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Corporate governance in the 2007–2008 financial crisis: Evidence from financial institutions worldwide

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ABSTRACT

This paper investigates the influence of corporate governance on financial firms' performance during the 2007–2008 financial crisis. Using a unique dataset of 296 financial firms from 30 countries that were at the center of the crisis, we find that firms with more independent boards and higher institutional ownership experienced worse stock returns during the crisis period. Further exploration suggests that this is because (1) firms with higher institutional ownership took more risk prior to the crisis, which resulted in larger shareholder losses during the crisis period, and (2) firms with more independent boards raised more equity capital during the crisis, which led to a wealth transfer from existing shareholders to debtholders. Overall, our findings add to the literature by examining the corporate governance determinants of financial firms' performance during the 2007–2008 crisis.

1. Introduction

An unprecedented large number of financial institutions collapsed or were bailed out by governments during the global financial crisis of 2007–2008.[1] The failure of these institutions resulted in a freeze of global credit markets and required government interventions worldwide. While the macroeconomic factors (e.g., loose monetary policies) that are at the roots of the financial crisis affected all firms (Taylor, 2009), some firms were affected much more than others. Recent studies argue that firms' risk management and financing policies had a significant impact on the degree to which firms were impacted by the financial crisis (Brunnermeier, 2009). Because firms' risk management and financing policies are ultimately the result of cost–benefit trade-offs made by corporate boards and shareholders (Kashyap et al., 2008), an important implication from these studies is that corporate governance affected firm performance during the crisis period.

In this paper, we provide empirical evidence on whether, and how corporate governance influenced the performance of financial firms during the crisis period. We examine in particular the role of independent directors and influential shareholders. We perform our investigation using a unique dataset of 296 of the world's largest financial firms across 30 countries that were at the center of the crisis. We examine the relation between firm performance and corporate governance by regressing stock returns

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[1] The list of casualties includes Bear Stearns, Citigroup, Lehman Brothers, Merrill Lynch (in the U.S.), HBOS and RBS (in the U.K.), and Dexia, Fortis, Hypo Real Estate and UBS (in continental Europe).

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during the crisis on measures of corporate governance and control variables. We capture stock returns during the crisis as buy-and-hold returns from January 2007 to September 2008 or to the date on which the firm was delisted, whichever is earlier. We include three corporate governance factors: (1) board independence, (2) institutional ownership, and (3) the presence of large shareholders, measured as of December 2006. In addition, we control for a dummy indicating whether a firm is cross-listed on U.S. stock exchanges, leverage, firm size, and dummy variables indicating a firm's industry and country.[2] Finally, we control for stock return in 2006 because the performance during the crisis period may reflect a reversal of pre-crisis performance (Beltratti and Stulz, 2010).[3]

Our analysis shows that firms with more independent boards and greater institutional ownership experienced worse stock returns during the crisis period. A potential explanation for this finding is that independent directors and institutional shareholders encouraged managers to increase shareholder returns through greater risk-taking prior to the crisis. Shareholders may find it optimal to increase risk because they do not internalize the social costs of financial institution failures and institutional arrangements such as deposit insurance may weaken debtholder discipline. In addition, because of their firm-specific human capital and private benefits of control, managers tend to seek a lower level of risk than shareholders (Laeven and Levine, 2009). Consistent with this view, DeYoung et al. (forthcoming) find that in the years leading up to the financial crisis (2000–2006), banks changed CEO compensation packages to encourage executives to exploit new growth opportunities created by deregulation and the explosion of debt securitization.

We test the risk-taking explanation by regressing expected default frequency (EDF) and stock return volatility on the governance factors and the same set of control variables.[4] We find mixed support for this explanation. In particular, while we find that firms with greater institutional ownership took more risk before the crisis, we do not find that firms with more independent boards did so. Thus, our findings are inconsistent with independent board members having encouraged managers to take greater risk in their investment policies before the onset of the crisis.

An alternative explanation for the negative relation between stock returns and board independence is that independent directors pressured managers into raising equity capital during the crisis to ensure capital adequacy and reduce bankruptcy risk. Capital raisings at depressed stock prices may have led to a significant wealth transfer from shareholders to debtholders during the crisis period (Kashyap et al., 2008; Myers, 1977). Consistent with this wealth transfer, we find negative abnormal stock returns and abnormal decreases in credit default swap (CDS) spreads in the 3-day window around the announcement of equity offerings.[5] To test our alternative explanation for the relation between stock returns and board independence we regress the amount of equity capital raised during the crisis (scaled by total assets) on the corporate governance factors and control variables. Consistent with this alternative explanation, we find that firms with more independent boards raised more equity capital. Moreover, we find that the association between stock returns and board independence becomes insignificant once we exclude firms that raised equity capital during the crisis from our sample.

While equity capital raisings may have led to poor performance during the crisis, they also may have helped firms survive the crisis and perform better after the crisis. We investigate this issue by performing additional analyses in which we examine whether equity capital raisings had a positive impact on the likelihood that a firm survived the financial crisis and firm performance over the long run. Consistent with equity capital raisings helping firms survive the crisis, we find that firms that raised more equity capital were less likely to be delisted during the crisis than firms matched on pre-capital raising performance. However, inconsistent with equity capital raisings helping firms perform better over the long run, we find that equity capital raising firms perform similarly to the matched firms in the period subsequent to equity capital raisings. One possible explanation is that regulatory interventions such as the Troubled Asset Relief Program (TARP) may have attenuated the positive effect of equity raisings on firm performance in the long run.

Although we focus on firm-level governance mechanisms, we also examine how country-level governance mechanisms, such as the quality of legal institutions and the extent of laws protecting shareholder rights, influenced firm performance during the crisis. We find an insignificant relation between firm performance and the country-level governance variables. This evidence is consistent with firm-level, but not country-level governance mechanisms being important in explaining why some financial firms were much more affected by the financial crisis than others.

One concern for our analysis is that our corporate governance measures are correlated with some other firm characteristic that is not included in our model, but that has an important influence on financial firms' performance during the crisis period. The

[2] We do not control for a dummy variable indicating whether a firm has a Big N auditor as in Mitton (2002) because only five of our sample firms have non-Big Four auditors. As reported in Section 4, our result is not sensitive to excluding firms with non-Big Four auditors or including a dummy variable indicating a Big Four auditor.

[3] We do not control for country-level regulatory and macroeconomic variables (as in Beltratti and Stulz, 2010) because this will introduce perfect multicollinearity with our country dummies. By controlling for country dummies in our regression model, our analysis essentially examines how the cross-sectional within-country variation in firm performance is related to within-country variation in corporate governance characteristics. In addition, since our sample consists of all financial institutions including not only banks, but also brokerage and insurance companies, we do not include the bank-specific financial statement variables (such as deposits or loans) used in Beltratti and Stulz (2010). Instead, our model addresses differences in balance sheet characteristics and capital requirements across global financial institutions by controlling for leverage, industry dummies (3-digit SIC), and country dummies.

[4] EDF is computed by Moody's KMV CreditMonitor implementation of Merton's (1974) structural model and has been used in prior studies to capture credit risk (Covitz and Downing, 2007).

[5] CDS is an “insurance” contract against the risk of default, in which the buyer makes a series of payments in exchange for the right to receive a payoff in case of default by the referenced entity. The more likely a firm is to default on its debt obligations, the higher a firm's CDS spread.