Corporate Governance and Pricing of Financial Assets

Noriyuki Yanagawa
Faculty of Economics
University of Tokyo
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.**
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.
  \[ f = f(O_1, O_2, O_3 \cdots) \]
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↑
  ⇒ 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 $\theta$ of the future return from his investment to creditors.

That is, the borrowing constraint becomes:

$$r_t b_t^i \leq \theta \alpha_t^i z_t^i,$$

(5)

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

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

This is a popular investment function under financial constraint problems.

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

(6)
Figure 3: Bubble region and $\theta$
Figure 2: Bubbles and Economic Growth
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.
* 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.