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Is corporate governance important for regulated firms' shareholders? Evidence from Japanese mergers and acquisitions

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ABSTRACT

This paper compares the reaction of bidders' stock prices to acquisition announcements by regulated non-financial firms, banks, and unregulated companies in Japan. Results suggest that regulated non-financial firms do not experience a significant stock price response at merger and acquisition (M&A) announcements, although banks' and unregulated firms' M&A announcements are regarded favorably by the stock market. Furthermore, the effect of stock option usage and strict boards on the stock price response is weak for regulated non-financial bidders. The results provide additional evidence that regulation results in managerial decisions' having less influence on shareholder wealth and thereby changes the firm's optimal governance structure. In contrast, the results provide no clear evidence that, for bank bidders, there is a significantly stronger or weaker relationship between governance and the stock price response to an M&A announcement than that of unregulated firms or regulated non-financial firms. The result does not support the view that regulatory monitoring weakens the effect of ordinary governance mechanisms.

1. Introduction

It is well documented that managerial decisions have no substantial impact on firm value in the less competitive markets in which regulated firms operate (Kole & Lehn, 1999; Smith & Watts, 1992). Reg-

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ulation substantially affects the contractual environment and gives regulated firms different optimal corporate governance structures from those of unregulated firms. In fact, some researchers have presented evidence that regulation gives firms an incentive to adopt a lax corporate governance structure (Adams & Ferreira, 2008; Becher, Campbell, & Frye, 2005; Booth, Cornett, & Tehranian, 2002; Crawford, Ezzell, & Miles, 1995; Hubbard & Palia, 1995; Kole & Lehn, 1999).

However, few studies have provided direct evidence that corporate governance mechanisms have a less positive effect on shareholder wealth in regulated firms. The analyses that have been done, which have been limited to the banking industry, have presented mixed results (Hagendorff, Collins, & Keasey, 2009; Subrahmanyam, Rangan, & Rosenstein, 1997). This study is designed to fill the research gap and to conduct a comprehensive test to determine whether regulation weakens the effect of corporate governance on shareholder wealth. A typical approach to the issue is to investigate the relationship between changes in the stock price of a bidder in response to a merger and acquisition (M&A) announcement and the bidder's corporate governance mechanisms. In fact, M&A events are frequently used to examine the effect of corporate governance mechanisms on shareholder wealth because they typically represent large and discrete capital budgeting decisions for which we can measure the stock market reaction by event study (Datta, Iskandar-Datta, & Raman, 2001; Hagendorff et al., 2009; Kang, Shivdasani, & Yamada, 2000; Masulis, Wang, & Xie, 2007). Mergers and acquisitions are good events to address for this research because we can collect more M&A events, especially for regulated non-financial firms, compared to other events like restructurings.

Using data for Japan, we compare the stock price reactions to M&A announcements made by banks, regulated non-financial firms, and unregulated companies. Hagendorff et al. (2009) presented a comparison of stock price reactions to bank mergers among countries that have different levels of regulatory strictness. In contrast to Hagendorff et al.'s research, we examine how regulation influences the effectiveness of governance devices on shareholder wealth in a more homogeneous environment. In addition, we include regulated non-financial firms, as well as banks, in the regulated firm sample. Banks are under regulatory scrutiny, such as in terms of the Bank for International Settlements (BIS) capital adequacy ratio, so they are good subjects for testing the prediction that regulation weakens the impact of corporate governance on shareholder wealth. By contrast, recent failures of U.S. investment banks remind us that banks have a high risk exposure and that their managerial decisions will strongly affect shareholder wealth. In addition, banks can achieve economies of scale and improve efficiency by undertaking effective M&A deals. These characteristics suggest that corporate governance is likely to be as important for bank shareholders as for unregulated firms' shareholders. In contrast, it is difficult for regulated utilities that are allowed to monopolize the regional market to seek M&A deals that achieve economies of scale. Even if they improve efficiency through M&A deals, regulatory authorities may require them to pass a substantial share of economic benefits to customers (Bartunek, Jessell, & Madura, 1993; Berry, 1998, 2000; Norris, 1990; Ray & Thompson, 1990; Studness, 1996). This type of environment leaves utilities only limited opportunities to create shareholder value via M&A. Comparisons among banks, regulated non-financial firms, and unregulated firms will enable us to examine what environments degrade the value of corporate governance mechanisms.

Our main findings are summarized as follows. First, regulated non-financial firms do not experience positive stock price reactions when they announce M&A transactions, although such announcements by banks and unregulated firms are received favorably by the stock market. Second, unregulated firms that have stricter corporate governance structures see stronger stock price responses to M&A announcements. Regulated non-financial firms show significantly weaker relationships between stock price reactions and corporate governance structure than unregulated firms do. These results provide additional support for the view that regulation lowers managerial decisions' effect on shareholder value and thereby changes the firm's optimal governance structure (Adams & Ferreira, 2008; Becher et al., 2005; Booth et al., 2002; Crawford et al., 1995; Hubbard & Palia, 1995; Kole & Lehn, 1999). By contrast, we find no clear evidence that the relationship between banks' governance and stock price responses is different from that of unregulated firms or regulated non-financial companies. We interpret that regulatory authorities specifically examine safety and soundness rather than shareholder wealth maximization (Becher & Frye, 2009; Joskow, Rose, & Shepard, 1993; Skeel, 1999), so regulatory monitoring does not substitute for ordinary governance mechanisms.