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# Does corporate governance influence corporate risk-taking? Evidence from the Institutional Shareholders Services (ISS)



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### ABSTRACT

We provide evidence on the effect of corporate governance on the extent of corporate risk-taking. Provided by the Institutional Shareholder Services (ISS), our governance metrics are among the most comprehensive in the literature. Our results show that firms with more effective governance exhibit corporate strategies that are significantly less risky. Left to their own devices, managers tend to take excessive risk. Effective governance, however, reduces the degree of risk-taking significantly. Exploiting the passage of the Sarbanes–Oxley Act of 2002 as an exogenous shock that improves governance quality, we show that the effect of corporate governance on risk-taking is likely causal.

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## 1. Introduction

The most recent financial crisis was a consequence of corporate executives taking excessive amount of risk. To prevent further crises, it is imperative that we understand factors the influence corporate risk-taking. The literature is replete with studies that examine the effects of corporate governance on critical corporate outcomes, such as firm value, capital structure, dividend policy, etc. Using governance metrics provided by the Institutional Shareholder Services (ISS), we investigate how corporate governance influences the extent of corporate risk-taking. We contribute to a crucial area of the literature that seeks to assess how various aspects of corporate governance influence risk-taking. For instance, a number of studies examine how executive compensation, a primary element of a firm's governance structure, affects risk-taking (Guay, 1999; Coles et al., 2006; Low, 2009; Dong et al., 2010; Armstrong and Vashishtha, 2012; Hayes et al., 2012; Gomley et al., 2013). Beyond executive compensation, Kim and Lu (2011) investigate the moderating effects of external governance on CEO ownership and corporate risk-taking. Bergeron et al. (2010) and Cohen et al. (2013) assess the effects of the Sarbanes–Oxley (SOX) Act on corporate risk-taking.

Our study adds to the vast literature in this area by using one of the most comprehensive governance metrics ever constructed to investigate the impact of corporate governance on risk-taking. Prior studies look at specific governance mechanisms, such as executive compensation or CEO ownership, whereas our study attempts to shed light on the overall effects of governance. It is imperative to use comprehensive governance measures because governance mechanisms tend to interact with one another (Agrawal and Knoeber, 1996).

We advance two opposing hypotheses. First, unlike typical shareholders who hold diversified portfolios, managers have their human capital as well as a significant portion of their wealth tied up in the firm and are therefore exposed to more non-systematic (firm-specific) risk (Fama, 1980; Amihud and Lev, 1981). This under-diversification leads the manager to develop a higher degree of risk aversion, resulting in corporate strategies that are less risky. Weaker corporate governance imposes fewer restrictions on managers, allowing managers more latitude in formulating corporate policies that reflect their own risk-aversion. As a result, this hypothesis argues that weaker corporate governance is associated with lower risk-taking. We refer to this hypothesis as the risk-avoidance view.

By contrast, the opposing hypothesis predicts that weaker governance is associated with more risk-taking. There are at least two reasons why this may be the case. First, most executive compensation contracts make managerial compensation contingent on firm performance. The nature of these compensation contracts likely induce managers to take more risk, expecting to obtain more lucrative compensation. The latest financial crisis is an example of a situation where executives were induced to take significantly more risk. Strong effective governance is expected to protect shareholders from unnecessary risk-taking. Conversely, weaker governance is less likely to keep managers from taking too much risk. This is the first reason why stronger governance is associated with less risk-taking. Second, managers enjoy more freedom in formulating corporate policies when governance is less restrictive (weaker governance). With more freedom, managers are less likely to have to compromise with shareholders, resulting in “less balanced decisions”, i.e. decisions that are either really good or really bad. Such extreme decisions result in more variability in firm performance, which reflects higher risk (Adams et al., 2005). We refer to this hypothesis as the risk-seeking hypothesis, which predicts that stronger governance leads to less risk-taking.<sup>2</sup>

Provided by the Institutional Shareholder Services, our governance metrics cover eight dimensions of corporate governance, consisting of a total of sixty-two governance factors. Our empirical evidence reveals that firms with stronger governance exhibit significantly less risk-taking, therefore supporting the risk-seeking hypothesis. This is true whether we measure risk-taking by using total risk or idiosyncratic risk. There is an inverse association between governance quality and the extent of risk-taking. Firms with more stringent governance exhibit corporate strategies that are significantly less risky.

<sup>2</sup> There is a debate in the literature over whether more risk-taking is beneficial or detrimental to shareholders and what the optimal level of risk-taking is (Bartram et al., 2012). It is important to note that we do not take a position on this debate. We simply investigate the effect of corporate governance on risk-taking. The debate on optimal risk-taking requires a much more careful separate analysis and is thus beyond the scope of this study.

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