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Block-ownership structure, bank nominee director and crash-risk

Yogesh Chauhan [a], Kavita Wadhwa [a], Sudhakar Reddy Syamala [a], Abhinav Goyal [b,*]

[a] *IBS Hyderabad, IFHE University, India*
[b] *University of Liverpool Management School, University of Liverpool, UK*

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ABSTRACT

We study the effect of *outside* block-ownership on the future firm-specific crash-risk of Indian firms. Major and dedicated block-owners play a significant role in aggravating the firm's susceptibility towards crash-risk. Within a novel regulatory setup in India, where borrowing firms are entitled to a bank nominated board-member, we find an ancillary influence of bank nominee's presence in dissipating block-owners influence on firm-level crash-risk. These results support the *monitoring hypothesis* in alleviating future firm-level crash-risk. Our results are robust to alternate model specifications, different crash-risk and block-ownership measures, clustering, and an array of control variables.

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1. Introduction

A little over eight decades ago, Berle and Means's (1932) seminal paper raised the daunting issue of agency problem stemming from the separation of ownership and control. Practitioners and academicians share common opinion that block-owners may effectively shrink the agency problem. By holding a significant share of the firm's equity, block-owners are likely to have higher incentives to safeguard their investment over minority shareholders. Consistent with *monitoring hypothesis* of agency

* Corresponding author at: G-05, Management School, Chatham Building, University of Liverpool, Liverpool L69 7ZH, UK. Tel.: +44 151 795 2150; fax: +44 151 795 3001.

E-mail address: agoyal@liv.ac.uk (A. Goyal).

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problem, a number of studies in last three decades provide empirical evidence on the benefits of block-ownership. Simultaneously, if monitoring is expensive and an easy low-cost exit is possible, block-owners may also exacerbate rather than solve agency problem. Alternately, block-owners can maximize their private benefits rather than firm value (Hirschman, 1970), and worse, they may even collude with managers to optimize their personal benefits at the cost of long-term firm value (Bushee, 1998). Managers may also be tempted to withhold bad news since their performance and incentives are tied with stock prices (Kim et al., 2011). Jin and Myers (2006) argue that there is an upper bound to the extent of bad news that can be accumulated by managers. When the accumulation of bad news touches the threshold then it drains out at once and leads to a significant drop in stock prices.

Therefore an important question to investigate is, "Do block-owners mitigate the risk of managerial expropriation (withholding bad news) through their monitoring role?" If block-owners are apparent to be effective monitors, then their presence should diminish stock price crash-risk. Nevertheless, long-term benefits derived from effective monitoring are unlikely to align with the transient block-owners who are expected to hold stocks for short-term periods. Overall, the direction of the impact of block-ownership on crash-risk is debatable. In particular, we analyze how the incentives of managers to withhold bad news are influenced due to the presence of *outside* block-owners who have ability and motivation to monitor managers. We focus on the emerging Indian market since investor risk is proportional to ownership concentration (LaPorta et al., 1998) and *inside* block-owners are likely to exercise inappropriate rights via complex ownership structure (Claessens et al., 2000). Since weak legal and regulatory institutions that offer inadequate protection to minority shareholders has led for a search of effective corporate governance mechanism, we believe that the role of block-owners has become more eminent as an external governance mechanism.

In this paper, following popular literature (Kim et al., 2011), we use two proxies of firm-specific crash-risk: (1) the negative conditional skewness of firm-specific daily return and (2) log of down-to-up volatility of firm-specific daily return. We find that block-ownership is positively and significantly related to one-quarter ahead crash-risk. We examine the impact of the investment horizon of block-owners on firm-specific crash-risk. Our empirical findings are in vein with *monitoring hypothesis*, *i.e.* dedicated long-term block-owners minimize the propensity of crash-risk while transient short-term block-owners adopt a myopic firm-value inflation motivation. We next examine whether the presence of a lending bank deputed nominee on the firm's board moderate the relationship of block-ownership and crash-risk. Corporate finance theories postulate that the manager of a highly leveraged firm prefers high-risk projects with lower probability of success compared to low-risk projects with higher probability of success (Jensen and Meckling, 1976). Generally in such firms, most of the benefits are cashed by the shareholders and most of the losses borne by the creditors. Basically lenders can discipline managers either by the threat of bankruptcy or by direct intervention in the decision making. Thus we study the direct role of lenders via bank nominated directors to discipline managers.

These findings contribute to existing literature in several ways. One, several studies that relate *overall* block-owners with various parameters, *viz.* information efficiency (Boehmer and Kelley, 2009), firm-specific information (Brockman and Yan, 2009) and corporate governance (Chung et al., 2010), show that institutional investors increase future crash-risk for developed markets but in this paper, we relate *outside* block-ownership with stock price crash-risk in the emerging economy where weak legal and regulatory efficacy offer inadequate protection to retail investors. Two, by focusing towards block-owners, our study adds to the literature that explains the complexity of the separation of ownership from control. Finally, we establish that in the presence of a weak institutional setup with a greater likelihood of expropriation, the role of creditors (banks) towards effective corporate governance is potentially far more critical.

2. Data and variable construction

2.1. Data

Our sample period is from 2001 to 2012, covering the firms listed on National Stock Exchange and Bombay Stock Exchange of India. Primary source of firm-level data *i.e.* both stock-prices and

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