Research in International Business and Finance 38 (2016) 439–454

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Full length article

The role of institutional investors in propagating the 2007 financial crisis in Southern Europe

José María Díez-Esteban [a], Jorge Bento Farinha [b], Conrado Diego García-Gómez [c,*]

[a] University of Burgos, Department of Economics and Business Administration, Pza. Infanta Elena, 09001 Burgos, Spain
[b] Faculdade de Economia do Porto, Universidade do Porto and CEF-UP—Center for Economics and Finance at UP Rua Roberto Frias, 4200-464 Porto, Portugal
[c] University of Valladolid—Soria Campus, Department of Accounting and Financial Economics, Calle Universidad s/n, 42004 Soria, Spain

ARTICLE INFO

Article history:
Received 11 May 2016
Received in revised form 24 June 2016
Accepted 8 July 2016
Available online 9 July 2016

JEL classifications:
G15
G32
G34

Keywords:
Risk-taking
Financial deregulation
Crisis
Institutional investors

ABSTRACT

The 2007 financial crisis has affected Southern European companies (Spanish, Portuguese, Italian and Greek) more than others. From a Minskyan bubble-burst cycle perspective (Minsky, 1986), we study the relation between institutional ownership structure and corporate risk-taking for a sample of non-financial listed companies from Spain, Portugal, Italy and Greece for the period 2001–2014. Our results suggest that the financial deregulation process, that lead to the financialization of the world economy before the 2007 financial crisis and the favourable macroeconomic scenario encouraged corporate risk-taking in those countries. We also find that the lack of effective control mechanisms provided an incentive for investment funds to assume a proactive role, encouraging companies to overinvest in risky projects.

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1. Introduction

The 2007 financial crisis was a consequence of a number of circumstances that in our view are consistent with two theories which appear, at a first look, contradictory, that is, the financial instability hypothesis (Minsky, 1986) and the theory of capital market inflation (Toporowski, 2000). However, as we look deeply into the turbulence effects in Southern Europe, we can find that once the evolution of the financial markets is taken into account, the classical Minskyian bubble and burst cycle is still a valid framework to understand the events leading to the crisis.

In this regard, the entry of a number of Southern European countries (Spain, Portugal, Italy and Greece) in the monetary union at the beginning of the XXI century led to the creation of numerous business opportunities for companies in these countries. At the same time, the deregulation process carried out all over the world and the interest rate policy of the ECB may have facilitated risky investments that, in other situations, would most likely never have been made (Cornand and Gimet, 2012; Sahuc and Smets, 2008).

* Corresponding author.
E-mail addresses: jmdiez@ubu.es (J.M. Díez-Esteban), jfarinha@fep.up.pt (J.B. Farinha), conradodiego.garcia@uva.es (C.D. García-Gómez).

http://dx.doi.org/10.1016/j.ribaf.2016.07.006
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In this scenario, it is possible that international institutional investors may have found a good channel for short-term investments in order to maximize their returns. In fact, during this period, institutional investors became major players in large southern European firms by assuming a more important role as shareholders, and most particularly by influencing investment decisions. Whether institutional investors play an active or a passive role in companies (Bhattacharya and Graham, 2007; Dalton et al., 2003; Ferreira and Matos, 2008) may be a relevant factor for determining the extent to which institutional investor's presence affected or not excessive risk-taking by listed firms prior to the 2007 financial crisis.

In this regard, and as a result of financial deregulation, investment funds, in their active role, may have favoured excessive risk-taking by managers in Southern European firms. Also, domestic banks, which traditionally held a passive attitude within companies in their roles as both shareholders and creditors, may have become aggressive investors, assuming high levels of risk (DeYoung et al., 2013). This possible new proactive attitude of banks as shareholders in these countries can be seen in our view as resulting from the decline in their interest income and as well as from financial deregulation, both of which may have provided an incentive for these institutions to maintain a more speculative position in companies (Cornand and Gimet, 2012). Therefore, due to their growing influence and the particular characteristics of their investments, institutional investors arguably became major players in the transmission of the crisis to the real economy (Luchtenberg and viet Vu, 2015; Erkens et al., 2012; Manconi et al., 2012)

Consistent with Minsky's moment hypothesis[1] (Minsky, 1986), it is commonly accepted that the fast economic growth prior to the financial crisis −combined with a lack of efficiency of the control mechanisms- may have helped to inflate a financial bubble that ended up exploding in 2007 (Duca et al., 2010). As a consequence, a large number of companies went bankrupt or were bailed out by governments. The failure of these financial institutions resulted in a freeze of global credit markets and required government interventions worldwide. The effect of the global financial crisis has been particularly critical in Southern European countries, whose economies went from being amongst the most dynamic in Europe to, in some cases, having to be rescued by State authorities. As Tong and Wei (2011) found, the decline in stock prices was more severe for firms that were more dependent on external (bank) finance.

Apart from the adverse macroeconomic scenario, the reason why the financial crisis affected so deeply those countries can be traced back to their legal environment. On the one hand, as the corruption indexes show, political institutions are weaker in these Southern European countries than in other European ones.[2] On the other hand, banks typically play there a much more decisive role in companies, as these countries are more bank-orientated due to their civil law origin and the special protection assigned to creditors' rights (La Porta et al., 1997).

Hence, it is conceivable that an active role played by institutional investors, especially banks, in Southern European countries, due to the previously favourable macroeconomic and their particular legal environment, may have created financial problems in companies by increasing excessively their corporate risk-taking, causing many of them to collapse and creating unemployment, an increase of public debt and the bankruptcy of many sectors of the economy.

Based on these arguments, we investigate the relation between the institutional investor ownership structure and corporate risk-taking. Using a sample of large quoted companies from Spain, Portugal, Italy and Greece for the period 2001–2014, we examine how the changes in institutional factors, carried out in the years leading up to the 2007 financial crisis, may have changed the attitude of institutional investors in non-financial companies and whether the consequences of the potential mismanagement that followed have had an effect on the institutional investors behaviour in the years following the onset of the crisis. Our results suggest that institutional investors, domestic banks and foreign investment funds have encouraged companies to assume excessive corporate risks due to the favourable environment which was created.

This study contributes to the existing literature in two ways. First, we provide evidence on how financial deregulation and the macroeconomic environment, in recent years, affected the behaviour of institutional investors (Bhattacharya and Graham, 2007). Deregulation may lead to various agency problems since institutional investors use their growing power as shareholders to enhance their short-term profits by increasing corporate risk levels. In a scenario of financial crisis this may cause bankruptcies and severe damage to long-term companies' value and job creation, accordingly to the bubble-burst hypothesis by Minsky (1986).

Second, we show that financial deregulation has had more harmful effects in countries in which banks or insurance companies are more relevant (traditionally civil law countries). In these countries, banks seem to have followed a pure speculative attitude, moving away from their traditional activity as lenders. Together with their lower level of adoption of modern banking practices, particularly when investing in complex products, this excessive risk-taking focus has led to a negative impact on the companies in which these banks participate.

[1] According to Minsky (1986), a sudden collapse in financial asset prices can occur following a relatively long prosperous period where increasing asset prices lead to growing levels of speculation in high risk assets, particularly when borrowed funds are extensively used. This initial cycle eventually ends up when defaults starts to become common as high-risk borrowers with excessive debt fail to repay their loans. This in turn leads to a massive sell-out of high risk securities causing their prices to fall. In this phase, even less speculative assets are affected as a major collapse in both prices and liquidity occur just when investors scramble to obtain cash to meet obligations. Therefore, in a "Minsky moment", a period of stability will initially encourage risk-taking and this eventually will lead to a period of crisis and instability followed by a cycle of deleveraging and a return to more conservative risk-taking attitudes on the part of investors.

[2] As Keen (1995) demonstrates, the absence of a powerful government sector is a key variable in explaining the link between financial market fragility, in the normal life cycle of an economy, with speculative investment bubbles endogenous to financial markets.

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