J. Japanese Int. Economies 34 (2014) 315–335

Contents lists available at ScienceDirect

Journal of The Japanese and International Economies

journal homepage: www.elsevier.com/locate/jjie

Corporate governance and the cost of public debt financing: Evidence from Japan

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ARTICLE INFO

Article history:
Received 28 December 2011
Revised 5 March 2014
Available online 21 March 2014

JEL classification:
G32
G34

Keywords:
Yield spreads
Ownership structure
Corporate governance

ABSTRACT

Tanaka, Takanori—Corporate governance and the cost of public debt financing: Evidence from Japan

This paper explores the relationship between corporate governance mechanisms and the cost of public debt financing in Japan. Using a sample of corporate bonds newly issued in Japan during the period 2005–2008, I find that CEO ownership is associated with higher yield spreads after controlling for other governance, bond, and firm characteristics. Founding family ownership is also positively related to yield spreads. In contrast, firms with large corporate shareholders enjoy lower yield spreads. These results are robust to various alternative specifications. Overall, my results indicate the importance of corporate governance mechanisms in Japanese corporate bond markets. *J. Japanese Int. Economies* **34** (2014) 315–335. Faculty of Economics, Ritsumeikan University, 1-1-1 Nojihigashi, Kusatsu, Shiga 525-8577, Japan.

1. Introduction

Investors are generally concerned about whether they will certainly achieve returns on their investments. The main purpose of corporate governance systems is to provide investors with an assurance that they will be distributed some profits as these returns (Shleifer and Vishny, 1997). Thus, investors have a great interest in the type of corporate governance systems adopted by the firms with which they invest. For example, if corporate governance systems that protect investor's interests

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http://dx.doi.org/10.1016/j.jjie.2014.03.002
0889-1583/

dominate, then the investors are likely to obtain returns, and these firms will enjoy a lower cost of external financing. In contrast, when corporate governance systems that generate agency conflicts with investors prevail, then the required returns on investments are not likely to materialize, and these firms will face a higher cost of external financing. Thus, the quality of the corporate governance systems has a significant effect on the ability of firms to raise external finance.

It is often argued that shareholder's interests do not fully align with those of bondholders.[1] For example, shareholders could expropriate wealth from bondholders by investing in riskier projects, and then reap the largest gains if the projects perform well even though bondholders bear most of the costs (asset substitution problem) (Jensen and Meckling, 1976). Such a divergence of interest between shareholders and bondholders becomes severe when controlling shareholders have an incentive to pursue self-serving activities. Controlling shareholders then tend to entrench themselves at the expense of other investors and enjoy the private benefits of control, thereby leading to a reduction in firm value (e.g., Shleifer and Vishny, 1997). Moreover, these activities include risk-taking and wealth transfer activities that are often detrimental to bondholders. Thus, such incentives could potentially exacerbate the shareholder–bondholder conflict and generate an increase in the potential default risk. Recognizing agency conflicts with controlling shareholders, bondholders will require higher yields for these firms. However, controlling shareholders often benefit bondholders. Controlling shareholders have an incentive to monitor, discipline, and even oust incumbent managers. These monitoring activities serve to curb managerial discretion and thus enhance firm value (e.g., Shleifer and Vishny, 1997). Consequently, monitoring activities may benefit bondholders, mitigate the shareholder–bondholder conflict, and thus lower the potential default risk (e.g., Bhojraj and Sengupta, 2003). Bondholders reflect such benefits in bond yields and thus permit the firms to enjoy lower yields.

In recent years, previous studies have provided extensive and growing evidence of the impact of corporate governance systems on the cost of public debt financing. Anderson et al. (2003) show that family ownership is associated with lower yield spreads. Anderson et al. (2010) argue that CEO ownership is negatively related to yield spreads. Bhojraj and Sengupta (2003) document that institutional ownership has an adverse impact on yield spreads, whereas a higher share of outside directors has a favorable effect on yield spreads. Cremers et al. (2007) explore the relationship between shareholder control as internal governance and takeover defense as external governance and provide evidence that the impact of shareholder control on yield spreads varies with takeover vulnerability. Klock et al. (2005) provide evidence that antitakeover provisions lower yield spreads. However, these studies are limited to corporate governance systems in the United States.

In this paper, I examine the relationship between corporate governance mechanisms and the cost of public debt financing using a sample of 640 corporate bonds newly issued by 196 Japanese firms during the period 2005–2008. Japan has one of the largest corporate bond markets outside of the United States, and is a country for which detailed data on corporate bonds and corporate governance are available. Moreover, Japan is characterized by corporate governance mechanisms, corporate financing patterns, and legal systems that are different from those in the United States. Thus, by studying the corporate bond markets in Japan, I aim to shed light on the general question of whether corporate governance mechanisms affect the cost of public debt financing.[2]

Among various corporate governance mechanisms, my focus is on CEO ownership, family firms, and non-financial firms as large shareholders. There are few studies on the effect of CEO ownership on the cost of public debt financing (Anderson et al., 2010). For family-owned firms, empirical results in existing studies are mixed (Anderson et al., 2003; Ellul et al., 2007). Previous papers consider large institutional shareholders that have no special relationship with firms other than ownership (Anderson et al., 2003, 2010; Bhojraj and Sengupta, 2003; Cremers et al., 2007). In contrast, Japanese

[1] The agency problems between shareholders and debtholders in Japan are explored by Prowse (1990), who reports that concentrated ownership by Japanese financial institutions as debtholders helps mitigate agency problems.

[2] In an examination of the relationship between managerial ownership and firm performance, previous works based on firms in the United States find an entrenchment effect (e.g., Morck et al., 1988). However, earlier studies using Japanese firms find no such effect (Chen et al., 2003; Hiraki et al., 2003). The different results suggest the importance of understanding different corporate governance systems across countries.