saxon countries (U.S., U.K., Australia, Canada) adopts an outsider system model i.e. the financial market rules the conflict between the management and the

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stakeholder. In particular, the capital market regulates the management and develops the creation of value for shareholders which is the key to success in marketplace i.e. market for corporate [5].

The key players in the Anglo-Saxon model are the directors, management, Government Agencies, Self-Regulatory Organisations (SROs), shareholders (particularly Institutional Investors) and consulting firms which advise shareholders or corporations on proxy voting and CG. Of these key players, the three major players are shareholders, directors and management. They form what is commonly known as the *'Corporate Governance Triangle'* [1]. This is depicted in the diagram blow:

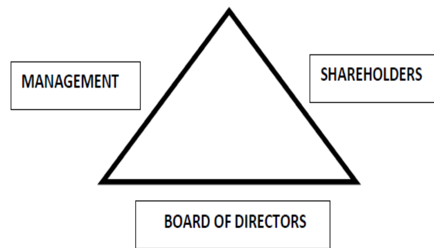

Fig. 2: CG Triangle Source: Adapted from [1]

The Anglo-Saxon model is characterised by the dominance in the company of individual shareholders and independent persons. The manager is responsible to shareholders and Board of Directors. The shareholders being interested in receiving dividends and profitable activities [6]. The shareholders appoint directors who in turn appoint the managers to manage the business. Thus, there is separation of ownership and control [7]. Ownership structure in U.K. and U.S. is featured by dispersed ownership as stated by [8]. This results in *agency problem* as stated by [9]. *Agency problem* occurs when management acting as agent of the shareholders (principal) pursue their own self-interest rather than for the interest of the shareholders [10]. In this context, it should be noted that the base theory for the *Anglo-Saxon model* is the *AT* focusing on the conflict between the mangers (agent) and the shareholders (principal) [2].

The CG model of a publicly listed company in the U.K. and the U.S. is depicted below:

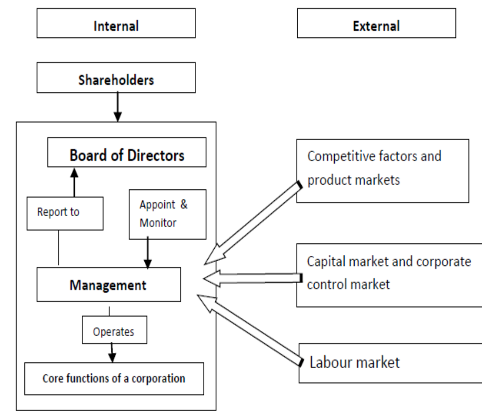

Fig. 3: CG model in the U.S. and U.K. Source: Adapted from [11]

From Fig. 3 it can be stated that the U.S.-U.K. type of CG model is comprised of internal and external mechanisms. As is evident from the above diagram, *'Internal'* refers to the internal mechanism. Here, shareholders appoint Board of Directors who then appoints and monitors managers and at the same time managers operate the core functions of the corporations and report back to the Board of Directors (who represent shareholders: the owners of the companies). In this context, it should be noted that there is only a one-tier board in the U.S.-U.K. type of CG model. The board is composed of non-executive directors (NEDs) or outside directors and executive directors depending on whether it is in the U.K .or U.S. and also the number of board members is related to the regulations of the respective countries [10]. In Fig. 3, *'External'* refers to the external mechanisms. For example, competitive factors in the product market, corporate control market, capital market and labour market act as monitor mechanisms for management. Competitive forces in the market for corporate control will make the under-performed organisation a take-over target which may result in the exile of the management by the acquirer. In addition, competitive factors in the product market play an important monitoring role as the organisation's performance against its competitors demonstrates whether managers are hardworking and competent in their jobs. Lastly, the competitiveness in the labour market for example the executive recruitment market can play an important role as it will be hard for an incompetent or shirking manager to go through the shrewd head-hunters' scrutiny to secure a job [10].

In the U.S. and U.K. a wide range of regulatory codes and laws define relationships between shareholders, directors and management. In the U.S., the Securities and Exchange Commission establishes disclosure requirements for organisations, regulates the securities industry and also regulates communication between organisations and shareholders. Laws regulating pension funds also have an important impact on CG. In comparison with other capital markets, U.S. has the most comprehensive disclosure

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requirements and a well-regulated complex system for shareholder communication. The regulatory framework of CG in U.K. is established in Parliamentary Rules and Acts established by SROs for example the Securities and Investment Board (SIB) which is responsible for the oversight of the capital market. Stock exchanges also play an important role in this model by establishing disclosure, listing and other requirements [1].

III. GERMAN MODEL

The German model adopts the insider system model. It is also known as *'relationship based'* i.e. a network–oriented corporate system. In this model, financial intermediation that issues risk capital is very influent whereas the presence of financial market is insufficient. It uses a bank–oriented perspective [2]. Traditionally, German banks have applied an important role in corporate decisions. Only one out of four organisations in Germany is entitled to public transactions. Hence, most organisations seek financial support from banks. Great importance is given to the protection of the creditors, to the point where a bank can dominate an organisation [6].

The key players in the German CG system are the German banks and to a lesser extent the corporate shareholders. Banks usually play a multi-faceted role as lender, depository (custodian bank), shareholder, voting agent at Annual General Meetings (AGMs) and issuer of both debt and equity. For example, in 1990 the three largest German banks (Commerzbank AG, Deutsche Bank AG and Dresdner Bank AG) held seats in the supervisory boards of 85 out of the 100 largest corporations. In Germany, corporations are also shareholders who sometimes hold long-term stakes in other corporations even when there is no commercial or industrial affiliation between the two corporations [1].

The three distinct features of the German model that distinguishes itself from the other models are stated as follows:

The first major feature is that the German CG model includes two boards with different members. German organisations have a two-tier board structure consisting of supervisory board (consisting of shareholder representative and employee/labour representatives) and management board (consisting entirely of insiders i.e. executives of the organisation) [1]. This is depicted in the diagram below:

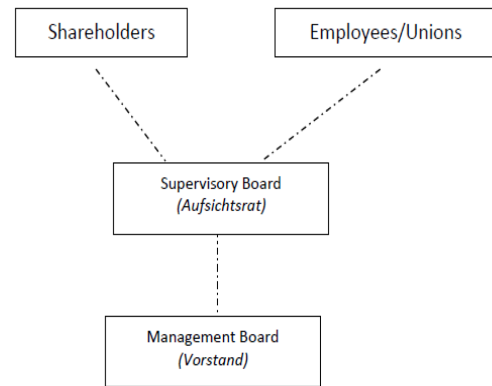

Fig. 4: Two – tier Board Structure in Germany Source: Adapted from [12]

From Fig. 4 it can be seen that the two-tier board is composed of supervisory board *(Aufsichtsrat)* and management board *(Vorstand)*. In this model, the management board is appointed by the supervisory board and not by shareholders as in U.S. or U.K. Organisation is run by the management board and its duties and powers are derived from the statute [13]. It can also be seen from Fig. 4 that the supervisory board has a complex composition. The supervisory directors are appointed by shareholders (banks) and employees depending on the type of organisation [10]. According to [13], post-World War II it is mandatory to include employee representatives in the supervisory board in the coal, steel and iron industries. Furthermore, according to the *German Co-determination Act 1976*, employee representatives are appointed by employees and usually the employee representatives are trade union members.

The second feature is that the size of the supervisory board is set by law and it cannot be changed by the shareholders [1].

The third feature is that voting right restrictions are legal which limits a shareholder to voting a certain percentage of an organisation's total share capital irrespective of share ownership position [1].

In Germany both state *(Laender)* and federal law influence CG. Federal laws include Stock Exchange Law, Commercial Law and Stock Corporation Law. In addition, the laws governing the composition of the supervisory board are federal laws. It should also be noted that the regulation of the stock exchanges is the mandate of the states. In 1995, a federal regulatory agency for the securities industry was established to fill the void in the German regulatory environment [1].

IV. JAPANESE MODEL

Japanese model adopts the insider system model. In this context, it should be noted that the base theory for the Japanese model is the *Stakeholder Theory* which

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emphasizes the relevance of the fulfilment of the stakeholders' interest [2]. The Japanese corporate sector is characterised by control-oriented shareholders and corporate groups. The management monitoring function is performed by creditors i.e. the *main bank* [14].

The key players of this model are the *main bank* and a financial/industrial network known as *'Keiretsu'*. The '*Keiretsu'* and the *main bank* are two different yet complimentary elements of the Japanese model. All Japanese organisations have close relationship with the *main bank*. The *main bank* is usually a major shareholder in the organisation. The bank provides its clients with loans along with services related to equity issues, consulting services, settlement of accounts and bond issues [1]. The *main bank* plays an important role in CG in Japan. The *main bank* can exert control over the management in a variety of ways. It may hold regular meetings with the management and may ask to be kept informed about the activities, plans and policies. Its personnel may sit in the organisation's Board of Directors. In times of crisis the bank will not only inject capital into the organisation but may temporarily takeover the management of the organisation [13]. Furthermore, it should be noted that the Japanese Government encourages the formation of *'Keiretsu'* and in return *'Keiretsu'* ensures Government representation in the organisation's board [15].

The Japanese model is depicted below:

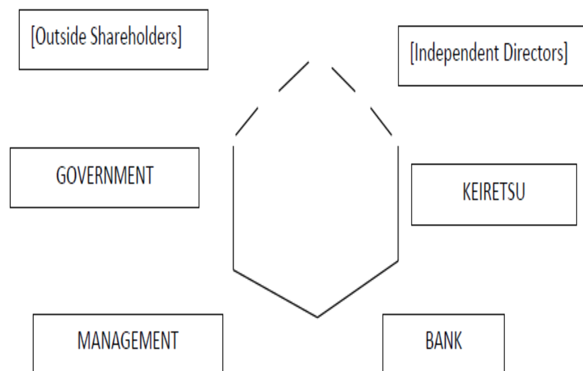

Fig. 5: Japanese Model Source: Adapted from [1]

In Fig. 5 the open lines at the top indicate a non-linked interest between the outside directors and the non-affiliated shareholders while the four connecting lines (at the base of the diagram) indicates the linked interest between Government, management, bank and '*Keiretsu'*.

Ownership structure in joint-stock companies *(Kabushiki Kaisha)* in Japan is characterised by Employee Share Ownership and *stable shareholders. Stable shareholders* means that there is no frequent trading and these shareholders are based for the long term prospect of the organisation. The *stable shareholders* can be the organisation's creditors or customers or suppliers of goods and services [13]. Employee Stock Ownership Programme (ESOP) plays an important aspect in Japanese share ownership structure. Employment in Japan is often considered as life-long employment. ESOP provides an incentive to the employees to work in the same organisation. Life-long employment combined with ESOP indicates that the employees hold the shares for a long time which in turn makes the shareholding relatively stable [13]. It should also be noted that even though there is only one-tier board in the Japanese CG system here also the employees play an important role like that in the German model. Japanese boards are composed almost entirely of senior employees *(Sakuma)* [13].

In Japan, ministries wield enormous regulatory control. However, lately several factors have affected the implementation of comprehensive industrial policy. Firstly, increasing internationalisation of Japanese corporation made them less dependent on the domestic market and thus less dependent on the industrial policy. Secondly, due to the growing role of the Japanese organisations abroad policy formation became fragmented due to the involvement of numerous ministries for example the Ministry of International Trade and Industry and the Ministry of Finance (MoF). Thirdly, the growth of Japanese capital markets led to partial liberalisation and an opening, albeit small to global standards. It should be noted that the regulatory framework of the Japanese securities industry was modelled in the U.S. system. In spite of several revisions the core of Japan's securities law remains similar to the U.S. laws. The primary regulatory bodies are Securities Exchange Surveillance Committee (SESC) and the Securities Bureau of the MoF established under the auspices of Securities Bureau in 1992. The SESC is responsible for monitoring corporate compliance and for investigating violations [1].

V. MAIN FEATURES OF THE THREE CORPORATE GOVERNANCE MODELS

The main features of the three CG models mentioned above are stated below:

	Anglo-Saxon Model	German Model	Japanese Model
Oriented towards	Stock market	Banking market	Banking market
Considers	Shareholders' property	Shareholders' property and company's relationship with its employees	Stakeholders' interests *(Keiretsu)*
Control System	External	Internal	Internal
Management	Executive Directors and NEDs	Board of Directors Supervisor	Revision Commission Board of

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		Board	Directors
Shareholding Structure	Dispersed	Concentrated	Concentrated (Cross possession of shares)
Accounting System	Generally Accepted Accounting Principles (GAAP)	International Financial Reporting Standards (IFRS)	GAAP and IFRS

Table 1: Main features of the three GC models Source: Adapted from [6]

From Table 1, it can be inferred that the Anglo-Saxon model is oriented towards stock market while the German and Japanese model is oriented towards banking market. The Anglo-Saxon model adopts the outsider system model while the German and Japanese models adopt the insider system model. In Anglo-Saxon model, managements constitute of Executive Directors and NEDs; the German model constitutes of Supervisor Board and the Board of Directors; and the Japanese model constitutes of Revision Commission and Board of Directors. In Anglo-Saxon model, the shareholding structure is dispersed in nature while in German and Japanese models it is concentrated in nature. In Anglo-Saxon model, the accounting system that is applicable is GAAP; in German model IFRS is applicable; and in Japanese model both IFRS and GAAP is applicable.

VI. INDIAN MODEL OF CORPORATE GOVERNANCE

The debate on CG on India is tended to draw heavily from the Anglo-Saxon model. However, it should be noted that the CG problems in India is different. The CG issue in U.K. and U.S. is essentially that of disciplining the management who is accountable to the owners. The problem in India [Indian private sector or Multinational Corporations (MNCs) and public sector] is that of disciplining the dominant shareholder and protecting the minority shareholders [16]. According to [7], the Indian model of CG is a mix of the Anglo-Saxon model and the German model. This is because in India there are different types of organisations like the Indian private companies or MNCs and public companies. For example, in private companies promoter and his family have complete control over the company. Hence, they depend less on outside equity capital. Therefore, the German model might be applicable in those companies [7].

The CG literature in U.K. and U.S. focuses on the role of the board as a bridge between the management and the owners. It is an environment where the management and ownership is widely separated and the owners are unable to exercise effective control over the board or the management. The management is self-perpetuating and the composition of the board is influenced by the likes and dislikes of the CEO. CG reforms in U.S. and

U.K. is focused on making the board independent of the Chief Executive Officer [16]. Although in India there has been an increasing concern with respect to improving the performance of the board. A close analysis reveals that the board is not central to the CG malaise in India. The central problem in India is not a conflict between the owners and the management but a conflict between the minority and dominant shareholders. Even in theory it is not possible for the board to resolve the conflict. As it is evident from the simple fact that

> 'How can one, even in theory, envisage a board that can discipline the dominant shareholders from whom the board derives all its powers?' [16, p.6)].

In India, the problem of the dominant shareholder arises in three large sectors. First are the Public Sector Units (PSUs) where the Government is the dominant shareholder. Second are the Indian business groups where the promoters (together with their families and friends) are the dominant shareholders. Third are the MNCs where the foreign parent is the dominant shareholder [16].

Regulators in India face a number of problems with respect to tackling the problem of CG abuses by the dominant shareholders. In many instances it is difficult to decide as to how far the regulator can go with respect to interfering with the normal course of corporate functioning. As in many cases correction of the governance abuses would imply a micro-management of the routine business decisions which lie beyond the regulators competence or mandate. The capital market on the other hand has the ability to make business judgements [16].

VII. CONCLUSION

This paper critically analysed the different models of CG namely the Anglo-Saxon Model (followed in U.K., U.S.A.), the German Model and the Japanese Model in order to understand how companies operate and consequently to find out those elements that are external and internal to the productive combination that influence the performance of the companies. It also makes a comparative analysis between Indian Model of CG and these models. In other words, the paper explains in detail as to how there is a relationship between the Indian Model of CG and the Anglo-Saxon and the German Model.

The findings of the paper are enumerated below:

- The Anglo-Saxon model adopts the outsider system model i.e. the financial market rules the conflict between the management and the stakeholder; the German model adopts the insider system model. It is also known as *'relationship based'* i.e. a network–

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oriented corporate system. In this model, financial intermediation that issues risk capital is very influent whereas the presence of financial market is insufficient; and the Japanese model like the German model also adopts the insider system model.

- The key players in the Anglo-Saxon model are the directors, management, Government Agencies, SROs, shareholders (particularly Institutional Investors) and consulting firms which advise shareholders or corporations on proxy voting and CG; in German model, the key players are the German banks and to a lesser extent the corporate shareholders; and in Japanese model the key players are the *main bank* and a financial/industrial network known as *'Keiretsu'*.
- The Anglo-Saxon model is comprised of internal and external mechanisms. *'Internal'* refers to the internal mechanism. Here, shareholders appoint Board of Directors who then appoints and monitors managers and at the same time managers operate the core functions of the corporations and report back to the Board of Directors (who represent shareholders: the owners of the companies). *'External'* refers to the external mechanisms. For example, competitive factors in the product market, corporate control market, capital market and labour market act as monitor mechanisms for management. In this context, it should be noted that there is only a one-tier board in Anglo-Saxon model; there are three distinct features of the German model that distinguishes itself from the Anglo-Saxon and Japanese models: the first major feature is that the German CG model includes two boards with different members, the second feature is that the size of the supervisory board is set by law and the third feature is that voting right restrictions are legal; and in Japanese model it should be noted that even though there is only one-tier board in the Japanese CG system here also the employees play an important role like that in the German model. Ownership structure in joint-stock companies *(Kabushiki Kaisha)* in Japan is characterised by ESOP and *stable shareholders.*
- The debate on CG on India is tended to draw heavily from the Anglo-Saxon model. However, it should be noted that the CG problems in India is different. The CG issue in U.K. and U.S. is that of disciplining the management while the problem in India is that of disciplining the dominant shareholder.
- The Indian model of CG is a mix of the Anglo-Saxon model and the German model. This is because in India there are different types of organisations like the Indian private companies and public companies. For example, in private companies promoter and his family have complete control over the company. Hence, they depend less on outside equity capital. Thus, these companies can be a good candidate for application of German model.
- The CG literature in U.K. and U.S. focuses on the role of the board as a bridge between the management and the owners. A close analysis reveals that the board is not central to the CG malaise in India. The central problem in India is not a conflict between the owners and the management but a conflict between the minority and dominant shareholders.

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