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Financial development, corporate governance and cost of equity capital[☆]

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ABSTRACT

Existing research suggests that external governance is more relevant than internal governance in affecting a firm's value. We contribute to the literature by explicitly examining the interactive role played by country-level financial development and legal institutions in influencing the impact of firm-level governance on the cost of equity capital. Using a comprehensive sample of 7380 firm years drawn from 22 developed countries, we show that firm-level corporate governance attributes affect the cost of equity capital primarily in the Common Law countries with high levels of financial development. Our study is the first to highlight the complementary effects of legal origin, financial development and firm-level governance attributes in influencing the cost of equity capital.

1. Introduction

What are the major factors that affect a firm's cost of equity capital? According to one strand of research, legal protection of minority shareholders is a significant factor.[1] Hail and Leuz (2006) document that firms from countries with more extensive disclosure, stronger securities regulation, and stricter enforcement mechanisms enjoy a lower cost of capital. Another strand posits that firm-level corporate governance is a crucial factor. Chen et al. (2009) show that firm-level corporate governance quality has a significantly negative effect on the cost of equity capital in emerging countries with weak legal protection of investors. Besides the country and firm-level corporate governance factors, another key factor that affects the cost of capital is the level of financial development and access to capital (Doidge et al., 2007; Aggarwal et al, 2009; Rajan and Zingales, 1998; Love, 2003). However, none of the papers explicitly investigate the role of financial development in influencing the corporate governance – cost of equity capital relationship.[2] Our study contributes to the literature by directly studying the corporate governance – cost of equity capital link by examining the level of financial development.

Arguably, the external governance environment in which a firm operates is more important than the internal governance

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[1] Legal protection encompasses both rights stipulated by laws and regulations and the effectiveness of enforcement. La Porta et al. (1997, 1998, 2002) show that countries with strong legal protection of investors have better corporate governance and higher firm valuation than countries with weak legal protection of investors.

[2] Love (2003) is an exception. She examines the linkage but does not estimate the cost of equity capital directly in her study.

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mechanisms that a firm adheres to. This is because the quality of a country's legal institutions reflects an ongoing commitment to good governance. Often the internal governance preferences of a firm reflect self-serving choices rather than a commitment to good governance. We therefore include both features and this study is the first one to show that internal governance and country-level financial development play complementary roles in influencing a firm's cost of equity capital.

There are a few cross-country studies that have studied both country-level institutional variables and firm-level governance. Chen et al. (2009) study a cross-country sample of firms from emerging markets and show that country-level institutional variables and firm-level corporate governance substitute for each other in affecting the cost of equity. Zhu (2014) examined a cross-country sample of developed countries and found that the association between governance practice and the cost of equity is more evident in countries characterised by strong legal protection, strict information rules, and high government quality. Therefore it appears that firm-level and country-level governance play complementary roles to each other in decreasing the cost of equity.

Overall, these results support the argument in Doidge et al. (2007) that the adoption of good internal governance is prohibitively expensive in weakly protected countries. Further, even if firms successfully commit to higher standards, the benefits of doing so in terms of access to capital markets on better terms, are limited since, in general, weakly protected countries are often associated with less financial development. However, none of the extant studies explicitly examine the interactive role of financial development with firm-level corporate governance on cost of equity.

We contribute to the literature in several ways. First, our main focus is on how financial market development facilitates a reduction in the cost of equity capital of well-governed firms. Chen et al. (2009) focussed on institutional quality in general and found that it had little emphasis on financial market development. They only used a single variable – MKDV – which is a dummy variable taking the value of one if the economy is included in MSCI's developed market index. We use two continuous variables – FININT and STKMKT – to denote two alternate measures of financial development. As such, our measures are much more granular compared to Chen et al. (2009).

Second, our sample is more recent, covers a larger sample, and includes developed markets. We cover 22 countries, compared to 17 countries covered by Chen et al. (2009). Their study is based on a sample of 559 firm-year observations, while our sample is composed of 7380 firm-year observations. Chen et al.'s results show that country-level institutional development and firm-level corporate governance are substitutes. Their results suggest that firm-level corporate governance is less important in countries with higher institutional quality. But empirical evidence suggests that firm-level corporate governance is higher in countries with better institutional quality (Zhu, 2014).

Third, by jointly examining the effects of country-level financial development, institutional factors and firm-level corporate governance initiatives, we hope to discern the relative impact of these major factors in influencing the cost of equity capital. While prior studies have looked at financial development as a potential explanatory variable, they do not condition their tests based on the level of financial development. We partition our sample on the basis of country-level financial development. This provides us with a direct test of the relative importance of this crucial variable in determining the relationship between firm-level corporate governance and cost of equity capital.

We expect the results of our study to inform the debate regarding whether firm-level corporate governance and country-level financial development act as substitutes or in a complementary manner in affecting a firm's cost of equity capital. There is as yet no empirical work on this issue. Our paper fills this void. As such, the empirical results of our study have major implications for policy makers and firm managers especially in countries with low levels of financial development. If our empirical work supports the substitution hypothesis, then it would provide an incentive to managers of firms to follow higher standards of corporate governance. On the other hand, if the data support complementarity hypothesis, then it is imperative for policy makers to improve the legal framework and financial development before firm-level corporate governance improvements will work.

Our empirical work is based on 7380 firm years of data drawn from 22 countries. We combine firm-level governance scores with country-level data on financial development and legal origin. We find that firms with high corporate governance scores have significantly lower cost of equity capital. On further examination, we find that the corporate governance and cost of equity capital linkage is significant only for (a) firms in Common Law countries and (b) firms in countries with high levels of financial development. It appears that the legal origin effect works in a complementary manner with the financial development effect to influence the impact of firm-level corporate governance on cost of equity capital.

Prior research suggests that strong legal institutional framework in a country is an important determinant in influencing firm-level improvements in corporate governance attributes (Doidge et al., 2007; Krishnamurti et al., 2005). Previous work has also documented that institutional development is associated with higher economic growth in a country due to an increase in the level of investments (due to cost of capital reductions). Taken together, our work highlights how country-level initiatives work in tandem with firm-level improvements in governance to reduce cost of capital, thereby improving the economic growth of the country.

The rest of the paper is organised as follows. We summarise the theoretical underpinnings relevant to our empirical tests in Section 2. Section 3 describes the sample selection process and measurement of key variables used in the study. Section 4 contains our empirical results and their discussions. Section 5 concludes the paper.

2. Theoretical underpinnings

In this section we survey extant research on factors that affect a firm's cost of equity capital. We first summarise work that relates firm-level corporate governance to cost of equity capital. This is followed by work that relates financial development to a firm's external financing environment. Finally, we develop our principal hypotheses based on prior literature on substitution and complementary effects of firm-level governance and country-level financial development.