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Relationship between Corporate Governance and Capital Market in Regional Cooperation

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Abstract:
Corporate Governance is a topic of great interest in financial world. The corporate governance has become increasingly important when financial crises have identified poor corporate governance. Good corporate governance is based on the principles of protecting the shareholders' rights, their equal treatment, taking into account the interests of other stakeholders, disclosure and transparency, accountability of the management and control structure. Stock markets could improve corporate governance. Regulated capital markets play a crucial role in ensuring the transparency of listed companies. This is particularly important for investors that introduce the corporate governance practice as the key criterion when making investment decisions. The regional cooperation will stimulate public companies to improve their corporate governance in order to attract new investors. The linkage between stock exchanges will broaden the investment opportunities for both individual and institutional investors and will potentially increase the competition between companies from the region.

Keywords: *Corporate governance, capital market, regional cooperation, stock exchange*

1. Introduction

Corporate governance generally refers to the set of mechanisms that influence the decisions made by managers when there is a separation of ownership and control. Some of these monitoring mechanisms are the board of directors, institutional shareholders, and operation of the market for corporate control (Larcker et al., 2004). Research findings documented greater investor protection throughmore extensive corporate governance provisions (La Porta et al., 1998). The globalization of economy and the liberalization of fiscal policies of various developing countries have brought to the fore the need to nurture good corporate governance for the local industries (Bagchi, 2011). According to Christiansen and Koldertsova, (2008) exchanges have suggested several complementary rationales for establishing themselves as a source of corporate governance-related regulations. In essence, by raising transparency and discouraging illegal or irregular practices, exchanges are themselves able to accumulate an amount of "reputational capital" (p. 212).

Corporate governance becomes particularly important in countries in transition from a centralized economic system to the market economy. One of the main common characteristics of these countries is underdeveloped financial markets, which makes banks the main source of financing and gives them a dominant role for economic growth (Arun & Turner, 2004). One might argue that banks might have gained this role due to countries choosing to embrace the insider model of corporate governance when designing their new legal and economic systems during the transition period (Pajaj & Ferzaj 2013). The stage of development of the capital markets and the special role that banks have in emerging markets is highly influenced by the challenges faced during the transition period. According to Shleifer and Vishny (1997), investor legal protection is a prerequisite for effective functioning of capital markets as an external force to sound corporate governance, because of the lack of private ownership and the perfectly 'monopolistic' state during the communist regime, these countries have very low levels of investor legal protection, particularly of minority shareholders (Pajaj & Ferzaj 2013). In addition to poor investor protection, especially of minority shareholders, the weak reliable financial information and disclosure requirements constitute an additional barrier to equity financing (Arun & Turner, 2004). According to Shleifer and Vishny (1997), in transition countries bank debt is a more secure means of financing as compared to equity, since debt is backed by collateral that is easier to valuate. Arun and Turner (2004) argue that the list of potential problems in transition countries is augmented with concentrated ownership.

2. Literature Review

Corporate Governance is a topic of great interest in today's financial world and as De la Torre and Schmukler (2007) cited, "another channel through which financial development may influence economic growth is by improving corporate governance" (p. 6). According to Christiansen and Koldertsova (2009), "historically, the main direct contribution of stock exchanges to corporate governance has been listing and disclosure standards and monitoring compliance." (p. 209).

- Gilson (2000) cited that "if management's performance cannot be effectively evaluated, if poor managers cannot be replaced, or if managers or a controlling shareholder can self-deal, the expected return from owning the corporation's shares will

decline, and so will the value of its stock. Good corporate governance is an effective equity contract that results in more valuable stock and a lower cost of capital" (p.4).

The value of the equity, the price investors will pay for a corporation's stock, depends directly on the quality of the corporate governance system. Equity investment requires good corporate governance, and good corporate governance requires the capacity to make credible disclosure of financial results. Effective corporate governance also requires ownership transparency. As Gilson (2000) cited, effective corporate governance is a prerequisite to a vigorous equity market. According to Gilson (2000), the relationship between good corporate governance and transparency should be apparent. Corporate governance at its core involves the monitoring of the corporation's performance and the monitor's capacity to respond to poor performance; the ability to observe and the ability to act. Transparency goes directly to the equity market's ability to observe a corporation's performance. Most information concerning a corporation's performance is uniquely available from the corporation. Without effective disclosure of financial performance, existing equity investors cannot evaluate management's past performance, and prospective investors cannot forecast the corporation's future cash flow (p.5).

Corporate governance problems are existent in all countries regardless of their system or their stage of development. Kirkpatrick (2009) focused on Corporate Governance developments and identifies insufficient regulatory and accounting standard requirements: poor risk management; and misalignment of remuneration policies with the strategy, risk appetite and long term interests of the firm. Solomon (2010), Clarke and Klettner (2010), stress upon other features of CG, like ethical behavior and opportunistic conduct or misconduct of the Board of Directors and Senior Management of financial institutions. It is widely accepted that governance failures and deficiencies of the regulatory system, if not facilitated have not prevented practices causing the financial turmoil in the banking sector (Kirkpatrick 2009).

Stock markets are efficient if the stock price incorporates all available information in the marketplace (Bekaert & Harvey, 1997). The modern theory of information provides strong theoretical reasons for banks to be on the whole more suitable vehicles for achieving the desired ends than stock-market (Sight, 1991). Without an efficient stock market, the manager and the shareholders can still agree on the value of the firm but establishing a contract would be difficult because the value is not verifiable. An efficient stock market can enhance growth by mitigating moral hazard and consequently increasing productivity (Bekaert & Harvey, 1997). Capital market tends to have both direct and indirect influence on the governance practices of the listed firms (Singh 2003). As illustrated in Figure 1, the capital market of a country can exert considerable influence on the firm by imposing certain rules and regulations relating to the firm's governance practices (Haque, Arun & Kirkpatrick, 2008).

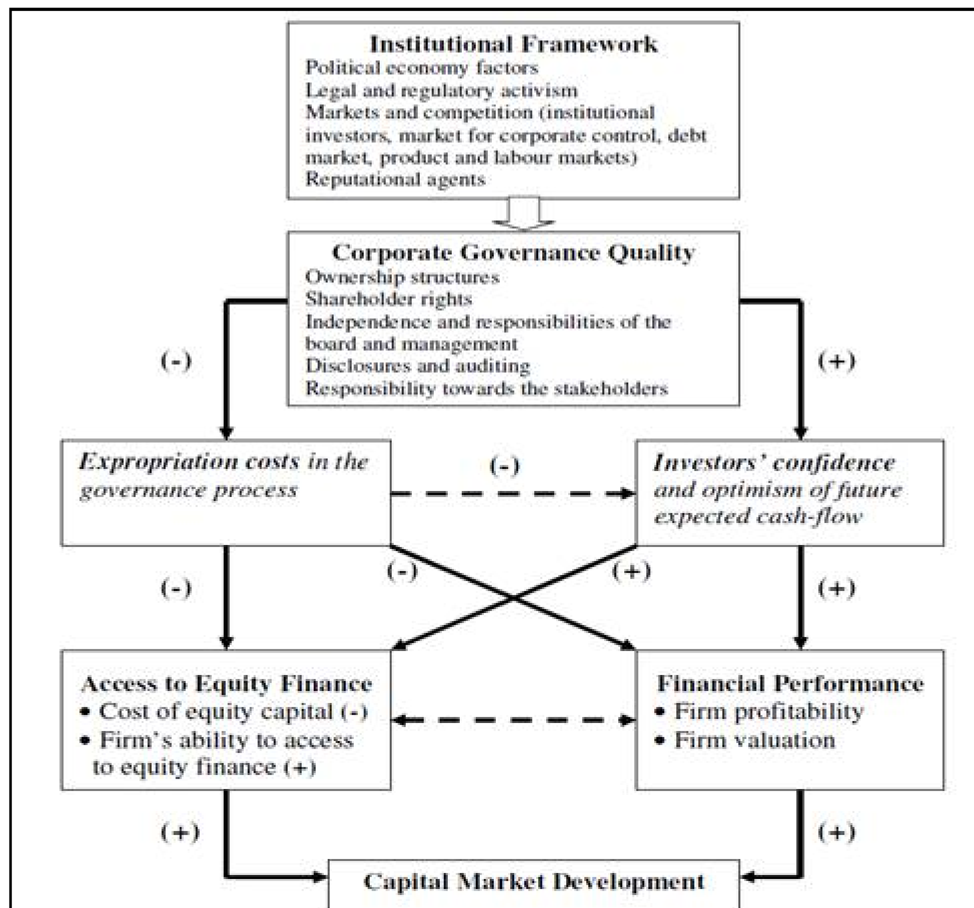

Figure 1: Capital market influence on corporate governance. Adapted from "Corporate Governance, Access to Finance and Financial Performance: A Conceptual Framework," by Haque, Arun & Kirkpatrick, 2008

Stock markets could improve corporate governance by alleviating the principal-agent problem between the owners and managers (Jensen & Murphy, 1990). Some critic studies show that stock market development could have negative effects by facilitating hostile counter-productive takeovers (Morck, Shleifer, & Vishny, 1990) and takeover threats could provoke managerial short-termism, discourage long-term investment, and therefore lead to inefficient allocation of resources (Singh & Weiss, 1998). According to Sight (1991) the ordinary shareholder of a large corporation has neither the ability nor the incentive to obtain the necessary information (costly to acquire) in order to monitor management activities, thus leading him or her to eschew "commitment" to the organization and to prefer liquidity. The banks, in the other hand, have both the means and the incentives to collect such information and to take a long-term view of firms' prospects – a perspective which is vital to industrialization in developing economies (p 23). Stock markets are more effective than banks in information acquisition and dissemination and therefore could enhance quality of investment and thus stimulate growth (Holmstrom & Tirole, 1994) but according to Sight (1997) banks are superior to stock markets in that they could monitor firms' investment and management at a lower cost.
The main benefit of this linkage is that it provides a range of cost-effective and generally more long-term financing options for companies that can meet certain standards, particularly regarding disclosure (Singletary, 2011). The globalization of economy and the liberalization of fiscal policies of various developing countries have brought to the fore the need to nurture good corporate governance for the local industries (Bagchi, 2011). The main benefit of this linkage is that it provides a range of cost-effective and generally more long-term financing options for companies that can meet certain standards, particularly regarding disclosure (Singletary, 2011).

3. Methodology

3.1. Research Design
The study is oriented in a positivist theoretical perspective and the descriptive method is used in the research. The study applies qualitative research and is a phenomenological descriptive study, based on interviews. Interviews are the most common form of data gathering in qualitative research studies, perhaps because they directly solicit the perspectives of the people they wish to study (Leavy & Saldana, 2011). The researcher will be conducted the interviews with open-ended questions to the eight participants. The sample for this research will consist on participants that are individuals who currently hold the position of a leader in company; they are representative of the Stock Exchange in South East European countries.

3.2. Population and Sampling Strategy
The population of the study consisted of eight participants. The sample size is six participants. The small but informative sample enabled the researcher to gather "deep" information and perceptions from the interviewees (Creswell, 2003). Participants represented different cultures, coming from Croatia, Slovenia, Serbia, Bulgaria, Montenegro, Macedonia, Bosnia and Herzegovina. One of the main advantages of using the interview method is that few participants are needed to gather rich and detailed data (Genise, 2002). The criterion sampling technique is used, and as Creswell (2007) said, all individuals studied represent people who have experienced the phenomenon (p. 128)

3.3. Research Instrument
According to Sun (2009) in qualitative studies, the researcher is the instrument of the research. As a result, the meaning derived from conducting a qualitative study has more depth since the researcher is much closer to the subjects of study. The researcher is an expert in Capital Markets. In this research, the researcher removes herself from the interviewee position and takes the role of the interviewer in order to gather data, explain the situation from the view point of the expert.

3.4. Data Collection Procedures
The open-ended questions were conducted with all eight participants in the current study. An open-ended interview protocol with twelve questions was used, and each interview lasted approximately 60-90 minutes. The interview was conducted in English and the questions were prepared according to protocol.

4. Findings from Interviews
According to Christiansen and Koldertsova (2008), "historically, the main direct contribution of stock exchanges to corporate governance has been listing and disclosure standards and monitoring compliance. Stock exchanges have established themselves as promoters of corporate governance recommendations for listed companies" (p. 209). All participant in this research responded by saying that the regional cooperation will contribute to the improvement of the corporate governance practices. The common trading platform for those markets would be market pressure for companies to implement best practices of corporate governance. The argument given from one of the participants is of particular importance: "Investors will seek the same level of corporate governance in all markets, and non-EU countries will benefit from CG practices in EU, long before actually adopting EU laws."
The corporate governance standards are sometimes more come across on other regional markets, and increased competition of companies to recognize the importance of the best practices of the corporate governance and communication with shareholders. The expansion of the market, which is essentially the result of regional networking, should contribute to the improvement of corporate governance practices. On the other hand, if the corporate governance practices in place are good, it is more likely that the invested funds will be used in the interests of all shareholders, without the danger that majority shareholders will be able to abuse their position.

Regional market is challenge for companies. An increase in the offer of securities would increase the need for companies' details, in order to make better decisions. More transparency would develop corporative leading. A crucial precondition for attracting investors is to enact solid corporate governance policies. As they would be (directly) competing with companies from other markets, there would be market pressure to implement corporate governance policies in line with international best practices.

5. Conclusion

Capital market tends to have both direct and indirect influence on the governance practices of the listed firms (Singh 2003). The regional cooperation have a positive impact and should contribute to the improvement of the corporate governance practices. According to Christiansen and Koldertsova, (2009) exchanges have suggested several complementary rationales for establishing themselves as a source of corporate governance-related regulations. The common trading platform for those markets will be the market pressure for companies to implement best practices of corporate governance. Regulated capital markets play a crucial role in ensuring the transparency of listed companies. This is particularly important for investors because they are provided with the insight into the company's operations. It is observed ever more frequently that investors introduce the corporate governance practice as the key criterion when making investment decisions. The expansion of the market, which is essentially the result of regional networking, should contribute to the improvement of corporate governance practices. As Gilson (2000) cited, effective corporate governance is a prerequisite to a vigorous equity market.

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