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Is corporate governance relevant during the financial crisis?☆

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ABSTRACT

We study the impact of internal corporate governance on performance during the current financial crisis for a comprehensive cross-country sample of 4046 publicly traded non-financial firms from the U.S. and 22 developed countries. Using a broad-based index of corporate governance quality, we find that well governed firms do not outperform poorly governed firms. We explore three potential explanations for the lack of significant impact of corporate governance quality on performance. First, we examine whether cross-country differences in institutional development have an impact on the effect of corporate governance on performance. Second, we investigate whether a narrowing down of the informationally efficient segment of the stock markets during the crisis can explain the results. We do not find support for either of these conjectures. Finally, we examine whether stock markets generally became less efficient in incorporating firm-specific information into stock prices during the crisis. Our empirical evidence is consistent with the latter view that during the crisis stock markets in developed countries became less efficient in incorporating firm-specific information into prices.

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1. Introduction

The current global financial crisis (GFC) has been compared to the Great Depression of the 1930s. Some economists such as Paul Krugman view the current crisis as being milder than the Great Depression basing their opinions on the relative fall in the US industrial production compared to the late-2007 peak [Krugman, 2009]. Other economists, most notably Eichengreen and O'Rourke (2009) take a global perspective and view the current crisis as comparable to the Great Depression if not worse. Although the crisis originated in the financial sector, it affected major stock markets around the globe, typically losing close to half of their value. This stock market meltdown constituted a major stress test for the market-oriented corporate governance models propounded and pursued by many advanced economies of the world.

There has been some suggestions that the current corporate governance system failed the test. For instance, a report commissioned by Organisation for Economic Co-operation and Development (OECD) steering group on corporate governance, Kirkpatrick (2009), concludes that the current global financial crisis can be "attributed to failures and weaknesses in corporate governance arrangements" in financial services companies. An op-ed piece by a prominent head of corporate governance at California Public Employees' Retirement System (CalPERS) suggested that "the governance deficit . . .undoubtedly exacerbated the scale and depth of the financial crisis" and "financial crisis exposed many boards as weak and incompetent" [Simpson, 2009]. Others such as Cheffins (2009) take a more benign view. Cheffins (2009) studied the case of 37 companies that were removed from the S&P 500 index in 2008 with particular reference to their corporate governance. He concludes that corporate failures outside the financial sector were largely fraud-free and that in various key aspects corporate governance operated satisfactorily.

While the link between corporate governance and firm performance has been extensively studied in the finance literature [Brown and Caylor, 2006], the critical question is whether the quality of corporate governance has an impact on the performance of firms during the crisis. Prior studies by Johnson et al. (2000) and Mitton (2002) related to the Asian financial crisis of late 1990s find that corporate governance was extremely relevant and that there was a "flight to quality" firms, in particular in emerging markets. As for the recent crisis, studies examining the link between corporate governance and performance focus mainly on banks and other financial firms. Fahlenbrach and Stulz (2011) find that banks with CEOs whose incentives are better aligned with shareholders' interests performed worse during the financial crisis. Furthermore, banks with higher option compensation for their CEOs did not perform worse during the crisis. Using a cross-country sample, Beltratti and Stulz (2010) find that banks with more shareholder friendly boards performed significantly worse during the crisis than other banks. Erkens et al. (2010), using a cross-country sample of financial institutions, find that firms with more independent boards and higher institutional ownership experienced worse stock returns during the crisis period. Chesney et al. (2010) find that financial institutions whose CEOs had strong risk taking incentives, weak ownership incentives, and independent boards had the highest write-downs both in absolute terms and relative to total assets. The only study on non-financial US firms, Francis et al. (2010), finds that firms with "true independent" boards, where outside directors are less connected with current CEOs, perform better during the crisis as compared to other firms.

However, there is a paucity of work on the impact of broadly defined good governance on performance of firms during the crisis, especially in the global context. Therefore, in this paper, using a broad-based index of the quality of corporate governance, we examine whether companies that are characterized as "good governance" firms perform better than "bad governance" firms during the global financial crisis, ceteris paribus The central issue that we are interested in is whether corporate governance matters during financial crises. There is as yet, to the best of our knowledge, no work relating overall firm-level corporate governance and performance of non-financial firms during the current crisis that encompasses a comprehensive global sample. While the study by Francis et al. (2010) that examines the relevance of one particular corporate governance attribute, board independence, for one country, namely the U.S., there is no study examining the relevance of a broad-based measure of corporate governance quality on performance on a global basis. Our work fills this void.

We examine the relationship between internal corporate governance and performance during the crisis, measured by buy-and-hold stock returns, for a cross-country sample of 4046 publicly traded

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