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Financial crisis and the dynamics of corporate governance: Evidence from Taiwan's listed firms

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ABSTRACT

This study complements the governance literature by investigating how Taiwan listed firms adjusted their governance structure to cope with the 2008 financial crisis. The results from the principal component analysis (PCA) suggest that there are significant differences in the factor scores, such as Board Power (of the Largest Shareholders), Information Transparency and Related Party Transactions; the changes in a firm's operating performance are associated with the changes in the scores of the governance factors during the financial crisis. The empirical evidence shows that Taiwan's listed firms adopted new governance structures to better cope with the challenges associated with the financial crisis in 2008.

1. Introduction

Corporate governance is an integrated set of internal and external control mechanisms designed to enable the shareholders to exercise appropriate oversight of a company to maximize firm value and ensure that the firm generates a return on their holdings (Berle & Means, 1932; Tirole, 2001; Williamson, 1984). Previous studies on corporate governance have generally investigated comparative static predictions linking firm performance to various governance dimensions, including: board characteristics,[1] ownership structures[2] and CEO compensation.[3] Recent studies have begun to examine how governance adapts to environmental changes to maintain the survival and success of firms (Agrawal, Jaffe, & Karpoff, 1999; Bethel & Liebeskind, 1993; Gilson, 1990; Kole & Lehn, 1997, 1999; Perry & Shivdasani, 2005; Rennie, 2006; Scholten, 2005). These studies find that firms in a rapidly changing business environment tend to adjust their governance structure toward the predictions of agency theory.

However, previous studies do not address how or whether governance adapts to sudden environmental changes, such as financial crises. During the stock market crash, corporations found it difficult to access capital markets to acquire external financing (Kroszner, Laeven, & Klingebiel, 2007). In addition, investors became more pessimistic about the market and were also more conservative in their consumption and investment behavior. Facing tough, rapid changes in the business environment during the financial crisis, firms had to adjust their governance structures and strategies to ensure survival. This study thus investigates how firms changed their governance structures to cope with the financial crisis of 2008, as well as the association between these structural adjustments and firm performance during the financial crisis.

The empirical results indicate that the financial crisis triggered the need for firms to adopt new governance structures to better cope with the challenges of the changed business environment. Governance structures adopted during the financial crisis include:

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[1] See, for example, Brickley, Coles, and Jarrel, (1997), Fama and Jensen (1983), and Monks and Minow (1995).

[2] See, for example, Demsetz and Lehn (1985), Hermalin and Weisbach (1991), Hubbard and Palia (1999), McConnell and Servaes (1990), and Morck, Shleifer and Vishny (1988).

[3] See, for example, Bizjak, Brickley, and Coles (1993), Datta, Iskandar-Datta, and Raman (2001), Fama and Miller (1972), and Jensen and Murphy (1990).

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a lower ratio of director and supervisor positions held by the largest shareholders, a higher percentage of outside directors serving on the board, a lower percentage of shareholding by the largest outsider, a lower percentage of founders serving as supervisors, a higher percentage of purchases from a related party, a lower percentage of loans to a related party and better information transparency. This study also implements exploratory principal component analysis (PCA) to identify eight governance factors which represent different dimensions or structures of corporate governance, and compares the differences in factor scores pre- and post-financial crisis. The results indicate that several governance factors exhibit significant differences in their factor scores during the financial crisis. Finally, this study also finds that Compensation, Board Power (of the Largest Shareholders), Control Rights, Leadership, Information Transparency, and Related Party Transactions are important governance factors that are significantly associated with the operating performance of Taiwan's listed companies during the financial crisis.

This study makes three contributions to the literature. First, it complements the governance literature by investigating the dynamics of the governance structure of Taiwan listed firms during the 2008 financial crisis. Although the literature documents the fact that firms adopt new governance systems to comply with sudden changes in the business environment, such as industry deregulation, these studies mainly focus on single industry firms in a deregulated industry. The effect of deregulation in one industry may not apply to other industries due to their differences (Kim & Prescott, 2005; Winston, 1998). Therefore, the knowledge gained from investigating the effect of deregulation in one industry cannot be comprehensively applied elsewhere to understand the association between the dynamics of the governance structure and the effect of the financial crisis. This study thus fills a gap in the literature. Second, this study uses principal component analysis to identify a set of governance factors. It systematically investigates the dynamics of the governance structure of Taiwan listed firms, and examines the association between the change in governance factors and the changes in firm performance during the financial crisis. Many previous studies show that better governance mechanisms help to mitigate agency problems and lead to higher firm performance.[4] To the best of our knowledge, no study has investigated the dynamics of governance structure and its association with changes in firm performance. Our analysis provides direct evidence on the linkage between the dynamics of governance and firm performance. Third, the corporate governance environment in Taiwan, in which firms are typically controlled by family members or controlling shareholders, is quite different from governance structures in the US or the UK. Studying how controlling shareholders respond to a financial crisis, as well as whether they expropriate the wealth of minority interests, complements the governance literature.

Although not focusing on the dynamics of governance structures, several related papers have considered the effect of governance on firm value during a financial crisis. Examining the extent of exchange rate depreciation and stock market decline for 25 emerging markets during the Asian financial crisis, Johnson, Boone, Breach, and Friedman (2000) present evidence that corporate governance, especially the protection of minority shareholder rights, has a profound effect on the extent of exchange rate depreciation and stock market decline in 1997–1998. Mitton (2002) investigated firms in the five countries most involved in the East Asian financial crisis and found that companies offering higher disclosure quality, greater transparency and a more favorable ownership structure appear to have provided greater protection to minority shareholders during the crisis. Lemmon and Lins (2003), investigating the effect of ownership structure of eight East Asian countries on firm value during the Asian financial crisis, found that ownership structure significantly affected firm value during that period. Specifically, stock returns are lower when managers of firms have a high degree of control rights but a low level of cash flow rights. Baek, Kang, and Park (2004) investigated the governance characteristics of Korean firms and their association with the changes in firm value during the financial crisis. Their results are quite consistent with Mitton's (2002). Our study complements the governance literature view that corporate governance is not only associated with firm performance but also adapts to the changing business environment. Our study, as far as we know, is the first to explore how governance structure adapts to the changing environment surrounding the financial crisis.

The remainder of this paper is organized as follows. The next section develops the hypotheses based on the existing literature; Section 3 discusses the research variables and the methodology. In Section 4, this paper presents the univariate analyses, describes the principal component analysis and reports on the empirical findings. The final section is the conclusion.

2. Literature review and hypothesis statements

How the corporate governance structure adapts to sudden changes in the business environment, such as a financial crisis, has not been systematically examined in the literature. Several studies investigate the effect of industry deregulation and corporate governance adjustment to the new market conditions; they found that firms in the deregulated industries adjust their governance structures to better align managerial interests with those of shareholders because shareholders retake responsibility for monitoring managerial operating strategies, giving management the incentives to act in the best interest of shareholders[5] (Delmas & Tokat, 2005; Hambrick & Finkelstein, 1987; Kim & Prescott, 2005; Kole & Lehn, 1997, 1999; Ovtchinnikov, 2010; Rennie, 2006). Although previous studies have fruitful results, deregulation generally applies only to single industries, limiting their applicability to describing

[4] See, for example, Aggarwal and Samwick (2006), Agrawal and Mandelker (1987), Bizjak et al. (1993), Datta and Raman (2001), Fama (1980), and Fama and Jensen (1983), among others.

[5] Studies argue that government regulation serves as an intermediary in the principal–agent relationship. In a regulated industry, regulatory agents usually play a major role in monitoring managerial actions prior to deregulation (Hubbard & Palia, 1995; Kim & Prescott, 2005; Rennie, 2006; Smith & Grimm, 1987). By removing the restrictions imposed on the regulated industry, the government forsakes its roles of monitoring and disciplining management. The intermediary role of government between shareholders and managers thus vanishes as regulations are relaxed; therefore, deregulation increases the need for shareholders to monitor and discipline management.