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From Financial Markets to Corporate Governance

Steering the capital allocation process and its implications for firm performance and society at large

Research Report – Management Summary

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Management summary

This research is an initiative of the Center for Corporate Governance at Leipzig Graduate School of Management (HHL). It aims to contribute to the debate about how to design, organize and steer efficient capital allocation processes.

Interested in efficient capital allocation, the research start from the observation that in free-market economies capital is allocated in a two-step process: *First*, investors decide on their investments (and thus on the channel through which their capital is assigned to potential uses), *subsequently* management decides on the capital allocation within the firm. As such, this research studies capital allocation on a country-level as well as among the firms.

Key results of the research are as follows:

(1) Starting from a macro-level perspective the research argues that the recent financial crises and the following Great Depression severely impact the economic development in Europe measured by gross domestic product (GDP), investments, unemployment, and inequality.

(2) Despite the fact that a "too large" financial system with "too much leverage" incentivizing excessive risk taking is often considered to be of the focal causes of the financial crises, the research document that the financial system did not decline in size and total credit did actually increase. Credit availability, however, is frequently criticized to be a potential obstacle to future growth.

(3) Interested in what actually facilitates future economic growth, the research hypothesizes – based on a brief literature review – that "*better developed equity markets have a positive impact for various dimensions of a society's economic development, in particular in association with strong institutions, which ensure strong ownership rights and facilitate the exercise of ownership rights by (institutional) investors."* However, the research also acknowledges that, particularly after the financial crisis, this optimistic "finance matters" view has been questioned and it is empirically challenging to provide convincing evidence about the direction of causality regarding the relation of interest between financial system development and economic development.

(4) Against this backdrop, the research provides novel evidence on the classical question about the importance of the financial system and its components for economic development based on [i] a novel dataset covering 98 countries over the years 1975-2016, [ii] advanced econometric methods using dynamic panel analysis with general methods of moments (GMM) estimations, and [iii] for a variety of measures of economic outcome. Thereby, the research follows the well-established literature examining the finance-growth nexus and focusses on the private sector, i.e., measures financial system size by the total of capital provided to the private sector.

(5) Regarding the impact of the financial system and its components on economic growth and economic risk, the research finds that while the overall size of the financial system is not significantly related to these two measures, the components debt market and equity markets are. Thereby, while stock market size has a positive (negative) influence on economic growth (economic risk), debt market size has the opposite effect. Moreover, the observed effects of stock markets become stronger in more developed economies and in economies with more powerful institutions. Overall, these results provide empirical support for the hypothesis that "*better developed equity markets have a positive impact for various dimensions of a society's economic development, in particular in association with strong institutions.*"

(6) Digging deeper the research then examines potential channels through which stock markets may affect economic growth. It finds that stock market size positively affects investment, as measured by capital formation and corporate research and development, and productivity. Again, many of these effects are found to be more pronounced in developed countries and countries with more stringent regulation.

(7) Going beyond growth the research then examines broader implications. Focusing on unemployment and inequality it provides evidence that the stock market contributes negatively to both measures, suggesting that economic growth associated with deeper stock markets does not come at the expense of parts of the society but provides grounds for a more inclusive ecosystem.

(8) Turning to a micro-level perspective the research argues that firm-level corporate governance can improve capital allocation decisions among the firms. Following extensive conceptual corporate governance research, firm-level corporate governance should be able (1) to mitigate managerial self-interest and (2) to provide a counselling function that pressures and supports managers in taking better capital allocation decisions.

(9) While European companies and institutions have given particular attention to develop and encourage improved firm-level corporate governance, firm-level scandals and crises are still recurring. While this questions the proposed benefits of firm-level corporate governance, large longitudinal and multi-country studies investigating this impact are rather limited. This research therefore uses a large longitudinal and multi-country dataset to provide novel empirical evidence on the proposed benefits of firm-level corporate governance.

(10) The research focuses on two major elements of firm-level corporate governance: (1) institutional investors and (2) supervisory boards. In the context of institutional investors, the research follows the view that long-term oriented and active institutional investors have the resources and the willingness to improve capital allocation decisions among the firms through increased monitoring and counselling. In the context of supervisory boards, the research follows the view that the ability for monitoring and counselling of the board is largely determined by the independence of directors.

(11) To analyze the impact of institutional investors and board independence, the research investigates two outcomes that are able to illustrate improved capital allocation decisions within firms: (1) the firm's cost of capital and (2) the firm's strategic uniqueness. Both outcomes are major drivers of a firm's long-term development and allow to provide indications on the two proposed benefits of firm-level corporate governance. Specifically, the firm's cost of capital reflects the information asymmetry between investors and the management, which should be reduced by improved monitoring. Strategic uniqueness indicates the ability to carry out more profound strategic

decisions, which should be enhanced by the counselling function of firm-level corporate governance.

(12) Employing firm-fixed effects regressions on a longitudinal dataset (2004-2016) covering more than 4,000 observations, the research finds that higher ownership of long term oriented and active institutional investors reduces the firm's cost of capital and increases the firm's strategy uniqueness. Regarding board independence, the research further provides empirical evidence that more independence decreases the firm's cost of capital and increases the firm's strategy uniqueness.

(13) Regarding policy implications the research concludes twofold. On the macroeconomic level: First, initiatives strengthening financial markets, and in particular equity markets, to provide long-term capital will be encouraged. Second, initiatives channeling money from the banking and insurance sector to more productive direct investments within the corporate sector should be encouraged.

(14) Specifically, on the macro-level it is suggested to consider an initiative to establish an ecosystem providing capital to young and innovative firms to enable them to grow at a sufficient pace such that they can eventually access the stock market. A crucial issue in that regard is the availability of risk-capital for young firms, partially due to a still fragmented European VC market.

(15) In parallel to a wave of novel corporate governance regulations, the number of listed firms has decreased in many developed economies. This puts the market infrastructure (trading facilities, equity research, broker services) and the market liquidity at risk. Thus, initiatives to stop these developments are needed.

(16) Stock markets provide risk capital to firms, which allows them to engage in innovations. However, in most economies of the world the corporate tax system penalizes equity financing. Tax initiatives, as for instance the "notional interest deduction" in the Belgian tax code, mai help to reduce the discrimination of equity financing vs. debt and could encourage additional investments.

(17) Finally, it is argued that in order to ensure a sufficient supply of capital for the development of stock markets it needs different initiatives

focusing on financial education, tax-incentives for long-term investments, and de- or regulation of financial pension investments. This will not only allow sufficient supply of capital for the development of stock markets, but also help individuals to earn a return on their long-term investments, particularly for retirement savings, as state pension systems will be increasingly unable to provide a reasonable pension level.

(18) On the micro-level, the research provides support for the necessary emphasis of corporate governance policies. Specifically, the results support the emphasis of European institutions on initiatives increasing the rights for shareholders to participate in firm decisions. Similar, our findings provide support for various corporate governance codes that highlight the independence of non-executive directors to ensure an adequate monitoring and counselling by the board.

(19) In addition to that, regarding institutional investors, our results imply that institutions should put additional efforts on providing guidelines for adequate stewardship and on calling for more transparent stewardship guidelines of investors. Another important element that should be encouraged is the active involvement and the exercising of voting rights by institutional investors in annual meetings. The active involvement in annual meetings and the transparency of stewardship guidelines could further help to increase the dialogue between the investor, the firm and other stakeholders (e.g., politicians or labor unions) as well as among different investors.

(20) Finally, regarding board independence, our findings suggest that initiatives should further encourage an active engagement of non-executive[1] directors. This should be particularly relevant, as some directors do not fully exercise their rights and responsibilities to the desired extent. Moreover, discussions, initiatives or regulations regarding board independence should consider its importance for different committees more intensively. The positive impact of independent non-executive directors could even be stronger if not only

[1] In our study, we consider one-tier and two-tier board systems and focus on the independence of non-executive directors. In a two-tier board system, the term non-executive directors refers to the members of the supervisory board and, in a one-tier system, to those directors that do not hold a position in the firm's executive team.

the board as a whole but each board committee possesses and exhibits adequate independence. Finally, as independence is hard to determine from observable characteristics there should be more emphasis on the explanation of each non-executive directors potential to provide independent judgment. Specifically, there should be a clear declaration of the firms on each non-executive directors' potential for independent judgment. A regular evaluation of this potential and the disclosure of the evaluation results could even further improve board effectiveness.