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Does regulation substitute or complement governance?

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ABSTRACT

We examine whether firms utilize governance systems and increased monitoring mechanisms when information asymmetry and managerial discretion are limited. Given that such monitoring is costly, we expect regulated firms to use less monitoring if regulation substitutes for governance. Using data from initial public offerings, we document that regulated firms have greater proportions of monitoring directors and larger boards as well as use similar amounts of equity-based compensation as non-regulated firms. Further, regulated and unregulated firms are analogous in terms of observed trade-offs between traditional monitoring mechanisms and insider ownership. Finally, regulated firms appear to decrease monitoring following a period of deregulation. These findings support the hypothesis that regulation and governance are complements and are consistent with the notion that regulators pressure firms to adopt effective monitoring structures.

1. Introduction

Governance mechanisms are costly to implement (Shleifer and Vishny, 1997; Baker and Gompers, 2003). When there is a separation of ownership and control, however, the benefits of monitoring may outweigh the costs. In fact, Jensen and Meckling (1976) suggest that monitoring can alleviate agency problems when insider ownership is low. Firms adopt governance mechanisms to align manager and shareholder interests, thereby assuring suppliers of finance a return on their investment (Shleifer and Vishny, 1997).

In an environment where executive decision-making may be more transparent and opportunity sets may be limited, however, the benefits of monitoring may be reduced (Joskow et al., 1993). Governance mechanisms may be less important in regulated industries. Much of the literature to date has taken a literal interpretation of this relationship, arguing that regulation should substitute for governance. However, empirical evidence does not fully support this notion (e.g., Hadlock et al., 2002; Houston and James, 1995), raising the question as to why regulated firms adopt governance structures with greater levels of monitoring given the cost.

In this paper, we provide an alternative explanation for the relation between regulation and governance that may shed light on why costly governance mechanisms are utilized by firms with restricted opportunity sets. Regulators do not have the same interests as shareholders. Their focus is on safety and soundness rather than wealth maximization (Joskow et al., 1993). While regulators do not control specific governance practices, the presence of regulators may pressure firms to adopt effective corporate governance structures that promote safety and soundness. In effect, regulators must ensure that firms comply with all procedures, but it is not feasible for them to monitor all activities. Stigler and Friedland (1962) note that it is very costly for regulators to monitor a firm's actions as they cannot control daily operations. This suggests regulators may rely on traditional governance systems to promote their goals. Booth et al. (2002) and Joskow et al. (1993) note the threat of corrective actions by regulators and increased scrutiny on regulated firms pressures these firms to adopt effective monitoring systems. Joskow et al. (1996) contend that governance differences are the results of regulatory pressure rather than inherent productivity differences. Regulatory pressure may encourage greater monitoring (e.g., "best practices" approach). Essentially, regulation and governance may work together to ensure an effective governance structure.

Our analysis is organized around a corporate event (initial public offering or IPO) rather than in calendar time. Baker and Gompers (2003) note that monitoring mechanisms are more likely optimally chosen at the IPO since existing shareholders bear the cost of suboptimal governance. Brown et al. (2005) demonstrate that IPO firms with the "proper initial governance structure" have better operating and stock performance. Wang et al. (forthcoming)

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contend monitoring mechanisms are less ambiguous at the IPO. Higgins and Gulati (2006) show young firms influence investor decisions by giving information that signals organizational legitimacy through effective governance structures at the IPO. Engel et al. (2002) find incentives to monitor newly public firms are stronger than at well-established firms, suggesting governance structures are more important. Finally, Hartzell et al. (2008) focus on the IPOs of a regulated industry (REITs) to analyze the impact of corporate governance. The authors contend this approach "... mitigates the endogeneity problem present in studies of the impact of governance on seasoned firms' valuation."

By contrast, in calendar time, governance structures may be as much a consequence of past performance as a measure of the quality of governance. Analyzing structures at the IPO enables us to examine governance while decreasing the impact of prior performance. However, firms do not arbitrarily decide to go public. It is a pre-determined choice that is planned for well in advance and requires the firm to establish a governance structure that will enable the firm to go public (Burton et al., 2004). Any 'IPO effect' will affect regulated and unregulated firms alike, thus minimizing any impact on our study.

Our paper provides strong support that regulatory pressure, rather than substitution, influences governance. We document that regulated firms have governance structures with greater monitoring than unregulated firms at the IPO. If governance mechanisms are unnecessary (regulation substitutes for governance), regulated firms should have less monitoring. This heightened monitoring is not related to firm characteristics typically associated with regulated firms, such as leverage age, or size.

We also examine trade-offs between monitoring mechanisms and ownership, controlling for firm characteristics. If regulation substitutes for governance, the degree of interdependency between traditional monitoring mechanisms and ownership should be lower at regulated firms (Booth et al., 2002). Regulatory pressure, however, suggests regulation and governance both ensure a "system" of governance where monitoring mechanisms are interchanged (Adams and Mehran, 2003). We document monitoring mechanisms serve as alternates for ownership at both regulated and unregulated firms at the IPO as well as 2 and 4 years post-IPO (using levels and changes). These results do not indicate that regulation substitutes for governance, rather regulation serves as a means of pressuring firms to adopt effective governance systems.

We further examine the impact of regulation on governance by analyzing the role of deregulation. Deregulation increases the importance of the managerial role within a firm and the need for monitoring (Kole and Lehn, 1997). Removing regulation introduces additional downside risk, increases managerial discretion, and may impact the sensitivity of firm value to the quality of managerial decisions. If regulation substitutes for governance, relaxing regulation should lead regulated firms to increase their monitoring (Kole and Lehn, 1999). However, governance mechanisms of regulated IPOs post-deregulation do not increase. In fact, consistent with the removal of regulatory pressure, some monitoring levels actually decrease post-deregulation.

While this paper focuses on regulated versus unregulated firms, our findings have implications for research on corporate governance more broadly. A debate exists as to whether corporate governance affects market values (Gompers et al., 2003). Corporate governance can reduce agency problems and lead to more effective monitoring of managers. However, adopting these mechanisms is costly. In an environment where information asymmetry and managerial discretion are limited, monitoring systems would be redundant (regulation would substitute for governance). Our results, however, are not consistent with this substitution assumption, and provide additional support on the importance of corporate governance in protecting shareholders.

The remainder of this paper is organized as follows. Section 2 details the motivation and hypotheses. In Section 3, we describe our samples and summary statistics. Section 4 presents empirical results and differences between regulated and unregulated firms at the IPO. In Sections 5 and 6, we provide additional specifications and robustness tests, while Section 7 concludes.

2. Motivation

2.1. Regulation as a substitute or a complement for governance

Adams and Ferreira (2008) note that the issue of whether regulation substitutes for governance remains an open question. Empirical research provides some evidence that regulation substitutes for traditional monitoring mechanisms. Joskow et al. (1993) find lower pay for regulated CEOs; Kole and Lehn (1999) note that the governance structures at regulated firms move toward structures of unregulated firms post-deregulation. Crawford et al. (1995) document a stronger link between compensation and performance post-deregulation. Becher et al. (2005) find bank directors receive less incentive compensation than non-bank directors, while Booth et al. (2002) show internal monitoring of managers at regulated firms is less important. Caprio et al. (2007) state "... bank regulations may be sufficiently pervasive that they render shareholder protection laws superfluous." Thus, the presence of regulators may substitute for traditional shareholder monitoring mechanisms by reducing the effect of managerial decisions on shareholder wealth.

However, others are inconsistent with the substitution argument. Hadlock et al. (2002) find regulated CEOs are held at least as accountable for performance as non-regulated CEOs. Houston and James (1995) indicate CEO stock holdings and option-based compensation are lower in banking due to differences in investment opportunities and other firm characteristics rather than regulation. Adams and Mehran (2003) and Booth et al. (2002) show that boards of regulated firms have greater independence than non-regulated firms. If regulated firms require less monitoring, boards should have a lower proportion of independent outside directors relative to non-regulated firms. Roengpitya (2007) finds that intrastate bank deregulation leads to a lower proportion of outsiders on the board. Pathan and Skully (2010) show that banks structure their boards in a way that is consistent with shareholder wealth maximization. These findings cast doubt on the substitution hypothesis.

Furthermore, Joskow et al. (1993) note that regulators do not have the same financial interests as shareholders and focus on safety and soundness rather than wealth maximization. Similarly, Caprio et al. (2007) indicate that regulation does not impact firm value (positively or negatively), consistent with regulation serving a different role. Regulators do not set specific monitoring levels,[1] board size, or board independence. However, regulatory presence may pressure firms to adopt effective corporate governance structures to ensure that rules and requirements are met. Given regulators are unable to effectively control daily operations, it is costly to monitor regulated firms' actions (Stigler and Friedland, 1962). Masulis and Thomas (2008) argue financial firms need more monitoring because of their heightened risk exposure.

To explain governance differences, Booth et al. (2002) point to the threat of corrective actions by regulators. Joskow et al. (1993) note regulation increases the visibility of corporate governance through enhanced public scrutiny and provides a set of instruments (price and allowable cost decisions) to penalize firms with poor governance structures. Joskow et al. (1993, 1996) note that

[1] Savings institutions face limitations on stock ownership: no person, firm, or group can acquire over 10% of voting stock without approval (Friesen and Swift, 2009). However, this appears non-binding. To illustrate, ownership levels exceed 10% for all savings banks in our sample.