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Investor protection rights and foreign investment ☆

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ABSTRACT

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Different investor classes are endowed with different rights, and conflicting interests among them can make protection afforded to one party detrimental to another. We find that investor protection laws have sizeable "cross" effects on foreign portfolio investment and the direction of these effects supports the conjecture that foreign investors are particularly sensitive to the perceived riskiness of assets. Specifically, we find that strong protection of creditor rights – limiting excessive risk taking – positively affects foreign shareholders, whereas strong protection of shareholder rights – potentially shifting firms toward riskier projects – negatively impacts foreign bondholders. These findings, on the one hand, emphasize that strengthening investor protection is not a universally desirable policy; on the other hand, they provide a rationale for the failure of convergence toward any successful standard of effective investor protection. The degree of protection enjoyed by investors in each country is indeed endogenously determined by the balancing of many forces. Among them, the political choice to promote inward investment and to favor particular categories of investor may play an important role. *Journal of Comparative Economics* **41** (2) (2013) 506–526. Center for Research on Pensions and Welfare Policies-Collegio Carlo Alberto (CeRP-CCA), Via Real Collegio 30, 10024 Moncalieri (Torino), Italy; University of Torino, Faculty of Economics, Corso Unione Sovietica 218/bis, 10134 Torino, Italy.

1. Introduction

This paper investigates the impact of investor protection rights on cross-border investment. Since domestic sources of outside finance are limited in many countries around the world (Giannetti and Koskinen, 2010), foreign capital has become increasingly important (Bekaert et al., 2002). In this respect, corporate governance, with its peculiar role of facilitating access to external finance through reduction of information asymmetry (La Porta et al., 1998; LLSV, 1998, henceforth), can be critical in attracting foreign portfolio investment. Indeed, in the presence of information barriers, domestic investment appear, other things equal, more attractive to investors that indeed display a strong preference for domestic assets. Corporate governance can partially offset this lack of information by signaling the quality of the institutions in terms of rights guaranteed to the investor and thereby foster international diversification.

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Standard asset pricing models using a representative agent predict that differences in investor rights and financial development should be capitalized in share prices such that investing in any given nation's stocks will be a fair investment regardless of that nation's level of investor protection (Dahlquist et al., 2003). However, as noted by Leuz et al. (2009), the key question is whether this price discount is sufficient for foreign investors that plausibly face information problems and monitoring costs beyond those of domestic investors. Indeed, the prevalence of disproportionate investment in domestic assets – the so-called "home bias" puzzle – can be read as evidence of the asymmetric perception of asset characteristics by home and foreign investors thus breaking the representative agent hypothesis (Gehrig, 1993; Kang and Stulz, 1997).

Dahlquist and Robertsson (2001) and Kang and Stulz (1997) emphasize that large, financially solid, well-known firms are preferred by foreigners, thereby underlining the asymmetry between resident and foreigner investors. Chan et al. (2005) investigate the determinants of foreign and domestic investment, finding that familiarity and variables capturing investment barriers have a significant but asymmetric effect on domestic and foreign bias. This evidence is consistent with the conjecture that foreign investors are more vulnerable to information asymmetry than domestic investors; hence, they might be more influenced by governance rules that reduce information costs.

In this work, we are interested in the impact of investor protection laws on stock and bond portfolios held by foreign investors.[1] This effect cannot be directly observed from market price or total market capitalization, since these indicators capture only aggregate equilibrium behavior.

Previous work originating from LLSV (1998) underlines how investor protection affects financial market development, that is, the supply of equity, leaving the demand side mostly unexplored.[2] This latter perspective is relevant insofar as we account for heterogeneity across investors. For instance, Giannetti and Koskinen (2010) show that investor protection impacts financial market development by influencing the demand for equity, because different classes of investor can differ in the benefits accruing to them and therefore in their willingness to pay for stocks. Specifically, controlling shareholders can gain access to both private and security benefits and thus be willing to pay more for a stock than investors who can enjoy only security benefits. These authors' theoretical model provides valuable testable implications with respect to home bias and stock market participation rates. However, they assume that domestic and foreign outside investors face the same cost of participation in both domestic and foreign markets. This hypothesis is quite strong and at odds with the prolific empirical literature emphasizing the role of asymmetric information as a potential explanation for the home bias puzzle.

Our contribution can be viewed as complementary to Giannetti and Koskinen (2010): while they split the universe of investors into inside and outside investors we focus on outside investors only, in order to test how corporate governance affects foreign portfolio investors. A perspective closer to ours, though at the firm-level, is taken by Leuz et al. (2009). They maintain that foreign investors are at an informational disadvantage relative to local investors and that these information asymmetries are particularly pronounced when it comes to evaluating firms' governance and ownership structures. They find indeed that foreigners invest less in firms with poor outsider protection and opaque earnings because firms with potentially problematic governance structures are particularly taxing to foreign investors in terms of their information and monitoring costs.

We depart from previous works in that we investigate the effect of investor protection laws on foreign portfolio investment – debt and equity portfolios – accounting for the interaction of various governance mechanisms on stakeholders endowed with different rights and interests.

More specifically our analysis accounts for the conflicting interests of the various stakeholder groups. Within the corporation, the distinct interests of managers, stockholders and creditors coexist and are often in conflict with one another. As a consequence, legislation particularly favorable to one type of stakeholder turns out to be detrimental to others.

Shareholder-manager conflicts have received much attention in the literature, but important sources of conflict can also arise between shareholders and bondholders. The corporate governance literature has analyzed the complex mechanisms of conflicts of interest between shareholders and creditors, suggesting that the potential conflict between equity and debt claimants lies primarily in wealth expropriation and risk shifting (Jensen and Meckling, 1976). These conflicts can give rise to intricate effects on portfolio decision making on the part of foreign investors that are particularly sensitive to information asymmetry issues. Specifically, strong shareholder rights protection are likely to benefit foreign shareholders ("direct" effect) but may also deter foreign bondholders ("cross" effect) as shareholders are more prone to risk-taking activities than is optimal for creditors (Myers, 1977; Jensen and Meckling, 1976). Creditors might indeed be more in line with managers, who may be more concerned with their own job security and so choose to undertake less risky projects. On the other hand, strong creditor rights are likely to attract foreign bondholders ("direct" effect) but may deter stock investments ("cross" effect) if firms are induced to engage in risk-reducing processes such as acquisitions that are likely to be value-destroying (Acharya et al., 2011).

Ultimately, the question of the impact of investor protection provisions on foreign investors, the focus of the present paper, is an empirical one and depends on foreigners' perception of the balance among various interests. Our results highlight that laws protecting the interests of different types of investors asymmetrically affect foreign stakeholders and, more specifically, that foreign portfolio investors highly value corporate governance practices that are risk-reducing. Foreign shareholders appear to appreciate strong creditor rights that potentially mitigate the riskiness of projects, while bondholders are negatively affected by strong shareholder rights that could induce the firm to engage in risky asset investments.

[1] We ignore any direct explanation relative to the home bias phenomenon and focus on the determinants of foreign positions. See Giannetti and Koskinen (2010) for a discussion of the implications of minority investor rights on home equity bias.

[2] For an extensive synthesis of the finance and law literature, see Beck and Levine (2004). For an empirical critique of the predictions of the theory of law and finance, see Graff (2008).