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What matters and for which firms for corporate governance in emerging markets? Evidence from Brazil (and other BRIK countries)☆

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ABSTRACT

A central issue in corporate governance research is the extent to which "good" governance practices are universal (one size mostly fits all) or instead depend on country and firm characteristics. We report evidence that supports the second view. We first conduct a case study of Brazil, in which we survey Brazilian firms' governance practices at year-end 2004, construct a corporate governance index, and show that the index, as well as subindices for ownership structure, board procedure, and minority shareholder rights, predicts higher lagged Tobin's *q*. In contrast to other studies, greater board independence predicts *lower* Tobin's q. Firm characteristics also matter: governance predicts market value for nonmanufacturing (but not manufacturing) firms, small (but not large) firms, and high-growth (but not low-growth) firms. We then extend prior studies of India, Korea, and Russia, and compare those countries to Brazil, to assess which aspects of governance matter in which countries, and for which types of firms. Our "multi-country" results suggest that country characteristics strongly influence both which aspects of governance predict firm market value, and at which firms that association is found. They support a flexible approach to governance, with ample room for firm choice.

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1. Introduction

Capital market development has been linked to improved resource allocation (Wurgler, 2000) and economic growth (e.g., Levine and Zervos, 1998). In turn, capital market development has been related to protection of minority investors (e.g., Gleaser et al., 2001; La Porta et al., 1997, 1998a,b). A number of articles also link firm-level corporate governance practices to firm value

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(e.g., Black et al., 2006a; Durnev and Kim, 2005). Overall these studies support the importance of firm-level corporate governance, especially in countries with weak legal protections for investors (e.g., Klapper and Love, 2004).

How to improve corporate governance, however, is not clear. There are different approaches with distinct consequences. One approach treats legal rules as central. Good governance is achieved principally through rules that protect minority investors. (Examples of this approach include the Sarbanes-Oxley Act in the U.S.; New York Stock Exchange listing rules (requiring, for example, a majority of independent directors and an audit committee composed entirely of independent directors), and the OECD principles of corporate governance (OECD, 2004). This approach can be effective if many corporate governance practices are universal, so that a common set of rules can be applied to a broad spectrum of countries, and a broad spectrum of firms within each country. In contrast, if good corporate governance is often "local" — varying across countries, and across firms within a country, a more flexible approach will often be appropriate. Examples of this approach include comply or explain rules, such as the UK Combined Code on Corporate Governance (Financial Reporting Council, 2006), and multiple governance stock exchange listing tiers, exemplified by the Brazilian stock exchange, Bovespa, discussed below.

There is, by now, substantial evidence that one size does not *always* fit all firms in all countries. Optimal governance likely differs between developed and emerging markets (e.g., Bebchuk and Hamdani, 2009), and potentially also between different emerging markets (Durnev and Fauver, 2007). Within a given country, optimal governance may depend on firm characteristics (e.g., Arcot and Bruno, 2006; Bruno and Claessens, 2007; Demsetz and Lehn, 1985). But we still know relatively little about the *extent* to which broad corporate governance principles can be applied across countries, or across firms within a country. If there is sufficient commonality, it could make sense to adopt "across the board" rules, both within and across countries, even if they do not perfectly fit every firm or every country. After all, there is also evidence that adoption of mandatory rules can be beneficial in some instances (e.g., Atanasov et al., 2010, on Korea; Black et al., 2006a, on Bulgaria).

We address two principal questions. For both, we first study Brazil, then extend our analysis to the other BRIK countries, and evaluate our results in light of other existing studies. For both, we focus on emerging markets. The additional differences that surely exist between developed and emerging markets are outside our scope.

Question 1: Which corporate governance rules are likely to be beneficial in emerging markets? One can readily compile a list of items that plausibly reflect good corporate governance and test whether, combined into an index, they predict firm market value (or performance). One can also test whether specific aspects of overall corporate governance (for example, board independence, disclosure, an audit committee, or cross-listing in the U.S.) predict firm market value on average, over many firms in many countries. These approaches are useful, but have important limits. Most centrally, they tell us little about which practices matter, for which firms and in which countries.

One core problem is that different aspects of corporate governance are correlated. Thus, if one measures the overall predictive power of a list of governance measures, one does not know which elements drive the overall power. For instance: Gompers et al. (2003) develop for the U.S. a corporate governance index based on twenty-four provisions (G-index) and show that it predicts firm value. But Bebchuk et al. (2009) report that only six of these provisions fully drive the Gompers–Ishii–Metrick results. A related problem arises for studies that focus on a particular subset of governance measures. One then faces a classic omitted variables problem — one does not know whether the subset is truly important, or merely proxies for omitted aspects of governance. For example, a number of corporate governance studies rely on a 2002 survey by Standard and Poor's, which covers only disclosure. To overcome this problem, one needs a broad index that captures multiple aspects of corporate governance. One can then test the relevance of each aspect, controlling for the others.

Moreover, what matters in corporate governance may vary from country to country, in ways not well captured by multi-country indices. As Bebchuk and Weisbach (2010) point out, the Gompers et al. (2003) and Bebchuk et al. (2009) indices principally measure take-over defenses, which are of limited relevance in countries in which most firms have controlling shareholders. The RiskMetrics (formerly ISS) measure focuses on features that are common in the US but often not found in other capital markets (Bebchuk and Hamdani, 2009). Variation across countries in ownership patterns and background legal rules limits what one can learn by assessing whether a particular governance measure or index matters on average across all countries. One needs to examine individual country results (a step often not taken in cross-country studies), to determine whether the results are driven by a subset, perhaps a small one, of the studied countries, and to which countries they apply.

A third concern for cross-country studies is that the available indices are limited. The S&P index (e.g., Durnev and Kim, 2005) covers only disclosure, and is available only for 2002. The Credit Lyonnais Securities Asia index (Durnev and Kim, 2005; Klapper and Love, 2004) includes subjective elements and is available only for 2001. The RiskMetrics (formerly ISS) index covers only developed countries (e.g., Aggarwal et al., 2009).[3]

Summing up, to identify what matters in corporate governance, in which countries, one needs a broad index that is (i) tailored to the nuances of particular countries; yet (ii) has sufficient commonality across countries to permit cautious generalization. One then needs to assess both the predictive power of the overall index, and the importance of different aspects of governance, controlling for other aspects of governance.

Question 2: What aspects of corporate governance matter to which firms? A second, often understudied question involves which firms can benefit from which aspects of corporate governance. A number of hypotheses have been suggested in prior work. *Firm size*. Large firms could need "better" (more formal) governance to respond to their more complex operations. They could have greater potential for agency costs due to greater financial resources or less concentrated ownership. Conversely,

[3] Morey et al. (2009) use a proprietary index from Alliance Bernstein. The index has many subjective elements and Alliance Bernstein does not allow them to disclose individual elements.

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