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# Multiple corporate governance attributes and the cost of capital – Evidence from Germany

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ABSTRACT

This paper investigates the extent to which corporate governance affects the cost of debt and equity capital of German exchange-listed companies. I examine corporate governance along three dimensions: financial information quality, ownership structure and board structure. The results suggest that firms with high levels of financial transparency and bonus compensations face lower cost of equity. In addition, block ownership is negatively related to firms' cost of equity when the blockholders are other firms, managers or founding-family members. Consistent with the conjecture that agency costs increase with firm size, I find significant cost of debt effects only in the largest German companies. Here, the creditors demand lower cost of debt from firms with block ownerships held by corporations or banks. My findings demonstrate that a uniform set of governance attributes is unlikely to satisfy suppliers of debt and equity capital equally.



## 1. Introduction

Using mostly hand-collected panel data on German listed firms, this paper investigates the relationship between corporate governance and the firms' cost of debt and equity capital. Following a conceptual framework provided by Standard & Poor's (2002), corporate governance is captured along multiple dimensions: (1) financial information quality, (2) ownership structure and (3) board compensation. Financial information quality is proxied by an independent disclosure score extracted from the yearly annual report contest of the German business magazine Capital (Leuz & Verrecchia, 2000). Ownership structure is measured using four different types of blockholders. To capture board compensation and following the provisions of German commercial law, I split the overall board members' compensation packages into three components: (1) fixed salary, (2) performance related bonus and (3) share-based incentive components.

Compared to the Anglo-Saxon capital market-based financial system, the German corporate landscape is characterised by a dominance of banks and concentrated ownership. Until the 1990s, prior studies (e.g. Edwards & Fischer, 1994) considered: i) corporate financing through house banks; ii) bank representation on companies' supervisory boards; and, iii) bank share ownership, as distinct features of the German financial system. The traditional house bank relationship implies more control and closer monitoring. The German proxy voting rules also enable banks to exert additional control by allowing voting by depositors who own shares. For these reasons, the rights of creditors are considered to be better protected than those of shareholders. Given the higher level of protection for lenders, I therefore expect a higher demand for firm-level corporate governance mechanisms by equity holders which I measure through an increase in the cost of capital. Given the unequal legal

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protection of capital providers, the German market offers an interesting setting for examining the effects of corporate governance on both the cost of debt and equity capital.

Prior studies (see Anderson & Reeb, 2003; Morck, Shleifer, & Vishny, 1988) show that different types of shareholders have diverging effects on the cost of capital of firms. Hence, it is not only important to control for blockholdings per se but also for blockholder identities. As concentrated ownership is a further distinctive feature of German firms, this provides an interesting setting for such an analysis.

This study therefore extends the empirical work on corporate governance and financing costs (Ashbaugh, Collins, & LaFond, 2004, 2006; Bhojraj & Sengupta, 2003; Cheng, Collins, & Huang, 2006) by considering the corporate governance arrangements amongst German firms as a special case. Whereas prior studies typically focus on a single governance mechanism, this study examines a multidimensional governance structure. Moreover, unlike previous studies, I set my study in an institutional framework where the rights of creditors and outside shareholders are unequally protected. This setting allows me to determine whether firm-level governance attributes are valued differently by outside shareholders and debtholders. Only a minority of studies (see Ball, Robin, & Sadka, 2008; Beatty & Harris, 1999) distinguishes amongst these competing groups of investors.

This study also adds to the literature concerning the relationship between corporate governance and firm valuation (e.g. Brown & Caylor, 2006; Gompers, Ishii, & Metrick, 2003). Hail and Leuz (2006) argue that the mechanisms by which firm valuation is affected by corporate governance are still unclear. On the one hand, the valuation effect can be primarily driven by different investment opportunities and levels of expropriation. On the other hand, effective corporate governance may also reduce the risk premium demanded by investors. This effect depends on the extent to which corporate governance structure allows for observable differences in non-diversifiable risk.

My study shows that the corporate governance structure used by German firms enables them to reduce agency costs, thereby reducing the cost of equity capital. More specifically, I find that firms' costs of equity are negatively associated with: i) block ownerships held by founding-family members, corporations, managers and governments; ii) the quality of financial transparency; and, iii) the bonus level of board members.

Unlike the findings reported in prior work, my results show that creditors appear to value firm-level governance attributes lower than equity holders. I attribute this finding to a special feature of the German market, namely, that banks have alternative channels for the protection of their interests. I also document that the creditors' demand for governance structures increases when the existing governance structures are no longer sufficient to mitigate agency conflicts. Accordingly, I find significant effects only in the largest listed German companies. This result is consistent with prior literature which posits a higher level of agency conflicts in larger firms (e.g. Demsetz & Lehn, 1985). Specifically, my results show that the cost of debt is negatively related to block ownerships held by banks and other companies and positively related to the quality of financial transparency. The latter indicates opposing information needs between debtholders and equity holders. Additional analyses, including the use of a composite governance score, support the abovementioned findings. Overall, the results lead me to conclude that a uniform set of governance attributes is unlikely to satisfy both groups of capital suppliers equally. The findings are of importance as they enhance knowledge of the role of governance in firms. Moreover, they shed light on whether the improvement of the firm-level governance structure affects the organisational performance of all firms.

There are a few contemporaneous single-country studies that are directly related to mine.[1] Ashbaugh et al. (2004) empirically find that the cost of equity capital of US firms is negatively associated with: i) financial information quality; ii) the independence of the board; and iii) the percentage of board members that own stock. Moreover, the number of blockholders is positively related to the cost of equity capital. Similarly, Cheng et al. (2006) find that S&P 500 firms with stronger shareholder rights regimes and higher levels of financial transparency face lower cost of equity capital. For German firms, Drobetz, Schillhofer, and Zimmermann (2004) find a negative association between their self-constructed governance score and stock returns. Also, Drobetz et al. (2004) use dividend yields as ex-post proxies for the cost of equity capital.

Turning to the cost of debt implications of governance, Bhojraj and Sengupta (2003) find that the cost of debt of US firms are negatively associated with: i) greater institutional ownership; and ii) stronger outside control of the board. The authors measure the cost of debt through bond credit ratings and bond yields. Ashbaugh et al. (2006) also find an association between several governance attributes and credit ratings for US firms. Similar to their previous study, they find that the credit ratings of US firms are positively associated with: i) financial transparency; ii) board independence; iii) board stock ownership; and iii) board expertise. They further find that the credit ratings are negatively related to the number of blockholders. These findings indicate that a uniform set of governance attributes is equally valued by both creditors and outside shareholders, which is inconsistent with my results.

Apart from the difference in institutional setting, this study differs from prior studies in the following respects: First, Ashbaugh et al. (2004, 2006) rely on earnings quality metrics to capture financial transparency. However, these constructs are difficult to interpret either consistently or satisfyingly with respect to earnings quality and financial transparency. Consequently, in common with Cheng et al. (2006), I employ a multidimensional measure of financial transparency in my study. Second, I distinguish amongst different types of blockholders. This stands in contrast to previous studies that concentrate on

[1] I am aware of further studies that examine the effect corporate governance has on the cost of capital in a cross-section of countries (e.g. Chen, Chen, & Wei, 2009; Hail & Leuz, 2006). However, I focus on studies within single jurisdictions, which I consider more closely related, thus more comparable, to my study.