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Control/ownership structure, creditor rights protection, and the cost of debt financing: International evidence

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ABSTRACT

We explore the effect of governance on bond yield-spreads and ratings in a multinational sample of firms. We find strong evidence that ultimate ownership (i.e., the voting/cash-flow rights wedge) and family control have a positive and significant effect on bond yield-spreads, and a negative and significant effect on bond ratings. Control in the hands of widely held financial firms has a positive effect on bond ratings *only*, while State control has no effect on either bond yield-spreads or ratings. We also find that a higher protection of debtholders' rights generally reduces bond yield-spreads and increases bond ratings. Our results additionally show that, for both bondholders and rating agencies, the enforcement of debt laws is crucially important. Finally, we document a negative effect of debt covenants on debt costs when there is a high expropriation risk and poor creditor rights protection.

1. Introduction

Shleifer and Vishny (1997) define corporate governance as "*the ways through which suppliers of capital to corporations assure themselves of getting a return on their investment.*"[1] A large body of empirical research links corporate governance (particularly ownership structure) to the managers–shareholders agency problems (Jensen, 1986; Morck et al., 1989; Walsh and Seward, 1990; Fluck, 1999; among others). However, little attention has been devoted to the shareholders–bondholders agency conflict. Indeed, as Jensen and Meckling (1976) show, shareholders may expropriate wealth from bondholders by undertaking risky new projects that will allow them to reap most of the gains, while bondholders bear most of the cost (Klock et al., 2005).

In this paper, we focus on the link between the ultimate ownership of the firm and its bond yield and rating. We look at ultimate ownership along two dimensions: (1) the discrepancy between voting and cash-flow rights of major shareholders, and (2) ultimate shareholder identity. The voting/cash-flow rights wedge measures the extent and the likelihood of expropriation by majority shareholders (Claessens et al., 2000; Faccio and Lang, 2002). Although bondholders may also face the risk that managers behave opportunistically, we choose to focus on the conflict between controlling shareholders and bondholders based on the following rationale: the literature to date shows that, outside the US, ownership structure is highly concentrated (Denis and McConnell, 2003).[2] This evidence makes expropriation by major shareholders more likely in an international setting such as ours. Moreover, managers' opportunistic behaviour is tackled to a large extent by the fact that controlling shareholders usually appoint managers among their relatives (La Porta et al., 1999; Claessens et al., 2000; Faccio and Lang, 2002), thus aligning both parties' interests. This situation in fact increases the likelihood that expropriation by controlling shareholders occurs. Assuming that bondholders anticipate such behaviour, they will require a higher premium, resulting in a higher debt cost.

Previous studies also suggest that the identity of the firms' (ultimate) owners is important to both bondholders and rating agencies. For example, families usually appoint managers among their relatives (see for example Faccio et al., 2001). This collusion

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[1] Shleifer and Vishny (1997, p. 737).

[2] Non-US studies that analyze ownership structure include, among others: Prowse (1992) in Japan, Franks and Mayer (2001) in Germany, Xu and Wang (1997) in China, Valadares and Leal (2000) in Brazil, Faccio and Lang (2002) in West Europe, and Claessens et al. (2000) in East Asia. Denis and McConnell (2003) offer an excellent literature review of this evidence.

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may be perceived by bondholders as an increased risk of expropriation. Their rational response will be to require higher yields. In the same vein, rating agencies are likely to award lower ratings to family firms. However, one could also argue that families are more likely to adopt value-maximizing strategies to ensure the firm's survival given that they intend to pass it on to subsequent generations (Anderson et al., 2003). This behaviour may benefit bondholders and other stakeholders, and may result in lower bond yield-spreads and higher ratings. Which of these two effects will dominate remains an open empirical question that only few studies tried to address (see for example Anderson et al. (2003) on controlling families and Bhojraj and Sengupta (2003) on the impact of institutional ownership, both set in the US). The common ground of these studies is that they use ownership-based measures (generally the direct ownership stake) to assess the power of the main shareholder. In this paper, we use control-based rather than ownership-based measures. The data on the identity of ultimate owners allows us to determine who is perceived by bondholders and rating agencies as ultimately representing a potential risk of expropriation.

Using a multinational sample of debt issuing firms from developed and developing countries, we assess how the quality of the institutional environment conditions the agency cost of debt across institutionally diverse environments. Our study thus contributes to the scarce academic literature on the link between governance mechanisms and the cost of debt financing, and contributes to our understanding of the functioning of fixed income securities' markets around the world. As Shleifer and Vishny (1997) note, empirical research on creditor governance is indeed an under researched area in the corporate governance literature.

While some recent studies analyze the relationship between governance mechanisms and debt costs, (Sengupta, 1998; Bhojraj and Sengupta, 2003; Anderson et al., 2003; Mansi et al., 2004; Ashbaugh et al., 2006), their evidence is drawn from the US, and thus cannot be generalized to other countries with less favourable legal environments. The lack of evidence on this issue is puzzling since debt constitutes an important external source of financing for publicly traded firms around the globe.

This paper adds to the international corporate governance literature on other grounds as well: for instance, the available literature focuses primarily on direct ownership. Our analysis relies instead on ultimate ownership and allows us to control for the extent and likelihood of expropriation by controlling shareholders (i.e., extent of agency conflicts within the firm). Few existing studies look at the potential impact of investor protection and overall quality of institutions in the country on the firms' cost of debt financing. Miller and Puthenpurackal (2002) offer the first empirical evidence on the importance of investor protection in the debt market. The authors analyze the cost of debt for a sample of 260 Yankee bonds issued by non-US firms and report that investors charge higher bond costs to firms that are located in countries with poor investors' rights protection and those that "do not have a prior history of ongoing disclosure." A more recent study by Ellul et al. (2005) provides some evidence on the impact of legal institutions on debt costs by analyzing US firms and foreign firms that issue ADRs in the US. However, such an approach is likely to suffer from a selection bias problem since ADR firms have to comply with (internal) corporate governance standards that are generally imposed by the American legislator and the Securities Exchange Commission (SEC). As a consequence, the firms used in Ellul et al. (2005)'s study are more likely to exhibit a better governance than their local counterparts that do not issue ADRs. Finally, our framework provides us with a valuable opportunity to identify the set of institutions that the legislator needs to adjust to foster the development and well functioning of financial debt markets.

Based on a sample of corporate bond issues in 19 countries from East Asia and Western Europe, we find that the wedge between ownership and control (i.e., our proxy for expropriation) affects significantly both the bond yield and rating. With respect to the controlling shareholder's identity, we find that family control is perceived as a potential risk of expropriation by both bondholders and rating agencies as it loads a positive statistical effect on bond spreads, and a negative statistical effect on bond ratings. Thus, contrary to Anderson et al. (2003) who show that US family firms are seen as a protector of bondholders' rights, our finding suggests that this type of owner is more likely to harm bondholders in other markets. Through their controlling position, families are able to extract private benefits that are costly to all stakeholders, including bondholders. Furthermore, families often avoid ownership dilution in order to keep a tight control over the firm, which leads them to prefer debt to equity financing, hence the higher leverage of such firms. Finally, we find that control in the hands of widely held financial firms affects positively bond ratings (*only*), while State control affects neither bond yields nor ratings.

Next, we analyze the effect of the institutional environment on corporate bond yields and ratings. We consider a large set of national governance mechanisms that encompasses regulatory institutions that previous studies (e.g., La Porta et al., 1998; Dyck and Zingales, 2004; Djankov et al., 2007, 2008) have shown to play a significant role in preserving investors' rights. Our results show that higher investors' (and essentially debt-holders') protection generally reduces bond spreads, and increases corporate bond ratings. However, we document that the creditor rights index (i.e. restrictions that directly protect their rights) does not matter for bond spreads and ratings, while most debt enforcement measures load statistically and economically significant coefficients. This result suggests that both debtholders and rating agencies value debt enforcement rather than the mere existence of debt laws. Thus, *ceteris paribus*, authorities who are seeking to develop bond markets should put more emphasis on the enforcement of laws protecting creditors (for example, by creating credit registries) rather than seek to create and enact new laws for the book.

Finally, the framework of this study offers the opportunity to test whether debt covenants affect the relation between bond yield-spreads and corporate governance. Cremers et al. (2007) find that the impact of a controlling shareholder on bond yield-spreads is smaller for bonds with covenants. The authors conclude that bond covenants could help "in the convergence of shareholders and bondholders interests", and hence reduce the agency cost of debt. We test this hypothesis in an international framework, and we find evidence that in general, protective covenants alleviate the potential risk of expropriation. In fact, the presence of covenants reduces bond yield-spreads by 12.4 bps for firms with higher voting/cash-flow rights wedge. However, covenants seem to be ineffective in reducing spreads if the ultimate owner is a family. Finally, debt convenants mitigate, but do not *totally eliminate*, the spreads in poor creditor rights environments.

We organize the remainder of this paper as follows. Section 2 presents the theoretical framework by describing the relation between corporate governance and the bond yields and ratings. In Section 3 we describe our models, the variable measurements, the sample and data sources, and we provide descriptive statistics. Section 4 discusses our empirical evidence and Section 5 concludes.

2. Corporate governance and the agency cost of debt: Hypothesis development

2.1. Theoretical framework: the agency cost of debt

Recent studies show that lenders do not only rely on the firm's past profitability and on the issue characteristics in order to infer the expected cash flows (and default probability). In fact, investors