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A QUESTION OF TRUST: HISTORICAL LESSONS FOR CURRENT DEVELOPMENT[1]

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Introduction

What are the financial sector preconditions for the successful development of financial systems and enterprise sectors? There is accumulating evidence of a relationship between financial development and economic growth. Several studies report a relation between the size of financial systems at the start of a period and subsequent economic growth. Controlling for other considerations, financial development appears to contribute to growth. A variety of measures of financial development are relevant - the volume of monetary assets, the size of banking systems and the size of stock markets.[2]

To the extent that it is possible to establish the channel by which financial development contributes to growth, it appears to be through the external financing of firms. Comparing the growth of different industries across countries or different companies suggests that there is an inter-relationship between their growth rates, the extent to which they are dependent on external finance and the development of financial systems in which they are operating (see Rajan and Zingales (1998)). In other words, financial development confers particular advantages on industries and companies that are especially dependent on external finance.

These results are consistent with the view that a primary function of financial institutions is to improve allocation of funds within an economy. Institutions that direct financing to activities that are most dependent on external finance assist corporate, industrial and economic growth. The studies therefore provide empirical confirmation at an aggregate or industry level of the theoretical underpinning of financial institutions.

However, the question that these studies leave unanswered is which institutions are particularly well suited to performing these functions. Do all institutions serve companies equally well or are some institutions particularly well adapted for the financing of, for example, high technology?

The second set of issues concerns the policies that can be used to influence the development of institutions. Over the last few years a literature has emerged emphasizing the important role that legal and regulatory structures play in influencing institutional development. This literature has suggested that protection of investors is a crucial determinant of the development of financial systems. Since, as noted above, the development of financial systems is in turn related to the external financing of firms, this suggests a key role for investor protection in promoting the external financing and growth of firms. The policy message that appears to emerge from these studies is clear: improve investor, in particular minority investor, protection, and financial development, investment and growth will follow.

This raises the question of what precisely is the relation between legal systems, regulation and the structure of financial institutions. Is there, as the above literature suggests, a straightforward relation between regulation and the development of institutions? In particular, are certain regulatory rules suited to the financing of high technology activities?

A third line of investigation has emerged recently that has thrown new light on this topic. This comes from examining the evolution of financial systems and corporate sectors over long periods of time. Long-run evolution studies have now been undertaken for the UK and Germany and are in progress for Japan and the US. They point to the importance of equity finance in the early evolution of capital markets. They also suggest a limited role for formal systems of regulation and instead, informal relations of trust appear to play a critical function.

Section 2 of the paper summarizes the literature on comparative financial systems. Section 3 contrasts ownership and control across countries. Section 4 looks at the influence of law and regulation on these differences. Section 5 discusses politics and finance. Section 6 summarizes the conclusions from the evidence on financial systems, ownership, law and

politics. Sections 7, 8 and 9 report evidence on the long-run evolution of capital markets in the UK, Germany and Japan respectively. Section 9 concludes the article.

Market- and Bank-Oriented Financial Systems

The most frequent contrast drawn is between the UK and USA on the one hand, and Germany and Japan on the other (see, for example, Edwards and Fischer, 1994 and Aoki and Dosi, 1992). The criteria by which systems are categorized include the size of banking systems and stock markets, the degree of external finance that comes from bank and market sources and the amount of corporate equity owned by banks. Bank-oriented systems are thought to have large banking systems, high levels of bank finance, and large equity holding by banks. There is thought to be a relation between the structure of financial systems and the balance of economic activities between, for example, innovative and more traditional industries (see for example Carlin and Mayer, 2003).

In fact, the distinction between bank- and market-oriented systems has proven to be fragile (see, for example, Mayer, 1988; Rajan and Zingales, 1995). Japan has a large banking system but also has a well-capitalized equity market. While banks are thought to have been actively involved in corporate activity and, in particular, restructurings in Japan, they have not in Germany. In addition, although early studies of Japan pointed to the advantages of close bank–firm relations, more recent ones have noted their defects in displaying excessive conservatism in corporate lending and inhibiting restructuring (see, for example, Weinstein and Yafeh, 1998; Kang and Stulz, 2000). Instead, what emerges as a common feature of all developed countries financial systems is the dominance of internal sources of finance. Retained earnings are by far and away the most important source of finance for companies in developed economies.

Table 16.1 illustrates this in relation to four countries, Germany, Japan, the UK and

US. It records the proportion of physical investment in the four countries that is financed from internal sources and a variety of different external sources. Over the period 1970 to 1998 the U.S. corporate sector on average raised 96% of its financing from internal sources. As Table 16.1 shows, internal sources accounted for more than three-quarters of finance in each of Germany, Japan and the UK.

Table 16.1: Sources of finance, average 1970-1988

	Germany (1970-1997)	Japan (1970-1997)	UK	US
Internal Sources	79.8 %	76.1 %	92.5 %	96.4 %
Of which depreciation	71.2 %	55.2 %	62.3 %	76.6 %
Retained Profits	8.6 %	20.9 %	30.2 %	19.8 %
Loans	12.4 %	17.4 %	13.9 %	12.6 %
Bonds	-0.5 %	4.8 %	6.5 %	16.0 %
New equity issues	0.4 %	3.8 %	-6.3 %	-10.6 %
Trade Credit	-0.9 %	-4.9 %	-0.6 %	-3.2 %
Other	9.2 %	2.7 %	2.5 %	-1.3 %
Statistical adjustment	-0.4 %	-	-8.5 %	-9.8 %
Total	100.0%	99.9%	100.0%	100.0%

Notes: This table records the net sources of finance of corporate sectors in Germany, Japan, the UK and the US averaged over the period 1970 to 1997/8. External financing is reported on a net basis, net of the accumulation of equivalent financial assets, e.g. bonds issued by the corporate sector net of purchase of bonds by corporations.

Source: Corbett and Jenkinson (1997) and recent unpublished data from Tim Jenkinson

Table 16.1 records that a substantial fraction of internal sources is associated with depreciation, i.e. the decline in value of the existing assets of the firm. Much of firms' retained earnings are therefore used simply to replace existing rather than to purchase additional new assets. However, even once depreciation is removed, retained earnings are still the most significant source of finance in Japan, the UK and US.

Turning to external finance, there are numerous sources available to firms. Here the most useful distinction is between money raised through financial intermediaries, predominantly banks, in the form of loans and that coming directly from investors via

securities markets, in particular through issues of bonds and equities. There is a second fact that applies here with nearly as much force as the one regarding internal finance and that is that external finance comes predominantly from banks.

Table 16.1 shows that 14% of external finance in the UK comes from banks. There are significant variations across countries. Bank finance is, for example, higher in Japan than in the UK and US. However, in Germany, banks account for a slightly smaller proportion of external finance than they do in the market-based systems of the UK and US. The stereotype descriptions of financial systems are not reflected in their corporate finance patterns.

This also holds the other way round. A third feature of corporate financing revealed in Table 16.1 is that securities markets do not in aggregate contribute a great deal to the financing of companies. Bond markets account for less than 10% of corporate finance in Germany, Japan and the UK. In Germany, the negative figure for bonds reveals that companies have actually been net purchasers rather than issuers of bonds. Only in North America have bonds been substantial sources of corporate finance and in the case of the US they are a larger source than banks.

What is even more striking is the small source of funding coming from stock markets. In none of the four countries of Table 16.1 do equity markets provide more than 5% of corporate financing. Furthermore, in the two countries with supposedly the largest and most efficient stock markets, the UK and the US, equity financing has in aggregate actually been negative. This reflects a combination of two factors: firstly, companies have been buying back (i.e. repurchasing) their own shares, in particular in the US, and, secondly, they have been purchasing shares in other companies in the process of acquiring them. Both of these have withdrawn funds from the corporate sector and therefore contributed to a negative net financing figure.

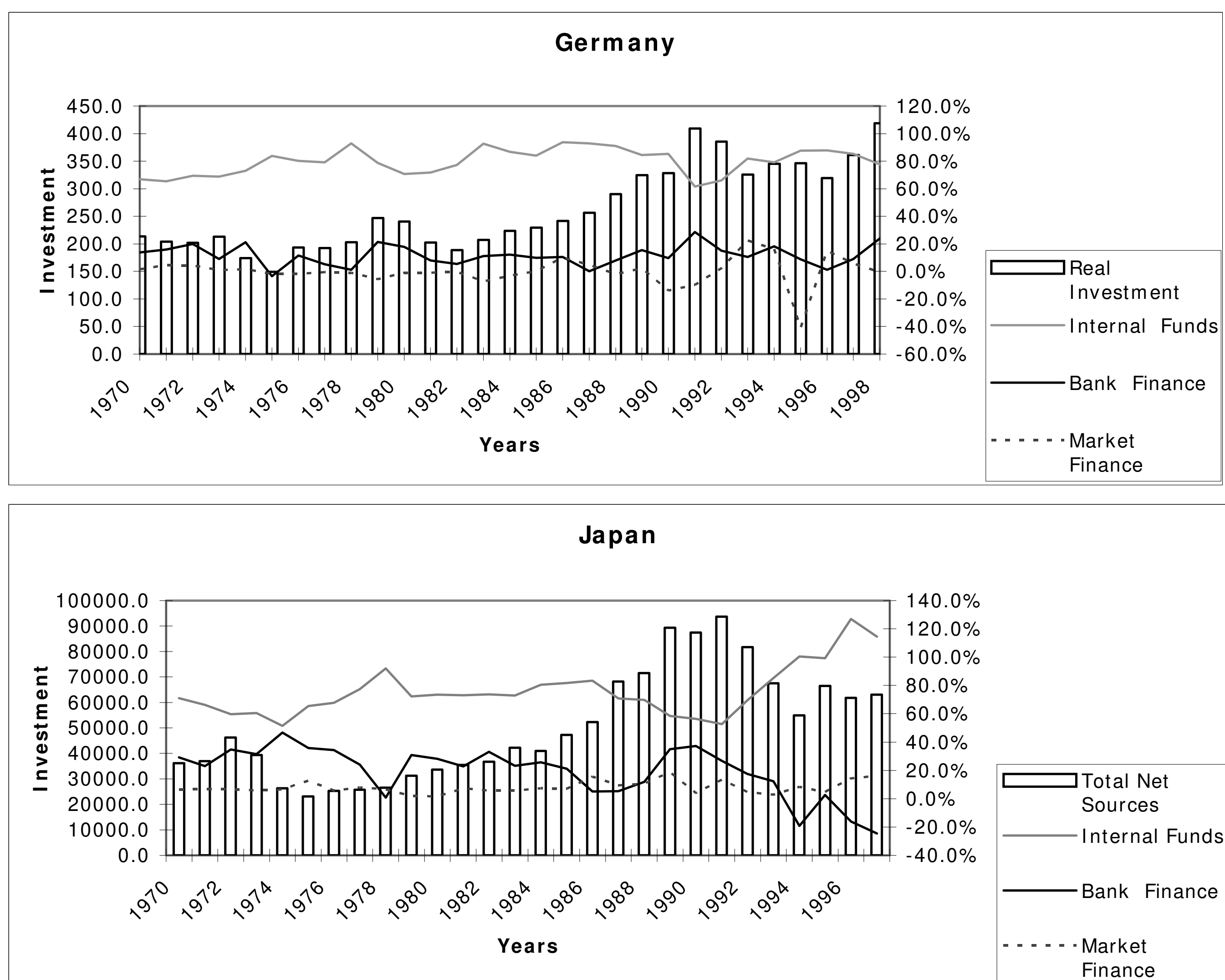
Table 16.1 averages financing proportions over the period 1970 to 1998. Figure 16.1

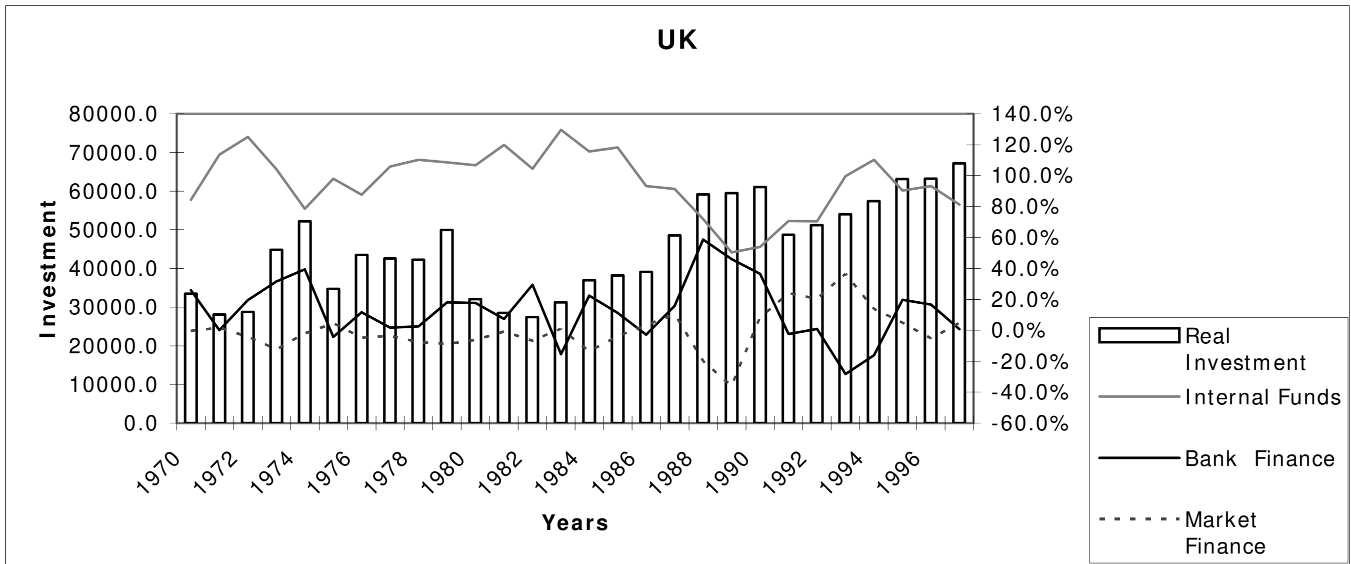
shows that during this period there were cyclical fluctuations and some trend movements in financing. The most striking cyclical feature, which is observed in all four countries, is the

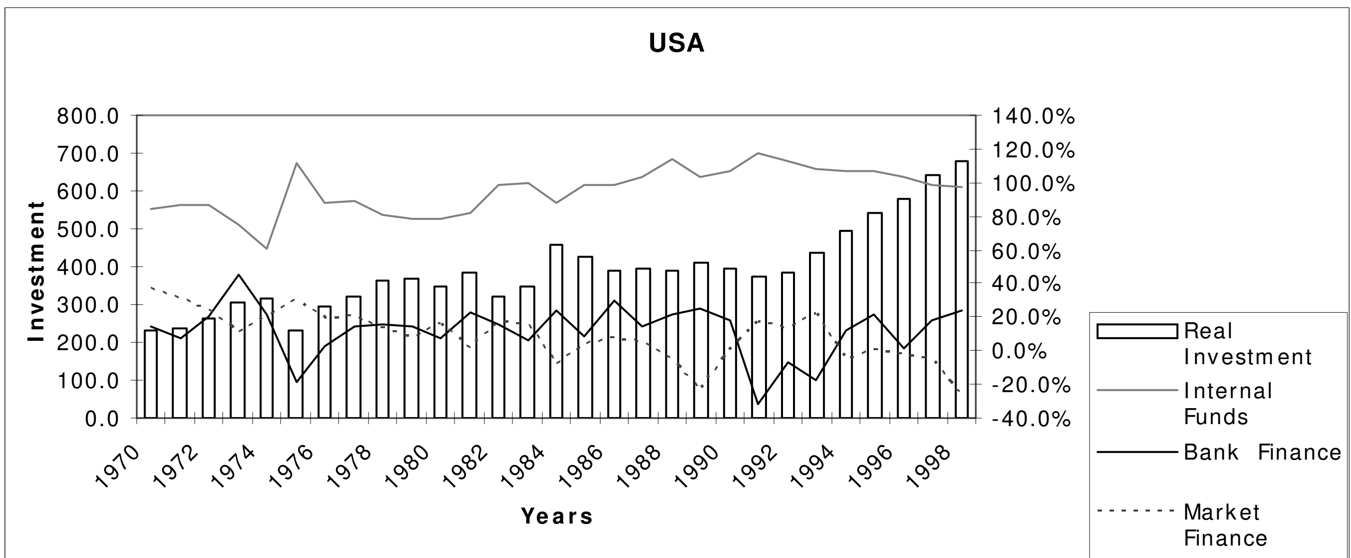
Figure 1: Sources of Corporate Finance in Germany, Japan, UK and US, 1970-1998

when internal sources are low.[3] The most pronounced trend movement is in the US where internal sources increased over much of the period and new equity sources declined. Far from new equity becoming a more significant source of finance in the last part of the century, acquisitions and share repurchases together took an increasing amount of funding out of the US corporate sector via equity markets.

Figure 16.1: Sources of Finance in Germany, Japan, UK and US, 1970 - 1998







Sources: Corbett and Jenkinson (1997) and recent unpublished data from Tim Jenkinson

In summary, the above has suggested five stylised facts of corporate finance:

1. Internal funds are the predominant source of finance for companies.
2. Bank finance is in general the most important source of external finance for companies.
3. There is an inverse relation between internal sources and bank finance.
4. Bond markets have in aggregate contributed only a modest amount to the

financing of companies in most countries, with the exception of North America.

5. Stock markets have in aggregate provided little finance for their corporate sectors and there is little association between the size and sophistication of stock markets and the amounts of finance raised on them.

The influence of financial systems on measures of corporate governance is also unclear. Close relations between financial institutions and companies might have been thought to influence incentives and disciplining of management. Systems with close relations have better information flows and thus a firmer basis on which to reward and discipline management. But they lack the powerful incentive and disciplining devices of stock markets. In fact, to the extent that there is evidence on this, it does not point to a clear difference in either incentive arrangements or disciplining across financial systems (see, for example, Kaplan, 1994).

The standard bank–market orientation distinction is neither particularly robust nor insightful. However, there is one important respect in which countries' financial systems do differ. This is the quality of information disclosure. Accounting standards differ appreciably across countries, ranging from the detailed provision of information for investors in some countries, to the most perfunctory disclosure of basic data in others.

There is increasing evidence that, even if other distinctions between market- and bank-oriented systems are not robust, information disclosure is. Rajan and Zingales (2002) describe how industries that are dependent on external finance grow more rapidly in countries with good accounting standards. They provide an interesting explanation for this relationship. They argue that developed financial systems play a particular role in financing activities that possess few tangible assets. The significance of this comes from the fact that tangible assets

can be used to offer collateral to banks, and firms that possess tangible assets can, therefore, obtain bank finance. However, firms that have few tangible assets are more reliant on market sources, which demand high standards of information disclosure. Activities that are dependent on external equity finance and other intangible inputs, such as skilled labour, should therefore prosper in systems with good accounting standards, and Rajan and Zingales cite evidence, in addition to their own article, in support of this proposition.

In addition, to the evidence from aggregate studies there is accumulating information on the way on which individual companies and specific activities are financed. For example, Mayer and Sussman (2005) examine the financing of large investment projects. They record that where firms have substantial financing needs then in the case of large firms these are met from debt, a mixture of bank and bond finance. However, in the case of small firms listed on the UK stock market external finance comes from stock markets. This again points to the importance of collateral in allowing debt finance to be raised. Large, well-established firms have assets that they can offer as collateral whereas small, particularly high technology firms do not and are reliant on comparatively expensive equity sources.

This is consistent with the evidence of Singh (see, for example, Singh, 2003) that in contrast to developed economies, enterprises in emerging economies raise a large amount of finance externally and a high proportion of this comes from equity markets. In both the case of small high growing firms and emerging economies, there is a greater dependence on equity sources of finance than in well established firms and economies. This suggests a life cycle of financing with equity finance being important in the early stages of development of companies and economies and debt finance in more developed and mature firms and economies.

Ownership and Control

Having examined financial systems, empirical analysis then turned to international differences in corporate governance and control. Here, pronounced differences, which stood up to close scrutiny, were found, even within developed economies (see La Porta *et al*., 1999 and Barca and Becht, 2001).

The most striking of these relate to comparisons of concentration of ownership in different countries. There are pronounced variations in ownership concentration in the UK and USA on the one hand, and Continental Europe and the Far East on the other. For example, in France and Germany, in more than 80 per cent of the largest 170 listed companies, there is a single shareholder owning more than 25 per cent of shares, and in more than 50 per cent of these companies, there is a single majority shareholder. In the UK, by contrast, in only 16 per cent of the largest 170 listed companies is there a single shareholder owning more than 25 per cent of shares, and in only 6 per cent is there a single majority shareholder. Concentration of ownership is appreciably higher on the Continent of Europe than in the UK. High levels of ownership concentration have also been reported for the Far East and South America, and ownership is as dispersed in the USA as in the UK.

Not only does the level of ownership differ appreciably between the UK and USA and most of the rest of the world, but so too does the nature of that ownership. In the UK and USA, institutions, such as pension funds, life insurance firms and mutual funds, and individual investors are the main holders of corporate equity. Ownership is dispersed in the sense that no one institution or individual holds a large stake in a single company. This is described as an 'outsider system' (see Franks and Mayer, 1995).

On the Continent and in the Far East, families (or family holding companies) and other firms are the main holders of share blocks. Inter-corporate holdings of large blocks of shares are commonplace, frequently in the form of pyramids of shareholdings, cross-shareholdings, or complex webs. As noted above, in most countries, bank holdings of shares

are modest and holdings by the government vary appreciably across countries. This is described as an ‘insider system’.

In the insider systems where ownership is concentrated, owners have incentives to be actively involved in the management of firms. In Albert Hirschman’s terms, they are more likely to exercise “voice” rather than “exit” which characterizes outsider systems where ownership is dispersed. There is little or no separation between ownership and control, and agency problems should be largely absent.

One implication of this is that ironically in insider systems banks may play a more important role as shareholders than creditors. It is generally observed that banks do not hold a large proportion of corporate equity on their own accounts, except for short periods around the financial distress of their borrowers when they take equity in exchange for impaired loans. However, in the case of Germany, which we describe below, banks hold equity as custodians on behalf of investors. As such they are frequently granted proxy votes that they cast for individual shareholders. This potentially overcomes problems of free-riding in monitoring and control of companies. It also means that banks are able to apply the knowledge that that acquire across industries as well as within particular firms.

But in solving one set of conflicts between owners and managers, insider systems create another, namely between large and small shareholders. Where there are strongly dominant shareholders, minority shareholders are at risk. Insider systems may therefore benefit one class of shareholders at the expense of others. For example, while in principle German banks can use their superior access to information to the benefit of shareholders, there is a potential conflict that arises between their role as custodian and creditor. Franks and Mayer (1998) record that where cases of conflict arise between banks in these two roles then they sometimes behave to the detriment of the shareholders for whom they are acting as custodians.

Why are there such pronounced differences in the ownership and control of companies across countries? One explanation is that the balance of these risks differs across activities and sectors. For some, strong governance is more critical than external financing, while for others the reverse holds. For example, mature industries may be less reliant on external financing than growing industries. Rajan and Zingales (2002) argue that venture capital can be viewed as a transition between different governance and financing arrangements. In their early years, firms have few tangible assets with which to raise external finance and are dependent on the active involvement of a small number of investors. Subsequently, the need for active governance diminishes and requirements for external sources of finance increase. For those firms coming to the stock market, ownership then moves from reliance on a small concentrated group of venture capitalists to dispersed market investors. The implication of this is that real differences in the activities of firms, industries, and economies give rise to differences in the governance and financing needs of firms. There is a complementarity between finance, governance, and real activities, but where causation lies is much harder to establish.

Law and Finance

A second explanation for the differences emerged in the next phase of empirical analysis. The observation that the primary conflict in insider systems is not between managers and owners but between majority and minority shareholders led to minority-investor protection as a primary subject of analysis. Regulation can be used to protect minority investors in systems in which ownership is dispersed. In an influential set of articles, La Porta, Lopez-de-Silanes, Shleifer, and Vishny ((1997), (1998), (1999), (2000)) turned the argument on its head by suggesting that financial structure is a product, not a cause, of legal structure.

The argument ran as follows. Where the law offers little protection, then investors

seek direct protection through taking large stakes. Where the law provides strong protection, then minorities can invest with confidence. The structure of financial systems is therefore a product of the legal systems within which they operate.

La Porta *et al.*’s analysis begins by classifying legal systems into four different ‘origins’: Anglo-Saxon, French, German, and Scandinavian. By and large, countries of Anglo-Saxon legal origin tend to give external investors the best protection, while countries of French legal origin tend to give investors the worst; countries of German or Scandinavian legal origin are somewhere in between. La Porta *et al.* go on to demonstrate that financial systems are better developed in countries of Anglo-Saxon legal origin than in those of, in particular, French legal origin. The message that emerges from these articles is clear. Strong minority investor protection is a prerequisite to the successful development of financial systems. Combined with the observation that financial development is associated with subsequent economic growth, the policy prescription is even more powerful. Countries should strengthen minority-investor protection to promote economic growth.

Using several different measures, Beck *et al.* (2001) report that financial development is further advanced in common-law than French civil-law systems. Controlling for differences in government and environmental endowments, they find that legal traditions remain an important explanation of cross-country differences in financial development. The difference in financial development between common-law and French civil-law countries is more pronounced than that between common-law and German civil-law countries. This is consistent with the view that it is the adaptability of, rather than the static differences in, legal systems that influences financial development.

Politics and Finance

The legal-tradition theories have been subject to criticism from two quarters. The first is that

legal origin does not capture relevant features of commercial codes. In certain key respects, differences between common-law systems are sometimes greater than those between civil- and common-law systems. Corporate-insolvency law illustrates the point. Franks and Sussman (2001) examine in detail the evolution of corporate-insolvency law in England and the USA. They report that, despite their common legal origin, corporate-insolvency law in the two countries is quite different. While in England the courts are expected to abide by the terms of debt contracts, in the USA the courts have the power to review the contractual rights of lenders, particularly in regard to liquidation rights of secured creditors.

In the area of corporate governance, Barca and Becht (2001) report higher levels of anti-shareholder devices in the USA than in the UK, with poison-pills, state legislation, and a variety of corporate board entrenchment devices being widely applied in the USA but not the UK. Corporate governance, as well as bankruptcy, differs significantly between supposedly similar systems.

Conversely, despite their different legal origins, England and Sweden have adopted similar principles of freedom of contracting within the area of corporate insolvency. As a result, in both countries, a secured creditor may exercise his contractual rights and seize the assets of a failed company without any court review. Likewise, in a recent paper, Biais and Recasens (2001) note that deviation from freedom of contracting makes France and the USA, two very different countries according to La Porta *et al.*, quite similar in terms of the powers that they confer on the judiciary to review liquidation decisions.

The second line of criticism that has emerged in relation to the law and finance literature is that financial systems are too transient to be explained by immutable legal origins. In an extensive analysis of the evolution of financial systems during the twentieth century, Rajan and Zingales (2003) report that financial systems at the beginning of the century were quite different from those at the end. They argue that these changes appear to

have much more to do with the influence of politics than law.

Summary of Financial Systems, Ownership, Law and Politics

At the same time as information and incomplete-contract models have provided the basis for the theoretical modelling of a diverse range of institutions, empirical analysis has produced a wealth of information on the operation of these institutions. A number of fundamental insights have emerged.

First, the structure of systems of capitalism is diverse. Very different forms of corporate ownership and control have co-existed in the presence of international trade and financial markets for a long period of time. Whether they will continue to persist with increasing financial integration and trade is much debated and still unclear. It is likely that there will be convergence in financial institutions and instruments before there is convergence in corporate ownership and control.

Second, simple prescriptions about bank- and market-oriented financial systems have not proved valid. Not only is the relevant performance of the two systems uncertain, but it is also unclear whether this is an appropriate basis for classifying financial systems in the first place.

Third, where differences in financial systems do appear robust, in particular in relation to the ownership and control of firms, neither the cause nor the implication of these differences is clear. It is easy to theorize. It is much harder to provide convincing evidence.

Fourth, it is very difficult to find truly exogenous variables in international comparisons of financial systems. Legal origin appeared to provide a way out, but more detailed analysis of actual legal systems raises questions about the relevance or validity of these variables. Correlations are straightforward, but it is much harder to draw inferences about causality.

Evolution of Financial Systems – the Case of the UK

By some criteria the UK had even more flourishing stock markets at the start of the century than at the end. It certainly had more of them. In the first half of the century from 1900 to 1950, not only was there a flourishing London Stock Exchange but there were also more than 19 provincial exchanges, which specialized in particular industries. For example the Birmingham exchange was important for cycle and rubber tube stocks, Sheffield for iron, coal and steel and Bradford for wool. Thomas (1973) describes how "the number of commercial and industrial companies quoted in the Manchester stock exchange list increased from 70 in 1885 to nearly 220 in 1906. Most of these were small companies with capitals ranging from £50,000 to £200,000" and "by the mid 1880s Sheffield, along with Oldham, was one of the two most important centres of joint stock in the country, with 44 companies, with a paid up capital of £12 million.'' (pp. 133 and 124)

One of the features of stock markets around the world today is the modest amount of finance that in aggregate they raise for their corporate sectors, even in countries with large stock markets such as the UK and US. However, stock markets are important sources of finance for two purposes: firstly for financing small rapidly expanding firms and, secondly, for funding acquisitions by large firms. Equity issues for internal investment are commonplace in recently listed companies and by larger firms taking over others.

To establish the financing patterns of companies early in the 20th century Franks, Mayer and Rossi (2005) collected data on all 20 firms that were incorporated in Britain between 1897 and 1903 and are still in existence today. They looked at how much equity they issued and in what form. The answer was that a lot was issued in the form of ordinary equity and some in the form of preference shares that receive dividends ahead of ordinary shareholders. Even at the beginning of the 20th century there was no evidence of the feature

of many countries today, namely the issue of more than one class of ordinary shares (dual class shares). But firms did issue a great deal of ordinary shares.

Strikingly, the main purpose to which equity issues were put at the beginning of the 20th century is the same as it is today – acquisitions. By far and away the dominant use of equity was to fund acquisitions. Firms grew rapidly through acquiring others and issued equity to do this. So acquisitions have been an important component of the growth of UK firms for more than a century and the existence of a large and vibrant stock market has contributed to this. Again there is no evidence here of a significant change in the structure or functioning of the UK stock market.

What about ownership? When did this become dispersed? Franks, Mayer and Rossi (2005) took the 20 companies incorporated at the start of the 20th century and examined the rate at which their ownership became dispersed, in the sense that the minimum number of shareholders required to control a certain percentage (for example, 25%) of their equity increased. They looked at 20 companies that were incorporated around 1900 but died sometime before 2000. They then compared the rate of dispersal of ownership of both the firms that survived and those that died with a third sample of firms that were incorporated around 1960. They used this last sample to provide a post WW2 benchmark against which to compare the rate of dispersion of ownership in the early part of the 20th century.

What they found was striking. The rate at which ownership of firms at the beginning of the 20th century became dispersed was very similar to that in the second half of the century. In both cases, ownership was rapidly dispersed. The main reason for ownership rapidly dispersing was not so much that directors and founding families sold their initial shareholdings but that their shares were diluted through takeovers. What happened and continued to happen throughout the 20th century was that firms issued shares to acquire others and in the process they diluted the shareholding of their directors and founders. For example,

if a family initially owned all 1 million shares in a company and issued another 1 million to purchase another firm then the family's shareholding declined from 100% to 50%.

So the dispersed ownership of the UK is not a recent phenomenon. It set in early in the 20th century and persisted throughout. It has consistently been associated with rapid growth through acquisitions. Again there is no evidence of the UK stock market having undergone a fundamental shift during the 20th century.

The stability of the UK financial system during the 20th century stands in marked contrast to its regulation. At the beginning of the century investor protection in the U.K. was very weak and UK stock markets were largely unregulated. According to an index of anti-director rights, compiled by La Porta et al (1998) the UK scored very low, 1 out of a possible 6, about the same score as Germany in 1990.

In contrast to the view that Common Law is associated with strong investor protection, Common Law in England contributed directly to the lack of protection of minorities. In a famous case in 1843, Foss v. Harbottle, a shareholder sued directors of a company for misuse of company funds. The court found in favour of the directors because their actions had been approved by a majority of shareholders. The basis of the court's reasoning was, that 'if a mere majority of the members of a company … is in favour of what has been done then *cadit quaestio*- the matter admits of no further argument'. In the evocative words of a senior English judge, Lord Justice Hoffman (1999), 'Emancipation of minority shareholders is a recent event in company law. For most of the twentieth century minority shareholders were virtually defenceless, kept in cowed submission by a fire-breathing and possibly multiple-headed monster called Foss v Harbottle. Only in exceptional cases could they claim protection of the court.'

The dominance of the strict majority was enshrined in English law, and those that hoped English common law would rescue Hoffman's oppressed minority were to wait a very

long time. Again in Hoffman's words, 'It was not until 1980 that Parliament forged the sword which is now section 459 of the Companies Act 1985 and which enables unfairly treated minority shareholders to slay the dragon.'

Landmark legislation was passed in 1948, when Parliament required substantially increased disclosure from listed companies and empowered 10% or more of shareholders to call extra ordinary meetings when they were dissatisfied with directors' actions. These provisions marked a step change in La Porta et al's measure of shareholder rights raising it from 1 at the beginning of the century to 3 in 1948. With the passage of legislation in 1980-1985 it rose further to a score of 5, where it remains today.

Thus during the 20th century there was a substantial increase in investor protection from a virtual absence in the first half to a high degree of protection by the 1980s. But despite this pronounced shift there was no change in the importance of stock markets in terms of their size or usage by the corporate sector. This runs quite counter to the law and finance theories that associate strong investor protection with financial market activity. The UK operated a large and vibrant stock market for the first half of the 20th century without investor protection. For those who regard regulation as a pre-requisite for market development, this is surprising. How could stock markets have flourished in the UK in the absence of investor protection?

One bit of evidence on this puzzle is the orderly way in which some aspects of stock markets operated. The takeover market in the UK is now conducted according to a set of self-regulatory rules known as the Takeover Code. These stipulate how takeovers should be conducted and in particular lay down the basis on which the shareholders of the target firm should be treated. One of these rules states that all shareholders in the target firm should be offered the same price for each of their shares. This is designed to avoid a practice that is common in many countries today by which some, namely large shareholders that own

controlling blocks, are offered one price and small minority shareholders are offered another, lower one.

These rules were introduced at the end of the 1960s. Before that the takeover market was essentially unregulated. Directors of acquiring firms therefore could in principle have followed the practice of gaining control of firms by purchasing blocks of shares at one price and offering other shareholders a lower price. This is clearly cheaper than paying everyone the same price. They could have done this but they didn't. Repeatedly they offered all shareholders the same price and also sold their own shares at the same price as was offered to other shareholders. For example, in a letter in the Times addressed to the shareholders of John Lysaght the directors made the following recommendation about a proposed takeover by GKN in 1920: 'The offer has been unanimously accepted by the Directors of your company for the whole of their individual shares, and they have no hesitation in recommending its acceptance to the shareholders.' Out of 33 acquisitions that occurred between 1919 and 1939 there was not a single case of price discrimination and in virtually every case almost all of the shares in the acquired company were purchased. In other words a law of one price prevailed without a law of one price being enacted. It occurred by convention rather than regulation.

Why? One clue comes from the observation above on the importance of local stock markets. Writing in 1921 on new shares issues, Lavington notes that "local knowledge on the part of the investor both of the business reputation of the vendor and the prospects of his undertaking would do a good deal to eliminate dishonest promotion and ensure that securities were sold at fair prices fairly near their investment values." Concentrating ownership among local investors was recognized as a method of reducing information problems as well as fraud. He cites the views of one broker: "the securities are rarely sold by means of a prospectus and are not underwritten, they are placed by private negotiation among local

people who understand the [cotton] trade" (p. 280).[4] To reduce information problems and fraud, securities were traded in the city in which most investors resided. For example, shareholders in Manchester were anxious that the shares of the Patent Nut and Bolt Co.[5] of Birmingham should be listed in Manchester where most of the shareholders lived (see Thomas, 1973, p. 118).

To quantify this, Franks, Mayer and Rossi (2005) examined the geographical distribution of the shareholders of one company GKN in 1900 and again in 1950. They looked at the addresses of the entire share register of investors in 1900 and measured the distance of their residence from the headquarters of GKN. They found that in 1900 40% of shareholders lived within 5 miles of the centre of Birmingham. By 1950 that fallen to 5%.

The significance of this comes from the fact that at the beginning of the century companies were very dependent on local shareholders to raise finance, in particular for acquisitions. Their reputation amongst local investors was therefore critically important to allow access to external sources of finance. Directors were therefore keen to uphold the interests of their shareholders to allow them to access finance for future expansion. In other words their dependence on local investors for future expansion acted as a commitment device.

As firms expanded through acquisition their activities developed beyond their hometowns. Their shareholder base also expanded and was no longer geographically concentrated. The need for more formal systems of information disclosure through company accounts and listing rules became more acute. The result was the 1949 Companies Act and the London Stock Exchange Listing rules that together substantially strengthened information disclosure.

Regulation not only responded to changing patterns of ownership and financing of firms but in turn influenced subsequent developments. In the first half of the 19th century

there were a large number of small local banks in Britain that were closely involved in the financing of firms. However, the existence of small banks empowered to engage in note issuance caused serious stability problems. Between 1809 and 1830 there were 311 bankruptcies of local banks. Large banks are less exposed to local market conditions and have more resources available to them than small banks. Encouraged by the Bank of England, banks withdrew from the illiquid investments in which they were engaged and began to spread their activities geographically frequently through mergers. A convenient relation emerged by which the clearing banks faced little competition and the Bank of England little financial failure. As a consequence, there is a high level of concentration of corporate lending in Britain and a noticeable absence of local banking.

Similarly, changes in corporate law in Britain in the middle of the 20th century referred to above prompted a wave of hostile takeovers during the 1950s and 1960s, particularly in response to the greater disclosure of accounting information on the book value of companies. For a brief period of time, the unregulated takeover market encouraged Continental European style ownership patterns with dual classes of shares and pyramid ownership structures. However, these prompted calls for the hostile takeover market to be regulated and in response the Takeover Panel was established and the Takeover Code introduced at the end of the 1960s. This in turn discouraged the persistence of dual class share ownership and pyramids.

It is therefore important to view regulatory changes as at least in part a response to emerging crises and in turn a determinant of the subsequent patterns of ownership and financing of corporations. Sarbanes-Oxley in the US is the latest example of this: corporate governance scandals prompted the introduction of significant legislative changes that have in turn affected the structure of ownership and control of US corporations.

Evolution of Financial Systems – the Case of Germany

Ownership of corporations in Germany is today highly concentrated in the hands of families and other companies. Franks, Mayer and Wagner (2005) provide the first long-run study of ownership and control of German corporations by assembling data on the ownership and financing of firms from samples spanning almost a century from 1860 to 1950. At first sight, German financial markets at the beginning of the 20th century looked remarkably similar to their UK counterparts. There were a large number of firms listed on German stock markets and firms raised large amounts of equity finance. This runs counter to the conventional view of Germany as a bank oriented financial system. Firms raised little finance from banks and surprisingly large amounts from stock markets.

As in the UK, issuance of equity caused the ownership of founding families and insider directors to be rapidly diluted. Even by the start of the 20th century, founding family ownership was modest and ownership by members of firms' supervisory boards, which was large at the beginning of the century, declined rapidly thereafter. But there was one important difference between Germany and the UK. In the UK, much of the new equity issuance went to funding acquisitions and mergers. In Germany it did not. To the extent that companies invested in other firms it was in the form of partial share stakes rather than full acquisitions. As a consequence, new equity was frequently purchased by other companies in blocks rather than by dispersed shareholders.

Furthermore, where equity was widely held by individual investors it was generally held on their behalf by custodian banks. Banks were able to cast a large number of votes at shareholder meetings, not only in respect of their own shareholdings which were in general modest, but as proxies for other shareholders. As a result, concentration of ownership did not decline at anything like the rate observed in the UK over the same period. This is the case, even if one assumes that all bank proxies were voted on behalf of dispersed shareholders.

Thus, a central conclusion of Franks, Mayer and Wagner (2005) is that concentration of ownership declined much less than in the UK.

Regulation, or rather existing measures of investor protection, do not explain these differences. Indices of both shareholder anti-director rights and levels of private enforcement are identical and equally low in Germany and the UK in the first three decades of the twentieth century. In this regard, the high level of stock market activity at the beginning of the 20th century is surprising in both countries. Small investors would not have been expected to subscribe to new equity issues in the absence of either strong anti-director or private enforcement provisions. Something else must have encouraged them to participate. In the case of the UK, Franks, Mayer and Rossi (2005) point to the existence of trust relations between investors and firms in local stock markets as the additional ingredient.

Trust mechanisms were different in Germany; Franks, Mayer and Wagner (2005) argue that they were associated with the role of banks as promoters of new equity issues, custodians of individual shareholdings and voters of proxies on behalf of individual investors. An English economic historian Lavington (1921) argued that banks provided a more secure basis for the issuance of IPOs in Germany than promoters in the UK whose interests were primarily confined to selling issues rather than ongoing relationships with companies. Regulation at the end of the 19th century contributed to this by conferring rights not on minority investors but on the banks, which as the promoters of corporate equity were able to control firms' access to the German stock markets. In the same way as firms in Britain upheld their reputation amongst local investors to gain access to equity markets, so German firms depended on banks as the gatekeepers to securities markets. How the two arrangements compared in protecting the interests of investors is an unresolved issue.

What then was going on? The overall picture that emerges is of firms issuing equity to fund their growth to other companies and individual investors. They were not growing

through full acquisitions but through companies taking partial stakes in each other and individuals holding shares via banks. Equity finance was therefore intermediated by companies and banks. In contrast, in Britain, there was little intermediation by financial institutions until the second half of the twentieth century and then it came from pension funds and life assurance companies rather than credit institutions. There has never been significant intermediation by inter-corporate pyramids in Britain.

In essence, Franks, Mayer and Wagner (2005) document the creation of the "insider system" of ownership that Franks and Mayer (1995) and (2001) describe in modern-day corporate Germany. This is characterized by inter-corporate holdings in the form of pyramids and complex webs of shareholdings, extensive bank proxy voting and family ownership. What distinguished its emergence from the dispersed ownership of the UK were two things: firstly, the partial rather than full acquisition of shares by one company in another thereby creating corporate pyramids and inter-corporate holdings and, secondly, the intermediation of equity shareholdings by banks. It is therefore insider not in the sense of ownership by directors but in terms of voting control remaining within the corporate and banking sector rather than being transferred to outside individual shareholders as in the UK and US.

Can regulation explain these developments? At one level, the clear answer to emerge from this paper is no. Investor protection was equally weak in Germany and the UK in the first three decades of the century when most of the developments documented in this paper occurred. But that response is probably more a reflection of the inadequacies of existing measures of investor protection than of the irrelevance of law and regulation. By the beginning of the twentieth century Germany had enacted a corporate code that provided more extensive corporate governance than existed in virtually any other country at the time. This may have been critical to the rapid development of the German stock market at the end of the

19th and the beginning of the 20th century. Furthermore, the Exchange Act of 1896 reinforced the control of the banks over German securities markets. Companies became dependent on banks for access to securities markets in the way in which firms in Britain were dependent on local investors for sources of equity. And since banks acted as custodians of minority investor shares, they could also in principle encourage firms to uphold minority shareholder as well as their own interests. Whether they did or whether their dual role as investors and custodians was a source of conflict is a critical issue.

Evolution of Ownership – The Case of Japan

In many respects the most striking country of the three reviewed here is Japan. As Franks, Mayer and Miyajima (2006) describe, it is striking because today we regard Japan as the archetypal banking system with companies closely interwoven and largely owned by banks and stock markets playing little role in the financing and ownership of firms. Whether or not that is true today, it certainly was not earlier in the 20th century.

On the contrary, in many respects Japan displays the highest dispersion of ownership of the three countries at the beginning of the 20th century. There were not many firms listed on the Japanese stock markets but ownership of the newly industrialized companies, such as the cotton spinning firms, which were listed at the beginning of the century became dispersed at a remarkably rapid pace. This was so pronounced that measures of concentration are in general lower for Japan than they are even in the stock market economy of the UK at the same time.

A second feature of Japan that is particularly interesting is the rapid change in investor protection that occurred just after the Second World War. The American occupation introduced legislation that transformed weak investor protection in the first half of the century into some of the strongest in the world in the second half of the century. Dispersion

of ownership therefore occurred in Japan in the first half of the century in the absence of strong investor protection. The emergence of the insider system of ownership in the second half of the century by which banks and companies had cross-shareholdings in each other occurred against the backdrop of strong investor protection. The move from outsider, dispersed ownership to insider cross-shareholdings therefore coincides with a marked strengthening of investor protection, quite contrary to the predictions of the law and finance literature.

As in Germany and the UK, Japan raises the question of how ownership dispersion occurred in the absence of strong investor protection. Franks, Mayer and Miyajima (2006) point again to informal arrangements of trust as being critical to the dispersion of ownership. But unlike in the UK these were not attributable to the prevalence of local stock exchanges. Most companies were listed on one of two stock exchanges – Osaka and Tokyo. Nor, unlike in Germany, did banks play an important role in the relations between investors and firms in the first half of the century. Instead, in the first two decades of the 20th century particular individuals rather than institutions were critical to the ability of companies to be able to access stock markets. These individuals were known as business coordinators and had some of the characteristics of today's private equity investors, particularly business angels. They were prominent members of the business community, sometimes senior figures in the local chambers of commerce, who sat on the boards of several firms. Their reputation acted as a validation of the soundness of the companies with which they were associated.

The role of business coordinators diminished from the 1920's onwards and their place was taken by the family firms, the zaibatsu which were incorporated during and after the First World War and in the 1930s sold their subsidiaries on stock markets. In this case the reputation of the zaibatsu families appears to have been important in facilitating access to stock markets.

In sum, all three of the UK, Germany and Japan illustrate that it was not investor protection that allowed stock markets to develop at the beginning of the 20th century. In all three cases, stock markets flourished and ownership was dispersed in the absence of strong investor protection. Instead, other institutions and individuals were important in upholding relations of trust between investors and firms. In the case of the UK it was local stock markets, in Germany the banks and in Japan business coordinators and zaibatsu families.

Conclusions

This paper has documented the considerable diversity in financial and corporate systems that exist across countries. However, that diversity is not primarily associated with the conventional distinction that is drawn between bank and market oriented systems. In terms of financing, the similarities across developed countries are more pronounced than the differences with the dominance of retained earnings, the importance of banks to external finance and the relative insignificance of new equity sources being generally observed in developed economies.

The differences have more to do with ownership and control of companies than financing. Concentrated ownership and control is prevalent in most countries and dispersed ownership and market control restricted to relatively few. Even within these two groups there are considerable variations between family dominated corporate sectors in some countries and intercorporate holdings in others. These differences may reflect the different needs of corporate sectors and a complementarity between ownership of firms and the types of activities in which they are engaged.

There is a widely held view that strong investor protection is a precondition for the successful development of financial systems and in particular for the emergence of dispersed as against concentrated ownership. For example the World Bank states: “Protecting

investors against self-dealing—the use of corporate assets for personal gain—is necessary for equity markets to develop. When small investors see a high risk of expropriation they do not invest—in countries with higher risk of expropriation, investment as a share of GDP is half that in countries with good investor protection. The markets stay underdeveloped. And fewer firms bother to list." (World Bank, 2005)

This paper has raised questions as to whether this is indeed the case. Looking at the emergence of early securities markets in developed economies reveals a number of striking features. The first is the importance of equity sources of finance and equity markets. The second is the emergence of these markets in the absence of formal systems of regulation and the third is the reliance on informal relations of trust. In some countries such as Germany and the US, financial institutions, in particular banks, appear to have played an important role in sustaining relations of trust. In others, such as the UK, trust mechanisms appeared to rely more heavily on close proximity between investors and firms in local stock markets. And in Japan, individuals of high repute, the business coordinators, sustained trust relations at the beginning of the 20th century.

What has not been explored to date is why trust mechanisms are very different, what is the consequence of those differences and what factors promoted the emergence of the various forms of trust. Understanding the development of relations of trust is critical to the formulation of policies towards enterprise and financial sectors in emerging and developing economies. It is easier to legislate for investor protection than it is to achieve effective enforcement of investor protection and still harder to promote the conditions for relations of trust. Furthermore, as the cases of Germany, Japan and the U.K. illustrate, there comes a point at which trust mechanisms appear to break down and more formal investor protection is required. Is regulation inevitable? Does it undermine the operation of more informal relations or is there a way in which the benefits of trust can be combined with those of formal

investor protection. We are just at the start of understanding the processes by which financial markets, institutions and enterprises develop and until then our policy prescriptions for developing economies will remain tenuous.

Notes

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[2] See for example the surveys by Levine (1997) and (2005) on this.

[3] Mayer (1990) reports correlations between bank finance and internal sources over the period 1970 to 1985 consistently in the range –0.45 and –0.88 in seven countries (Canada, Finland, France, Germany, Italy, UK and US).

[4] Stock exchange introductions (the creation of markets in existing shares) enjoyed complete exemption from prospectus requirements, and lenient "statements in lieu of prospectus" could accompany private placements (Companies Act 1929, secs. 34, 35 and 355).

[5] Patent Nut & Bolt Co. was owned by the Keen family, and merged with Dowlais Iron Company owned by the Guests which in turn developed into Guest and Keen, incorporated in Birmingham in 1900. This is included in our sample.

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