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Predicting corporate governance in emerging markets

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ABSTRACT

This paper investigates what predicts corporate governance in emerging markets. Specifically, we examine what predicts governance *changes* and the *level* of governance itself. To conduct this study, we utilize a unique dataset from AllianceBernstein that consists of monthly firm-level corporate governance ratings for 24 emerging market countries for almost seven years. Since the AllianceBernstein ratings are time-series data, they allow us to determine the direction of change in a firm's corporate governance, and the timing of these changes. Using these data, we find two main results. First, as firms grow they are more likely to improve their governance. Second, the *level* of political risk where the firm resides is negatively and significantly related to the *level* of firm governance but positively and significantly related to *changes* in firm governance. Hence, firm governance is better in countries with lower political risk but firms are more likely to improve their governance in countries with higher political risk.

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1. Introduction

A large literature has generally found that better governance is linked to better performing and valued firms in emerging markets.[1] Despite this evidence, and the clear incentive to improve their governance, many similar firms make very different governance choices. To better comprehend why firms choose different governance schemes, one needs to examine what predicts firm governance in these emerging economies. This paper adds to this discussion.

There are number of papers that have begun to examine what factors predict firm governance decisions in emerging markets. However, the findings of these papers have been disparate. For example, Doidge et al. (2007) and Durnev and Fauver (2010) find that country conditions explain much more of the variance in firm governance ratings than firm characteristics. Indeed, according to Doidge et al. (2007), firm characteristics don't predict governance much at all. Conversely, Black et al. (2006b), Durnev and Kim (2005), Klapper and Love (2004) and Klapper et al. (2006) all find that some firm characteristics are important to governance decisions, however they find that quite different firm characteristics are predictive.

Case in point, while Durnev and Kim (2005) find that firm growth, the firm's need for equity finance, and the amount of insider ownership predict better governance, Black et al. (2006b) find that none of these characteristics are significant. Instead they find that firm size and firm risk predict better governance but little else does. To make matters more complicated, Klapper and Love (2004) find that capital intensity of the firm is a predictor of worse governance while the other papers do not find such a conclusion. Indeed, the one consistent finding seems to be that few factors, if any, consistently predict governance. In fact, Black et al. (2006b) test 17 different factors and many controls, and find that only firm size and firm risk have any consistent predictive ability governance in Korea. Indeed, other than these two variables nothing else predicts governance decisions in Korea. In another paper, Balasubramanian et al. (2010) also find that very little predicts governance when examining governance decisions in India.

In this paper we also examine what factors predict firm governance in emerging markets. However, we do this in a different way than the previously mentioned papers. While the other papers all use cross-sectional data, in this paper we use a dataset from AllianceBernstein that consists of monthly, time-series, firm-level, corporate governance ratings for 24 emerging market countries that span almost seven years. These data allow us to examine *changes* in corporate governance. Hence, while previous studies can examine what country and firm characteristics are linked to better governance, we can examine what, if anything, is causing firm governance to *improve* or *deteriorate* over a period of time. We feel this is worthy supplement to the cross-sectional approach as it allows us to see the effects of changes (in the country and in the firm) on firm governance and thus assess if such changes are worth pursuing to improve governance. While our major focus is on predicting changes in governance, we also use the more traditional approach of investigating what predicts the level of governance. We do this using a fixed effects, panel approach.

The rest of this paper is organized as follows. Section 2 describes the data used in the study. Section 3 provides the methodology. In Section 4 we present our results and we conclude with Section 5.

2. Data

2.1. AllianceBernstein corporate governance ratings

Our study utilizes corporate governance ratings compiled by AllianceBernstein. These ratings were used for internal purposes and have been used by Morey et al. (2009). They are constructed by

[1] Many studies have found this relationship in emerging markets. In single country studies the list includes Leal and Carvalhal-da-Silva (2005), and Braga-Alves and Shastri (2011) (Brazil); Atanasov et al. (2010) (Bulgaria); Bai et al. (2004), and Beltratti and Bortolotti (2007) (China); Black and Khanna (2007), and Balasubramanian et al. (2010) (India); Black et al. (2006a, 2008), and Black and Kim (2012) (Korea); Black (2001), and Black et al. (2006) (Russia). In addition there are a number of cross-country studies that have documented the same relationship. These include Klapper and Love (2004), Durnev and Kim (2005), Doidge et al. (2007), De Nicolò et al. (2008), Aggarwal et al. (2009), Chhaochharia and Laeven (2009), Morey et al. (2009), and Durnev and Fauver (2010). Also for an excellent recent survey see Love (2010). The same positive relationship between governance and performance has been found in the U.S. in Gompers et al. (2003), Larcker et al. (2007), Bebchuk et al. (2009), and Brown and Caylor (2009).