Corporate Governance and Pricing of Financial Assets

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Objectives of Corporate Governance

* Shareholders view VS Stakeholders view.

* In Japan, this is very common controversy.

* The key point of this controversy is

  not the definition of "owner" of a firm.

* The key point is

  Single objective VS Multi objectives.

Objectives of Corporate Governance

* Theoretically, it is possible to manage, even if there are multi principals and multi objectives.

* However, It tends to be Multi objectives ⇒ No explicit objective.

No objective of Corporate Governance

* Recent problem in Japanese companies

* Stakeholder view ⇒ No explicit objectives.

* No clear objectives in Corporate Governance

* It must be clear

      the relative importance, rank.

* It is necessary to formulate an objective function.

$$f = f(O_1, O_2, O_3 \quad \bullet\bullet\bullet\bullet\bullet\bullet)$$

Price and Governance

* Usually, focused on the control aspect in the Corporate Governance literature.

* However, the pricing and market condition of securities are important even for considering Corporate Governance problems.

* Miss pricing or distortions in financial market must distort the decisions of security holders and top managements.

Price and Governance

* For example, if there are asset price bubbles or boom-burst cycle of pricing, one share – one vote principle does not work well.
* High price: difficult to be a major shareholder, Low price: easy to be a major shareholder.

* Equity price of a firm ↑
$$\Rightarrow \quad \text{It easy to acquire other firms}$$

Financial market and bubbles

* Hirao and Yanagawa (2011)
* If the financial imperfection level becomes worse,
   asset bubbles become more easy to exist.
* Legal rule or institutional quality of financial system is important for existence or effect of asset bubbles.

Imperfect financial market

- Because of frictions in a financial market, the entrepreneur can pledge at most a fraction θ of the future return from his investment to creditors.
- That is, the borrowing constraint becomes:

$$r_t b_t^i \leq \theta \alpha_t^i z_t^i, \tag{5}$$

- The borrowing constraint, (5), is binding and b_t^i satisfies the following relation,

$$b_t^i = \frac{\theta \alpha^H}{r_t} z_t^i.$$

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$$z_t^i = \frac{\beta(y_t^i - r_{t-1} b_{t-1}^i)}{1 - \frac{\theta \alpha^H}{r_t}}. \tag{6}$$

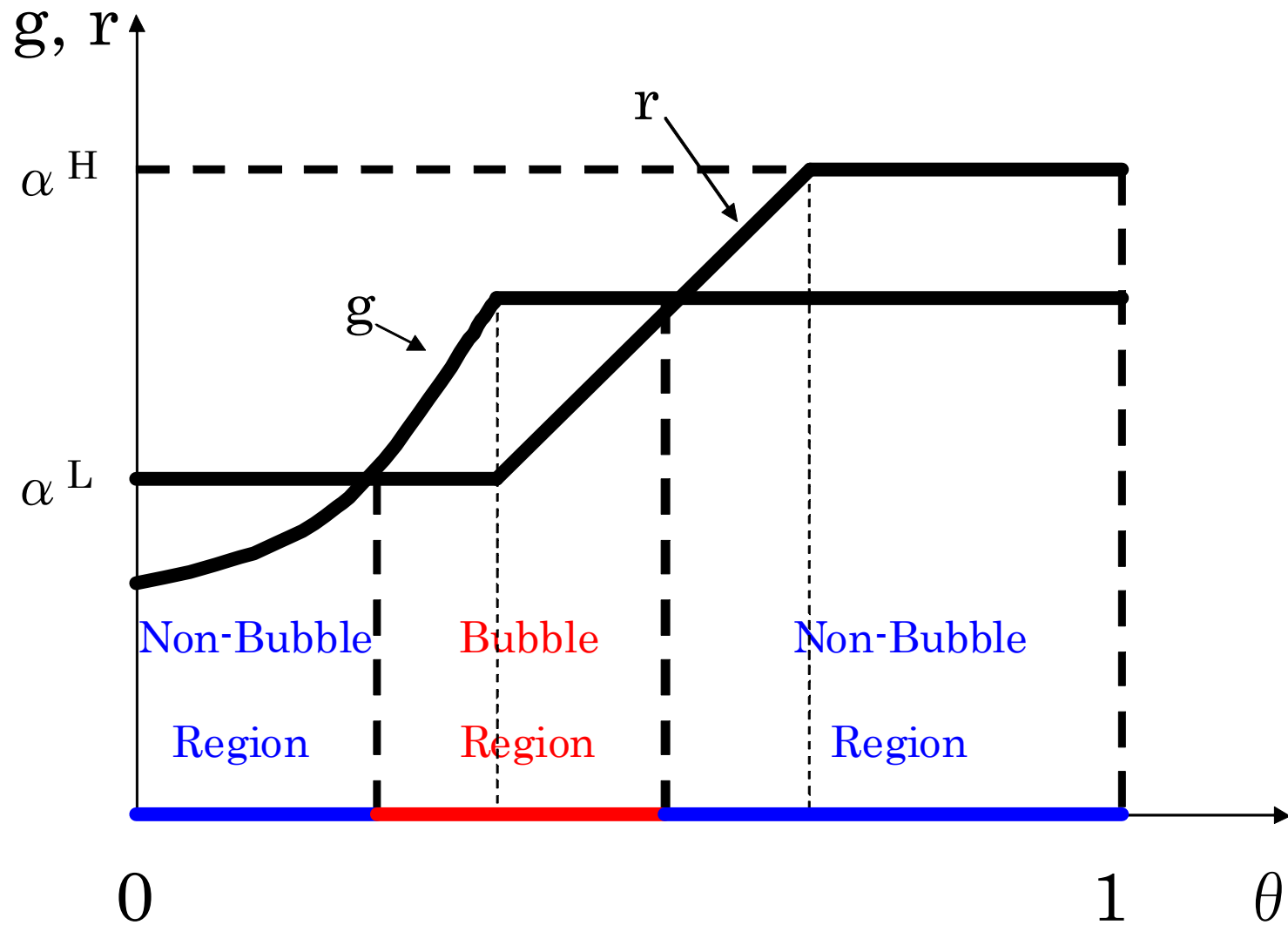This is a popular investment function under financial constraint problems.

Figure 3: Bubble region and θ

Figure 2: Bubbles and Economic Growth

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Liquidity and governance

* It is recognized that liquidity is an important factor for determining security prices.

* This means that even for considering corporate governance problems, liquidity of securities is an important factor.

* For making good corporate governance mechanism (not legal rule, maybe), it might be better to incorporate liquidity aspect of each security.

Insider Trading, etc.

* Appropriate pricing is a necessary condition for realizing good corporate governance system.

* Insider trading or other behaviors which distort fair pricing must be regulated appropriately.

* Even each firm should take care prices of securities for making better corporate governance.

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