Journal of Corporate Finance 18 (2012) 311–330

Contents lists available at SciVerse ScienceDirect

Journal of Corporate Finance

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

Does property rights protection affect corporate risk management strategy? Intra- and cross-country evidence ☆

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ARTICLE INFO

Article history:
Received 31 August 2011
Received in revised form 21 December 2011
Accepted 23 December 2011
Available online 3 January 2012

JEL classification:
G32
G38
D23

Keywords:
Property rights protection
Banking
Risk management

ABSTRACT

Recent studies in the law and finance literature have shown that property rights protection is central to corporate financing and investment decisions and economic growth at large. We extend this literature by examining the effect of property rights security on corporate risk management decisions — an important element of a firm's business strategy. Using a unique dataset covering over 55,000 Chinese firms and employing both institution- and firm-level measures of property rights security, we find that secure property rights lead to higher corporate demand for property insurance, suggesting that property rights security is an important determinant of corporate risk management decisions. The effect of property rights protection on insurance consumption is also validated by a cross-country analysis that uses data from 93 countries over the period 1995–2008. Our study sheds light on the importance of property rights protection to corporate risk management decisions.

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1. Introduction

Property rights are a fundamental concept in the economics and finance literature. As pointed out by Levine (p.61, 2005), "the security of property rights … is not a natural occurrence; rather it is an outcome of policy choices and social institutions." Recent studies show that good legal environments that provide strong property rights protection and contract enforcement reduce cost of capital, enhance corporate governance, firm valuation, reinvestment rates, assets allocation, corporate innovation, firm growth and thereby economic growth (e.g., Acemoglu et al., 2001; Acemoglu and Johnson, 2005; Beck et al., 2003; Beck et al., 2005; Besley, 1995; Chen et al., 2009; Claessens and Laeven, 2003; Cull and Xu, 2005; Johnson et al., 2002; La Porta et al., 1998, 2002; Lin et al., 2010; Shleifer and Wolfenzon, 2002). Using a unique large corporate property insurance dataset covering more than 55,000 manufacturing firms in China and following the framework of Cull and Xu (2005) and Levine (2005), we add to this line of research by empirically testing the effect of property rights security on corporate risk management — an important

☆ Authors listed alphabetically. We thank Jeffry Netter (the editor) and an anonymous reviewer for very constructive comments. We also thank Mike Adams, Steve Diacon, Arthur Hau, Stan Hoi, Jiahui Lu, Damian Ward, Jason Xiao, Tong Yu, Steve Young, Rongli Yuan and participants at the seminar held at City University of Hong Kong and Southwestern University of Finance and Economics, and the All China Economics International Conference for helpful suggestions on the paper. Chen Lin and Ping Lin acknowledge the financial support from Chinese University of Hong Kong and financial support from Lingnan University (Grants DR05A2 and DR07B2, respectively). Zou acknowledges the financial support of City University of Hong Kong. Research assistance of Wanbin Pan and Leo Zhang is appreciated.

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doi:10.1016/j.jcorpfin.2011.12.006

element of a firm's overall business strategy (Guay and Kothari, 2003, p.423) but has been generally neglected so far in the law and finance literature. Bankruptcy is one of the major risks facing businesses and their investors and hence corporate risk management is of paramount importance in preventing financial distress and bankruptcy.

The study also adds to the existing literature of corporate risk management. The extant literature strives to explain why firms undertake risk management activities since risk management should be irrelevant in a classic Modigliani and Miller (M&M) world without market imperfections. In the real world with market imperfections, scholars have identified several important determinants of corporate risk management activities such as the expected cost of financial distress (e.g., Mayers and Smith, 1982; Smith and Stulz, 1985), tax incentives (e.g., Frestad, 2010; Mayers and Smith, 1982; Smith and Stulz, 1985), underinvestment and predation risk (e.g., Froot et al., 1993; Haushalter, 2000), and managerial risk aversion (e.g. Smith and Stulz, 1985). Our study adds to this strand of literature by showing, for the first time, that property rights security is a new important determinant of corporate risk management decisions. By doing so, it also contributes to the broader corporate hedging and risk management literature, which examines the causes and consequences of various hedging mechanisms such as financial derivatives and corporate cash holdings (e.g., Fauver and Naranjo, 2010; Kuersten and Linde, 2011; Kusnadi and Wei, 2011).

Due to scarcity of data on corporate use of insurance, the corporate risk management literature normally takes the use of derivatives as a proxy for corporate hedging.[1] The existing corporate risk management literature assumes that firms use derivatives purely for hedging purposes (Guay and Kothari, 2003). However, managers may also engage in selective hedging or speculation with derivatives though this is rarely successful. Géczy et al. (2007) report that investors often are unable to discern the speculation activities from the financial disclosures. Unlike derivatives, insurance cannot be used for speculation and therefore it provides a cleaner testing ground for the relation between property rights security and corporate risk management (Adams et al., 2008; Aunon-Nerin and Ehling, 2008). As pointed out by MacMinn and Garven (2000), insurance represents a simple and widely used corporate risk management tool and the corporate property–casualty insurance (P/C insurance) premiums typically exceed dividend payments by an order of 30–40%. In 2004, property–casualty insurance premiums amounted to US$1395 billion globally. Indeed, Mayers and Smith (1982) and Smith (1986) conclude that insurance is an integral part of corporate financial policies. As such, evidence on the linkage between property rights security and corporate insurance is of significant managerial and policymaking implications.

There is a close theoretical linkage between corporate risk management via insurance purchases and property rights security. Corporate insurance is a contractual transfer of risks where the insurer agrees to reimburse the insured firm losses arising from specified accidental events (e.g., a fire). Property rights protection provides firms with the right to own assets, to benefit from the income generated from those assets, to dispose of the assets, and to seek compensation for any damages to such assets caused by third parties. The value of the insurance contract thus hinges on the degree of property rights protection afforded by legal rules and contract enforcement. Moreover, secure property rights lead to more corporate investments and thereby better growth opportunities (Besley, 1995; Cull and Xu, 2005) and this further provides a rationale for corporate risk management (e.g., via insurance) in order to mitigate the underinvestment problem (Froot et al., 1993). The important linkage between property rights security and insurance purchase, however, has rarely been tested, due to the paucity of corporate insurance data. Using a country-level dataset, Esho et al. (2004) is the only study that shows a positive relation between a country's protection of property rights and its aggregate property–casualty insurance consumption. Our study is the first to examine the relation between variations in property rights security and the purchase of insurance at the *firm-level*. This is important as Beck et al. (2006) argue that one needs to control for firm-specific characteristics to draw appropriate inferences about the relationship between institutions and firm behavior (e.g., risk management in our case).

China represents a unique environment within which to investigate the relation between property rights and corporate insurance because of the following salient features. First, property insurance is a common and major commercial risk management tool for companies in China because of the general lack of risk management expertise among Chinese firms and/or the relatively low safety standard.[2] By purchasing an insurance policy, the insured firm not only obtains loss coverage but also the insurer's services on loss prevention and control. According to Swiss Re (2004), property–casualty insurance premiums in China amounted to US $16.77 billion in 2004, with roughly 65% derived from corporate purchases.

Second, while extant risk management studies typically examine either corporate use of derivatives or insurance in managing risks, we recognize that firms may manage overall risks in a coordinated way with more than one commercial tool (e.g., both insurance and derivatives uses). Failure to take account of the interaction among different risk management tools may lead to a biased inference on the effect of using a particular tool (Allayannis and Weston, 2001). This possibility, however, is minimized in China because China does not have developed financial derivatives markets. Therefore, in this regard, China represents a cleaner setting for our investigation.

[1] Corporate disclosure requirement has made derivative use data readily available in many countries, whereas there is no similar requirement concerning the purchase of insurance. While numerous studies have empirically examined the determinants of derivative use, investigations of corporate risk management via insurance purchases have been relatively sparse. Only several studies (e.g., Aunon-Nerin and Ehling, 2008; Hoyt and Khang, 2000; Mayers and Smith, 1990; Regan and Hur, 2007; Zou and Adams, 2006) have examined the determinants of corporate insurance. These studies typically use a sample of several hundred listed firms and invariably focus on firm characteristics in explaining the corporate purchase of insurance. None of them has focused on the importance of property rights security. In contrast, our study uses a sample of about 56,000 firms and examines the roles of both firm-specific characteristics and external institutional factors (e.g., property rights protection, legal and financing environment, economic development) in corporate insurance decisions.

[2] Property insurance covers accidental asset losses and is normally valid for one year and renewable upon mutual agreements between the insured and the insurer. The purchase of property insurance in China is voluntary (Zou and Adams, 2006).

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