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## Corporate governance and default risk in financial firms over the post-financial crisis period: International evidence <sup>☆</sup>

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### ABSTRACT

This paper investigates the relationship between default risk and corporate governance for financial firms in 28 countries outside of North America in the post-financial crisis period, where default risk is measured by both credit default swap (CDS) spreads and estimated by a Merton-type model. Reduced default risk helps the stock market rebound during the post-crisis period. Both internal governance variables, including institutional and insider ownership, board composition and CEO power, and external regulatory factors, are examined and they show significant effect on default risk. In addition, the impacts of various governance variables are continent-specific: they have a higher impact on default risk for Asian firms than for European firms. Regulatory factors are important moderators of the governance mechanisms for banks: higher Tier 1 capital ratios reduce both CDS and fundamental default risk; recipients of secret emergency loans from the US Federal Reserve System (the Fed) exhibit lower CDS spreads post-crisis but higher fundamental default probabilities.

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## 1. Introduction

The financial crisis of 2007–08 engendered huge losses to many firms worldwide, especially in financial sectors. The severity of the large-scale defaults in financial sectors and the wealth loss of stakeholders, especially stockholders and bondholders, and the associated impact on financial stability have attracted the attention of policy-makers, scholars, and practitioners. How to control and reduce risk prior to and during a crisis period has been the subject of considerable research in the corporate governance literature for the past several years (e.g., [Gupta et al., 2013](#); [Caprio et al., 2007](#)). However, crisis conditions in many international markets did not end with the recovery of the US market. By end of 2009, with Eurozone

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member states unable to bail out their over-indebted banks, the European Banking Crisis erupted, leading to widespread defaults and various stopgap banking system bailouts.<sup>1</sup> The IMF has dubbed the post-crisis experience of different regions of the world as reflecting the “multispeed global economy.”<sup>2</sup> There is no doubt that bondholders prefer default risk reduction. The question is whether the reduced default risk favored by bondholders really benefits stockholders so that stockholders also have an incentive to take actions that can reduce firms' risk, rather than focusing solely on increasing their investment return. We show that there is a positive relation between the lagged default risk and stock returns for our sample firms, both before and during the crisis period, which is consistent with Chava and Purnanandam's (2010) finding that stockholders expect higher returns for bearing default risk. However, during the post-crisis period there is a negative relationship between the lagged default probability and stock return, implying that the stock market rebound reflects the declining default risk.<sup>3</sup> Therefore, reduced default risk indeed benefits shareholders during the post-crisis period.

Now the question is how to reduce the default risk of the financial sector over the post-crisis period. There is a widespread view that the problems in many countries outside North America can be attributed to failures and/or weaknesses in corporate governance structures, both internal and external, that result in a lack of safeguarding against excessive risk-taking by financial services companies. Indeed, no countries outside the United States have introduced the sweeping Dodd Frank-type regulatory initiatives to improve the governance of the financial sector. Some studies have examined the interaction of governance mechanisms and the performance of firms during the 2007–08 crisis period (e.g., Aebi et al., 2012; Beltratti and Stulz, 2012; Erkens et al., 2012; Liu et al., 2012). However, few papers look at the performance of non-US firms in the aftermath of the crisis. Hence, it is worthwhile to perform **robustness tests** for not just different sample periods, but also for different countries. Are there differential responses to internal and external governance mechanisms for countries outside the US? Do we observe convergence of governance structures around the world, as per Denis and McConnell (2003)? Such convergence is the goal of regulators in international financial markets. Basel III requires financial institutions to have higher Tier 1 (T1) capital ratios, but whether this requirement is well founded in terms of reducing firms' default calls for more evidence. In addition, during the crisis the US Federal Reserve System (the Fed) did provide foreign financial institutions with emergency loans, but did those foreign financial institutions become less risky after the Fed came to their rescue? We directly address these questions as well. To the best of our knowledge, there has been no research **examining the impact of governance mechanisms on credit risk for financial firms in countries outside North America, taking into account the impact of the secret emergency loans that were provided by the Fed to foreign financial institutions over the period 2007–2009 on default risk.**

The purpose of this study is to address these gaps. We consider a sample of firms from 28 different countries and analyze the impacts of various governance variables on firm default risk, controlling for the differences in country development and general market conditions, in addition to a set of firm characteristics. We use two measures of firm default risk to explore the relationship between corporate governance and firm default risk during the post-crisis period. The first measure is the five-year credit default swap (CDS) spread. CDS spread has several advantages in capturing default probabilities. Unlike bonds, CDS are not in fixed supply and should be less sensitive than bonds to liquidity effects. In addition, as noted by Garcia and Yang (2009), compared to corporate bonds, CDS spreads are less susceptible to squeezes or to becoming “special” with repo rates below market rates for similar maturities and credit risks. However, a large number of firms do not have traded CDS information, so there could be sample selection bias. Therefore, we also address the possibility of selection bias for our CDS sample firms. The second measure is Merton-type five-year default probability to measure a firm's *fundamental* default risk.

We consider five key internal governance mechanisms: institutional ownership, insider ownership, board independence, board size, and CEO duality. These measures are widely used as factors directly linked to firms' corporate governance quality (e.g., Anderson and Fraser, 2000; Bhojraj and Sengupta, 2003; Erkens, Hung, and Matos, 2012; Liu et al., 2012; Switzer and Wang, 2013a, 2013b). We further examine two important external regulatory factors, including T1 capital ratio and whether the firms are recipients of secret emergency funding from the Fed, based on data availability. We use instrumental variable methods to address the potential endogeneity of institutional ownership and find that institutional ownership (board size) is negatively (positively) related to default risk using both measures across countries; board independence (insider holdings and CEO duality) lowers (increases) default probabilities but not CDS. Moreover, we find that the impacts of various governance variables on firm default risk are continent-specific: most governance variables are significantly related to default risk for Asian firms; for European firms, however, only board size and institutional holdings are significant. Regulatory factors are also important. Foreign financial institutions with higher T1 capital ratio have lower CDS and lower fundamental default

<sup>1</sup> For example, the Allied Irish Bank and the Bank of Ireland received a €7 billion rescue package in 2009 and recapitalized their assets. Greece's four largest banks—National Bank of Greece SA, Piraeus Bank SA, Euro-bank Ergasias SA, and Alpha Bank AE—have been regular recipients of emergency loans from the European Central Bank. In addition to European banks, several financial firms in Asia have faced default during the post-financial crisis period. Aiful Corporation, one of the largest Japanese consumer finance companies, failed to honor maturing loans in December of 2009, which triggered a restructuring event and involved the payout of CDS insuring \$1.3 billion of its debt. Neo-China Land Group, an investment holding company based in China, had its credit rating downgraded by Moody's by three notches, to “Ca,” in 2009 due to missed coupon payments of \$19.5 million on its outstanding \$400 million 2014 bonds.

<sup>2</sup> World Economic Outlook Reports 2013. <https://www.imf.org/external/ns/cs.aspx?id=29>.

<sup>3</sup> We perform a set of regressions of the stock return on the lagged default probability during three periods: before the crisis, during the crisis, post-crisis, using data collected from Bloomberg, and the whole sample period is from 2006 to 2013. The coefficients of default risk are 0.1376 (before), 0.2675 (during), –0.0271 (post), and 0.1500 (whole period). Except for the coefficient estimated during the crisis period, all coefficients are significant at the 10% level.

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