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Firm, market and top management antecedents of speculation: Lessons for corporate governance

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ABSTRACT

In this paper, we explore the corporate governance traits of companies that posted hefty losses related to derivatives trading in the aftermath of the financial crisis. Using concepts from agency theory, cognitive decision making and institutional theory we theorize on potential facilitators of trading losses. Our sample is comprised of 346 companies from 10 international markets, of which 49 companies (and a subsample of 14 distressed companies) lost an aggregate of US\$18.9 billion in derivatives. An event study shows that most companies experience substantial and long-term abnormal returns following these incidents. The results of a probit model indicate that the lack of a formal hedging policy, weak monitoring of the top management, overconfidence in technical trends, *hubris* and remuneration contribute to the mismanagement of hedging policies. Our study contributes to the existing financial risk management literature by identifying antecedents of derivatives losses.

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1. Introduction

The purpose of this paper is to relate risk management with corporate governance by investigating the characteristics of non-financial companies that posted hefty losses in derivatives trading during the financial crisis that started in 2007. [Dodd \(2009\)](#) estimates that for 12 countries that include Poland and the economies of Asia and Latin America, derivative trading affects possibly 50,000 firms, with losses of roughly \$530 billion. [Kamil et al. \(2009\)](#) present a small subsample of companies in Mexico (6 companies) with total losses of US\$4.7 billion (an average loss of 23% of total assets) and 3 companies in Brazil with total losses of US\$5.5 billion—and an average loss of 46% of total assets.

During the financial crisis hedging scandals became more frequent. These scandals resulted in companies filing for bankruptcy; stocks plummeting; and costly lawsuits between companies, banks and shareholders. How this is possible, considering that the primary goal of hedging is to reduce a company's risk and ensure stable cash-flows for strategic investment ([Froot et al., 1994](#); [Stulz, 2013](#)), is a question finance researchers have yet to answer. One explanation for this could be simple incompetence of managers confronted with increasingly complex derivatives. A more plausible explanation, however, is that those companies intentionally or carelessly engaged in speculation.

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In this paper, we analyze the factors that contributed to such derivatives mismanagement and investigate which corporate governance mechanisms failed in providing sufficient protection and monitoring to shareholders. We identify characteristics that distinguish mismanaged companies from a matched control group.

First, we show that the disclosure of losses from derivatives contracts by 49 non-financial companies results in negative abnormal results, for most companies. While this itself is not sufficient evidence of hedging failure, it is evidence of a sustained destruction of shareholder value. Then, we use a probit cross-sectional model to compare the corporate governance structure of companies with derivatives losses (treatment group) to matched companies. We establish a binary dependent variable which assumes the value 1 for the companies in our sample that reported losses and 0 for the control group without losses. Since we have a clearly defined event – the losses – the probit model is suitable to analyze which corporate governance mechanisms and characteristics fail in preventing executives from engaging in value-destroying hedging strategies. It is important to note that there are limits to the generalizability of our results due to possible sample selection. However, case control methodology is the only possible approximation of a randomized experiment in this particular empirical setting.

Our results indicate that 10 out of 14 companies experience negative absolute returns one year after the incident, confirming the long-term ramifications of financial mismanagement. We hand-collect data on qualitative indicators of corporate governance, proxies for top management *hubris*, and other management characteristics such as the remuneration scheme and the ownership stake of the management in the companies. We cannot disentangle the roles and dynamics between different positions within the top management team (i.e. CEO, CFO) which is why the interpretation of our measures and results is limited at the top management team level. Results of two econometric models based on probit panel data show that skewed incentives for managers coupled with lax governance structure (especially a formal hedging policy and no monitoring) contribute to companies' mismanagement of hedging policies.

The present paper contributes to the current literature in two ways. First, it presents hard evidence on sustained value destruction for speculating non-financial companies during the financial crisis through an event study. Second, it relates these losses to corporate governance mechanisms and to contextual developments within affected companies. Several authors have theorized about the relationship between agency theory and risk management (Sheedy, 1999; Wiseman and Gomez-Mejia, 1998) but no research, to our knowledge, has attempted to empirically model agency predictors of corporate hedging losses.

2. Risk management and corporate governance

Tufano (1996, p. 1097) remarks that academics know remarkably little about corporate risk management practices. Even though academia has been playing catch up in the last 15 years (recent models include Purnanandam, 2008; Fehle and Tsyplakov, 2005), we are still ignorant of many risk management practices. Because risk strategies are not completely disclosed in financial statements it is difficult to properly assess the extent of hedging policies and their effectiveness. In the present paper there is a clear event in which risk management strategies are unveiled as a consequence of the financial crisis. The losses by public companies are an ideal background on which to further investigate risk management practices and their effects on stock prices. We also look into the antecedents of losses, relating the corporate governance structures of the affected companies to comparable matches without reported losses.

There exists a number of direct and indirect benefits of hedging (see Fok et al., 1997; Brown, 2001; Stulz, 2013). As Stulz (1996) and Bartram (2000) show, to generate value, hedging policies need to reduce bankruptcy or distress costs related to expected tax payments, expected payments to stakeholders or costs of raising funds. Hedging practices differ immensely across companies (on determinants see Smith and Stulz, 1985; Nance et al., 1993; Mian, 1996; Goldberg et al., 1998) and the success of hedging ultimately depends on the motivations behind it (see Dobson and Soenen, 1993; Hagelin, 2003). However, it is essential to note that the success of hedging strategies must be seen in the context of the individual company's motive. Until the late 1990s the prevailing theoretical goal of hedging has been to reduce the variance of cash-flows. Stulz (1996) and others proposed that the elimination of costly lower tail outcomes and securing a company's ability to make important strategic investments should be the primary goal of hedging since. Since then, the focus shifted from reducing cost of financial distress through variance minimization to reducing cost of financial distress through reducing downside risks. In both cases, losses from hedging appear naturally. Most recently, however, Aabo (2015) has shown that these two strategies have the same effect on average, but may differ in terms of their maximum loss and standard deviation. Hence, a hedging strategy that might be considered a "failure" in one strategy may still constitute an optimal hedge for the other strategy. This makes the ex-post identification of suboptimal hedging strategies extremely difficult and contingent on prior assumptions.

Tufano (1996) shows that determining if companies hedge or not can be expressed by two variables, related to executives: the amount of shares owned by managers and the nature of the managerial compensation contract. Managers maximize their utilities through risk management in two ways: if managerial wealth is affected by share prices companies hedge substantially, the converse being true if management owns a small stake. If executive compensation involves options or similar features, managers are more risk-prone and thus hedge less.

More recent models, like Fehle and Tsyplakov (2005) and Purnanandam (2008), expand theoretical literature by including more sophisticated hypotheses, but the main results remain the same—risk management is strongly influenced by managers' incentives resulting from ownership of shares and the structure of managerial compensation (as in Tufano, 1996).

Additionally, recent literature has been investigating the impact of the institutional context on the behavior of management in designing hedging policies. The main idea is that managers are affected by the institutional environment in

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