

CORPORATE HARMONY AND CONFIDENCE BUILDING SPHERES ON THE FINANCIAL MARKET

Krzysztof Grabowski

Kozminski University, Warszawa, Poland

Abstract: As the last financial crisis was caused by abuse of trust on the part of the financial institutions, this paper describes a proposed structure integrating sustainability and ethics based on trust and confidence. The author describes relations between business ethics and some theories of corporate governance and presents a possible answer to the question of whether trust can be measured. Then, he sketches a square of rules and regulations in which the financial market with its regulations is immersed, split into four overlapping sectors of financial market law, company law, codes of best practices and corporate governance principles. Interactions between these sectors lead to the creation of an inner circle describing the integration sphere where all the areas merge together in harmony. Last, the author formulates a proposal for the broadest understanding of corporate governance – corporate harmony.

Keywords: corporate governance, corporate harmony, rules and regulations square, business ethics, financial institutions

The last financial crisis has already been named as a crisis of trust that came about as a result of financial institutions abusing the trust of their clients and shareholders on an unprecedented scale. It disrupted a process of sustainable development of financial institutions, largely due to unethical behavior on the part of their managers. We can now find strong declarations at the highest levels that *“in a context of crisis, authorities must consider how to safeguard competition principles without hampering policy measures to avoid a slump or the erosion of trust in the financial sector”* (OECD, 2009a, p. 11). However, when we get down to more specific documents, such as another OECD report (2009b) that provides recommendations for some improvements in corporate governance, what we see, surprisingly, is that the words “trust” or “confidence” disappear completely. Several issues are discussed there that require mutual trust and confidence, but those words never appear in the report.

It might seem like corporate governance had nothing in common with business ethics, which obviously is not true. In a recent study, Nordberg (2010) examines three main theories: agency theory, stewardship theory, and stakeholder theory. Then he analyzes the role of ethics in corporate governance, discussing three ways in which it can be approached: as teleological, deontological, or virtue ethics. He concludes that *“the link to the ethics of corporate governance comes in what directors aspire to achieve”* (Nordberg, 2010, p. 185) and compares the implications those three theoretical perspectives may have on such a practical outcome as behavior of individual directors and of whole corporations.

If we define the stewardship theory as a model in which managers are *“motivated by a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby to gain recognition from peers and bosses”* (Donaldson and Davis, 1991, p. 51), we can derive from Nordberg’s conclusions that virtue ethics expresses itself in

the stewardship approach to doing business. Trust and confidence play a crucial role, and satisfied managers earn esteem by creating long-term value of “their” company. As he explains, “*in a virtue-based system, individual and collective aims seem to be self-reinforcing*” (Nordberg, 2010, p. 187). However, mechanisms have to be implemented to support such an approach and prevent would-be stewards from becoming frustrated and turning into unfettered agents. Therefore, I set out an integrated corporate governance model based on a well-balanced equilibrium between all regulation and self-regulation spheres. I develop here an idea of a rules and regulations square specified earlier (Grabowski, 2010) that leads to a concept of corporate harmony built on trust and confidence. This specific square is constructed for the financial market case, but may be easily applied to any branch or business area.

How Trust Can Be Measured?

In the whole variety of financial institutions, there is one thing in common: we entrust them with our financial assets that we earn during our lifetimes in the hope that these will be reasonably managed to assure our future profits. We entrust them with our fortunes in the confidence that they will not be lost. We entrust them with trust...

One question that naturally arises is how trust can be measured, if at all. Of considerable interest in this regard is a study in which a Corporate Governance Index (CGI) designed on the basis of OECD Principles (OECD, 2004) was plotted against the market-to-book ratio of companies listed on the Hong Kong Stock Exchange (Cheung, 2007). A positive relation was proved, and further conclusions were presented by Cheung, Connely, Limpaphayom, and Jiang (2008). They explained that in 2003-2006 corporate governance practices measured by CGI were improving continuously. More interesting, however, were the next results that showed “*an asymmetric response between stock returns and changes in corporate governance practice.*” In the language of trust, it means that trust is built slowly but may be lost very quickly.

Confidence Building Spheres

The issue is well-known from the point of view of customers who should trust financial institutions but are afraid that their trust might be abused. However, almost all big banks in Poland (and in several other countries) are listed on the stock exchange, and their shares may be bought by everybody, even by the same clients mentioned above, who enter into quite another relation with the banks. Clients may become shareholders with their direct investments or indirectly through investment or pension funds or insurance companies that reinvest their money. So, even without their full knowledge of that fact, they enter into an inevitable conflict of interest, as they are to have an interest not only in their personal profits as customers but also in the long-term value of banks as their shareholders. As listed banks function under financial regulations and also under company law and other corporate regulations, we can specify two distinct areas where financial regulations are devised to protect clients from financial institutions, and corporate regulations are devised to protect shareholders.

On the other hand, we can look at those areas of regulation from the point of view of their authors, so that we obtain another classification – legally binding regulations (hard law) and self-regulations (soft law). Such overlapping categories prompted me to draft the diagram below and to consider how their mutual interactions may influence the trust building process on the financial markets.

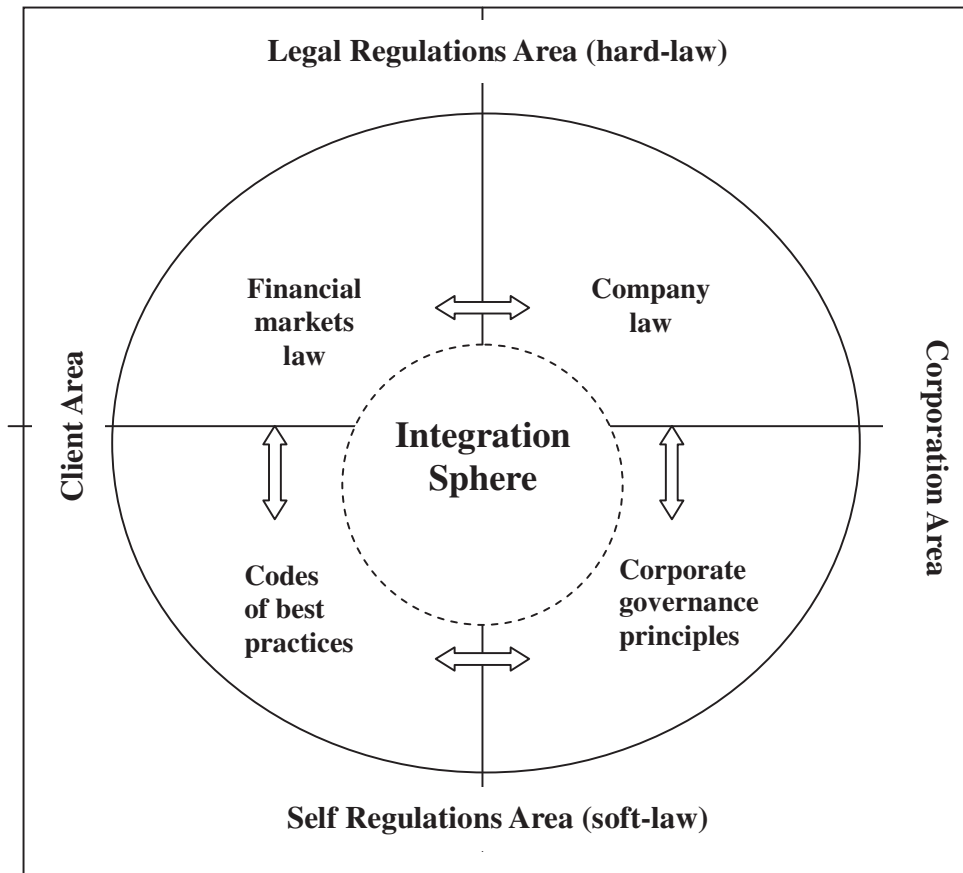


Figure 1. Rules and Regulation Square

We can identify three regulation layers there: the first, basic layer represented by the rules and regulations square depicting the system of law in a given jurisdiction, the second layer sketched as an outer circle of regulations for a given field of activities with four specific sectors, and the third layer with an inner circle representing the integration sphere where all four sectors merge in harmony.

The financial market works within the rules and regulation area sketched as an external square cut into four smaller areas delimited by two perpendicular lines crossing in the centre. The vertical line splits the square into two main areas – the client area on the left-hand side with external relations between market institutions and their clients and the corporate area on the right-hand side with internal relations between those institutions and their shareholders. The horizontal line splits the square into two other main areas – the hard law area on top with the entire body of law regulations, and the soft law area below with the broad spectrum of self-regulations.

The whole regulation system for financial institutions and their stakeholders is immersed in the external rules and regulation square. This is represented by an outer circle just inside the square, divided between four sectors according to the primary division described above. On the top left-hand side, we can see the financial market law sector where the hard law area and the client area intersect, and below we can find the codes of best practices sector where the soft law area and the client area intersect. On the right-hand side, there are two remaining sectors: the company law sector on top, where the hard law area

and the corporation area intersect, and the corporate governance principles sector below, where the soft law area and the corporation area intersect. The most interesting part of that diagram is the two-directional arrows that symbolize a mutual penetration of boundaries. It becomes more intensive in the central part of the diagram, finally leading to the creation of an integration sphere represented by the inner circle. A dotted line emphasizes its flexibility, as it surrounds an area where all the regulation fields merge together. The deeper and more harmonious this integration sphere is, the better conditions exist for building trust between financial institutions and their stakeholders.

Interactions Leading to Integration

Interactions Between Client Area And Corporation Area

The mutual penetration of boundaries between these two areas is the easiest to identify, as several financial institutions are organized as stock companies. They consequently fall both under company law regulations and under regulations appropriate for specific branches of financial law. The more those two areas are consistent, the more effective they are. Such a clarity and uniformity of law promotes the protection of its “consumers,” which, in this context, we can refer to as being both financial institutions and their clients.

These interesting relations can be observed in the self-regulation area at the lower part of the diagram, as the clients of a bank may at the same time be its shareholders. They are, therefore, interested in the lowest level of all fees for the services the bank is providing to them, even if that comes at the cost of lower protection of the bank’s interests as such. On the other hand, as shareholders of that bank, they are interested in the highest earnings and the easiest way of creating earnings is to make the fees as high as possible. However, those are the same fees for services that their bank offers them as clients. The conflict of interests is obvious and may be resolved only when we consider the company interest in the holistic and long-term context, as in the short-term period the most important factor is quick profit only. By contrast, when we consider the long-time perspective we easily discover that security and the bank’s development become much more important, as they ensure a constant grow of client numbers and also the security of their deposits. The conscious clients-shareholders will, therefore, tend to favor the equilibrium between the needs of “their” bank and its clients, leading them to the conclusion that the company interest should be understood as a mutual interest of all shareholders that understand and take into account the interests of all other stakeholders, including clients (which is the main motive of modern stakeholder theory). Such reasonable client-shareholder relations will, therefore, be very careful to ensure that the self-regulations applied by the bank take into account all those complex interdependences, promoting sustainable development and building long-term ties between the bank and its clients based on mutual trust.

Interactions between Hard Law Area And Soft Law Area

Let us start with the right-hand side of the diagram, namely with the corporation area. I have already analyzed (Grabowski, 2006) some examples of interrelations between law regulations and self-regulations with corporate governance understood as a splice of all regulation levels. In some models, the regulation crux is shifted to provisions of codified law; in others, more emphasis is put on corporate governance codes that are developed on a more voluntary basis. The boundary is dynamic, and we can identify its

constant flow in both directions. The most typical movement is the “hardening” of the law by absorption of particular principles of corporate governance in company law, but we can also observe some softening moves in the opposite direction. An interesting approach could be seen in the shareholders rights directive (Directive, 2007). It introduced a set of universal regulations for all Member States of the European Union, but left them a great deal of freedom in a choice as to the area (hard law or soft law) in which they should be applied. In my earlier paper (Grabowski, 2008, p. 486), I discussed an interesting example of that approach with the possibility of casting votes by correspondence. It is specified as follows: “*while the timing of disclosure (...) of votes cast in advance of the general meeting electronically or by correspondence is an important matter of corporate governance, it can be determined by Member States*” (Directive, 2007, motive 12).

One of the characteristics of self-regulations in the corporate area is their high centralization – on a given market only one document with a corporate governance code exists that is directed to all listed companies, and only in some exceptional cases may a few codes co-exist in one country. As corporate governance is an important issue for all enterprises, a centralized set of guidance directed specifically to unlisted companies was developed lately by the European Confederation of Directors’ Association (ecoDa, 2010).

A much more complex situation appears in the client area on the left-hand side of the diagram. The hard law area is highly centralized here, as apart from the set of acts of law mentioned earlier another set exists that deals with consumer protection. Quite the opposite situation may be observed in the soft law area, as the granulation in the codes of best practices sector is really extensive. Over twenty sets of such codes were developed by different branch organizations in Poland. An attempt was, therefore, made to prepare a Canon of Good Practices on the Financial Market (KNF, 2008), which sets out the principles common to all financial institutions. This is a nice example of co-existence and infiltration of both areas, as the Canon was worked out together by thirty organizations that represented all types of financial institutions and consumer protection organizations and, also, some governmental agencies, including the Polish Financial Supervision Authority (KNF).

Crossing the Boundaries

The works of the European Commission are a good example how the boundaries of the four sectors described above could be crossed. Let us begin with four recommendations (European Commission, 2004, 2005, 2009a, 2009b) that create a set of complementary documents touching on some crucial problems of corporate governance in financial institutions and listed companies. Later on, the European Commission (2010) issued a green paper on corporate governance in financial institutions and remuneration policies. All those documents are about specific regulations concerning both the client area and the corporate area. The green paper points out the overlapping interests of financial institutions’ clients and shareholders, leading to the conclusion that “*the supervisory authorities, whose mission to maintain financial stability coincides with the interests of depositors and other creditors to control risk-taking by the financial sector, have an important role to play in shaping best practices for governance in financial institutions*” (European Commission, 2010, p. 4).

In all the above documents, we can see a deep infiltration of the area of legal regulations and that of self-regulations. The European Commission (2005, motive 4) also invited Member States “*to take the*

steps necessary to introduce at national level a set of provisions based on the principles set out in this Recommendation, to be used by listed companies either on the basis of the ‘comply or explain’ approach or pursuant to legislation.” Some conclusions were then converted into hard law directives addressed to the financial institutions, but others concerning listed companies are still being examined. Finally, the European Commission (2011) issued another green paper on the governance framework with a clearly stated intention to leave ample maneuvering room for self-regulation. The boundaries between particular sectors are floating and are delimited variously in different Member States.

Integration Sphere

Finally, we reach the inner circle in the centre of the square that delimits an integration sphere where all four specific sectors co-exist in harmony. The better all the areas are coordinated, the more this sphere is homogenous. In the deep integration sphere, all regulations are consistent, and no small-print provisions are hidden. Only such a system creates a level playing field free of suspicions and fears of being cheated. Only then may an atmosphere of true co-operation and mutual trust be built effectively.

In that internal sphere some new initiatives may appear, among which the so-called stewardship code is worth mentioning as a set of self-regulations for institutional investors who play a dual role in both the corporation and client spheres. On the one hand, they are shareholders exercising their corporate rights, but on the other, they earn those rights through individual investors entrusting them with their financial assets to be invested. Those institutional investors, therefore, should exercise their corporate rights in such a way that the interests of the beneficial owners are respected so as to promote relations built on trust and confidence.

The OECD Principles of Corporate Governance (OECD, 2004) should also be placed in this sphere together with another document that supplements the Principles with methodology for assessing their implementation (OECD, 2007). The methodology identifies the company law (corporation area) and the securities regulation system (client area). The document is based on the assumption that it is not enough to examine the regulations only, as their assignment to specific regulation areas is less important than their effectiveness. That is why another factor is also studied there, namely what recourse mechanisms are open to stakeholders when their rights are breached. Even the best regulation system cannot be assessed positively if court procedures are too slow or ineffective. Here, too, the soft law area might be useful, as *“enforcement and redress might be handled by special courts and institutions such as arbitration tribunals. In forming a judgment, the reviewer should examine the effectiveness of such institutions and their achievements”* (OECD, 2007, p. 74).

Corporate Harmony

All the above considerations lead me to make a proposal of a new definition of corporate governance understood very broadly as a whole set of relations between the company and its stakeholders built on mutual trust and confidence. It takes into account not only the company itself, but also all the external spheres, both legal regulations and self-regulations together with local corporate culture and tradition. As it seems to integrate not only the three main theories of corporate governance, namely agency theory, stakeholders theory, and stewardship theory, but also the most basic notions of business ethics, the name “corporate governance integrated” looks like the best one. This is even more adequate as it incorporates

also “integrity” that is crucial to describe a very good manager. However, another name appears even better, which takes its source from the Polish name for corporate governance: “Ład korporacyjny.” The Polish word “Ład” (It should be pronounced something like “wad” or “wa:d) means “beauty”, but also “order” and “harmony.” I strongly believe that “harmony” constitutes the best characteristics of really good corporate governance in its broadest sense, and therefore propose the name “corporate harmony.”

Acknowledgement

I would like to thank Dr. Boleslaw Rok from the Kozminski University who, after reading the first version of my paper, suggested the title that is currently in use.

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