

Global Financial Stability Report

October 2016



**Global Financial Stability Analysis Division
Monetary and Capital Markets Department**



Corporate Governance, Investor Protection, and Financial Stability in Emerging Markets

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The views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management.



Standard disclaimer:

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Motivation

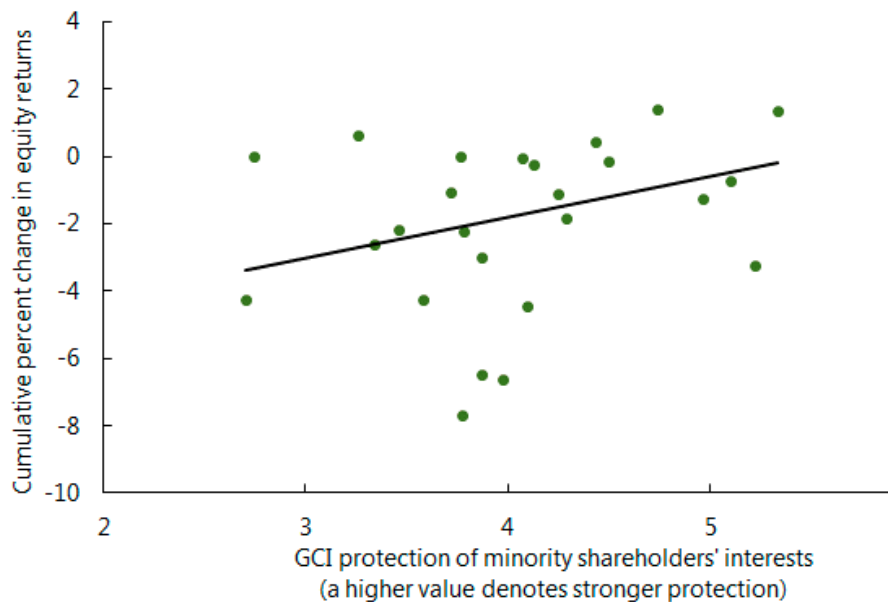
- Emerging markets (EMs) have become more financially integrated...
 - ...allowing greater access to capital...
 - ...but also exposing them to financial shocks.
- With this increased integration...
 - ...have institutional frameworks improved accordingly...
 - ...helping EMs to be more resilient in the face of a potentially more volatile external environment?

Corporate Governance, Investor Protection, and Financial Stability

- Weaker corporate governance can raise financial stability risks by heightening vulnerability to external shocks:
 - Dysfunctional governance associated with expropriation which exacerbated asset price collapses during Asian Crisis.
 - Corporate opacity may amplify price swings.
- Deficiencies in corporate governance and investor protection may play a role in elevating corporate fragility.
 - Outside investors may only be willing to provide financing to weakly-governed companies at shorter maturities.

Governance and Stock Markets

Corporate Governance and Equity Returns *(Cumulative changes in dollar returns during Brexit)*



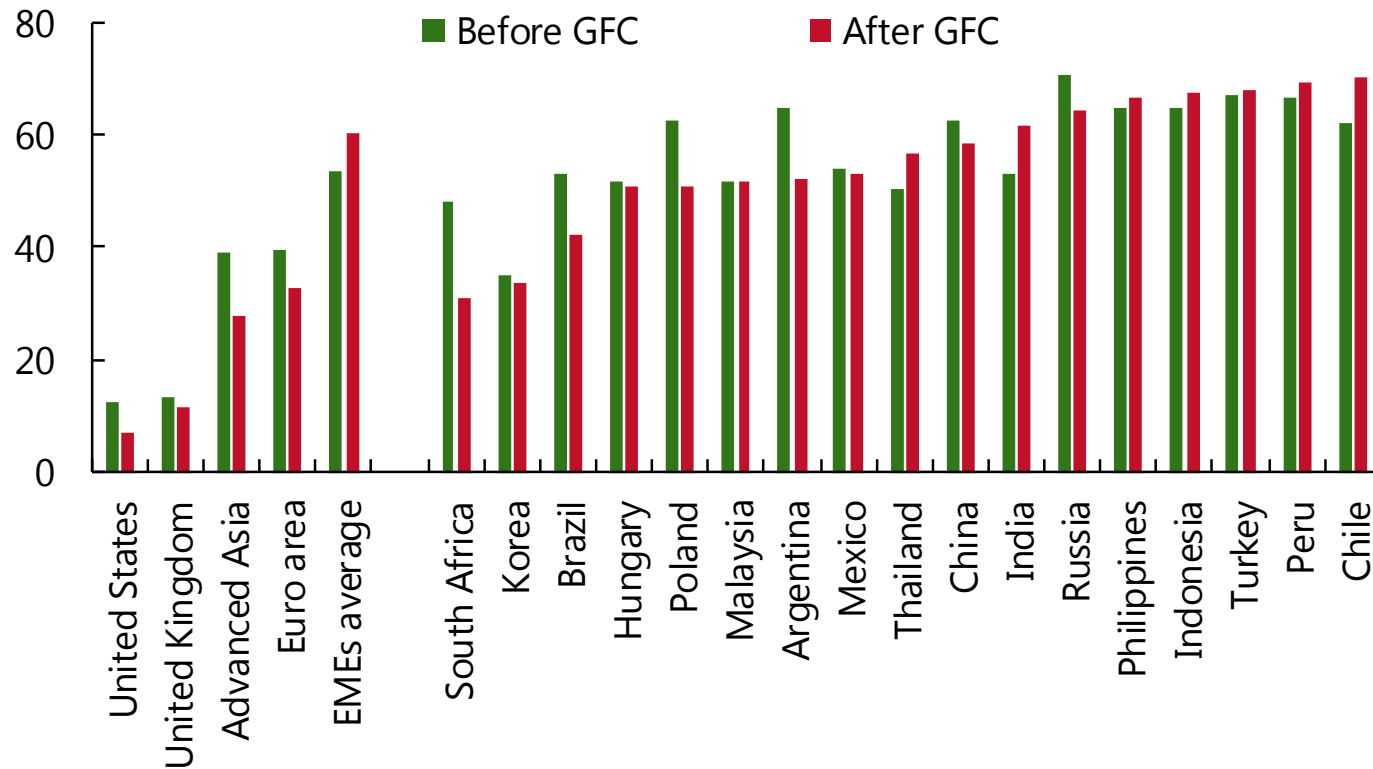
Corporate Governance and Volatility of Stock Market Returns in Emerging Markets *(Market Return Volatility against Minority Shareholder Protection)*



How Do EMs Differ?

Closely Held Shares

(Percent of outstanding shares, market value weighted averages)



Sources: Thomson Reuters Datastream ; and IMF staff calculations.

Questions

- How has governance evolved in emerging market economies, sectors, and firms over the past two decades?
- Are EMs with better corporate governance frameworks less exposed to global financial shocks?
- What is the role of corporate governance and investor protection frameworks in reducing corporate fragility?

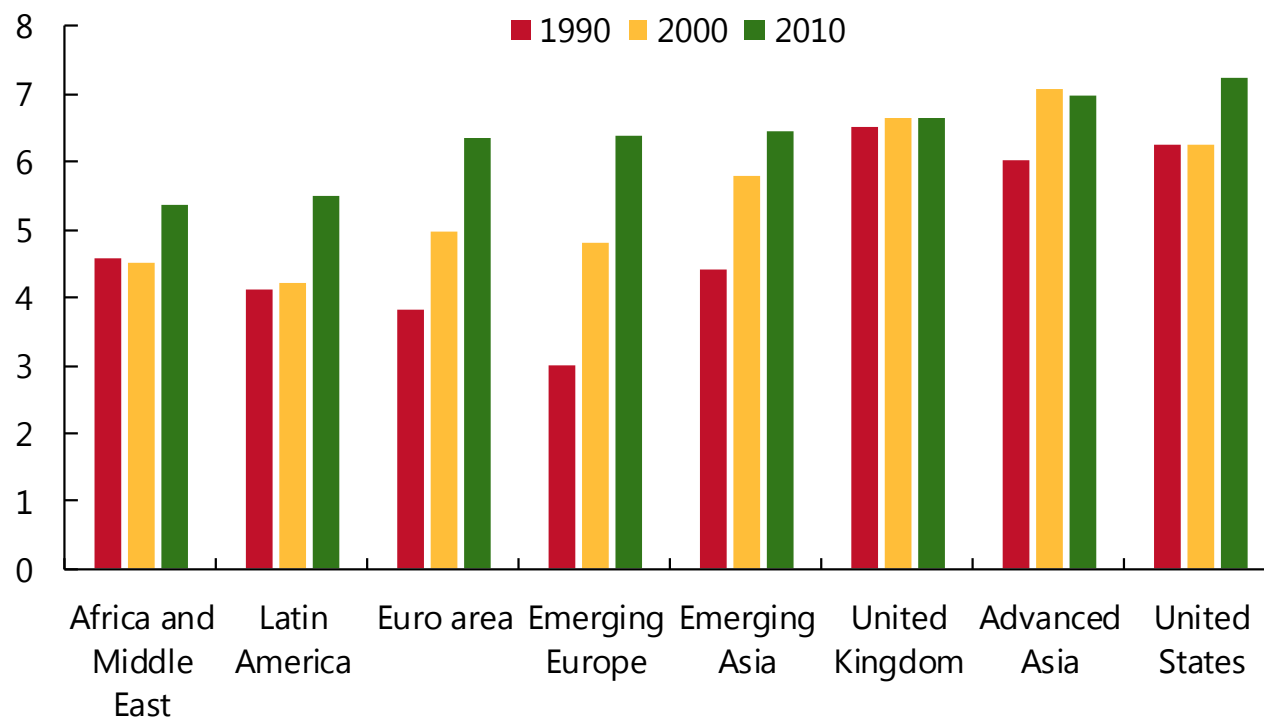
What's New?

- The chapter goes beyond existing studies:
 - Focuses on the link between corporate governance, investor protection, and financial stability
 - Develops new firm-level indices of governance for a panel of emerging market economies...
 - ...link to financial systems' volatility, corporate solvency, and for example, crash risk.

Corporate Governance Has Improved

Minority Shareholder Protection

(Index; higher value denotes stronger protection)

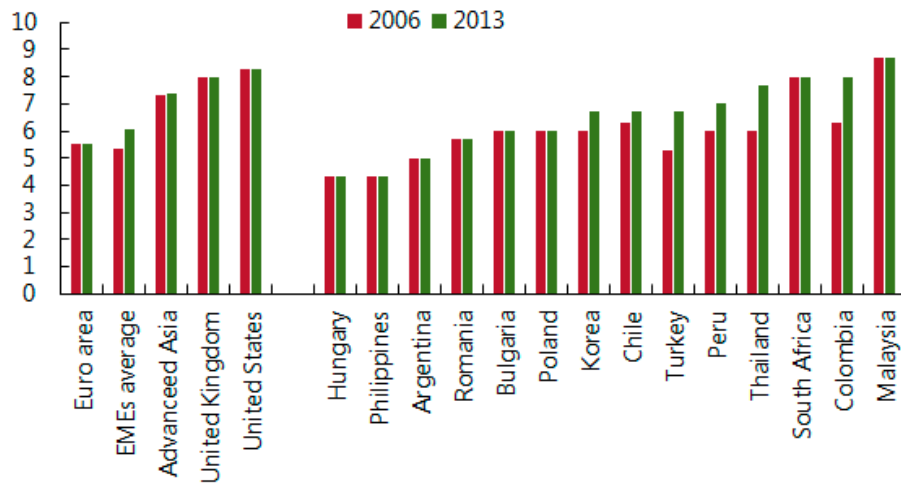


Sources: Guillén and Capron 2016; and IMF staff calculations.

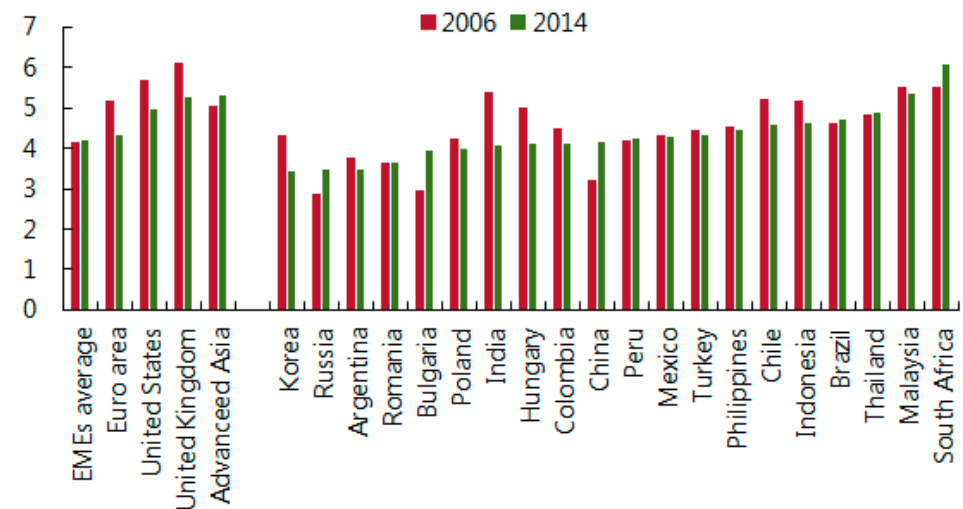
Governance and Investor Protection

Country-Level Corporate Governance and Investor Protection

Strength of Investor Protection Index
(Index, higher value denotes stronger protection)



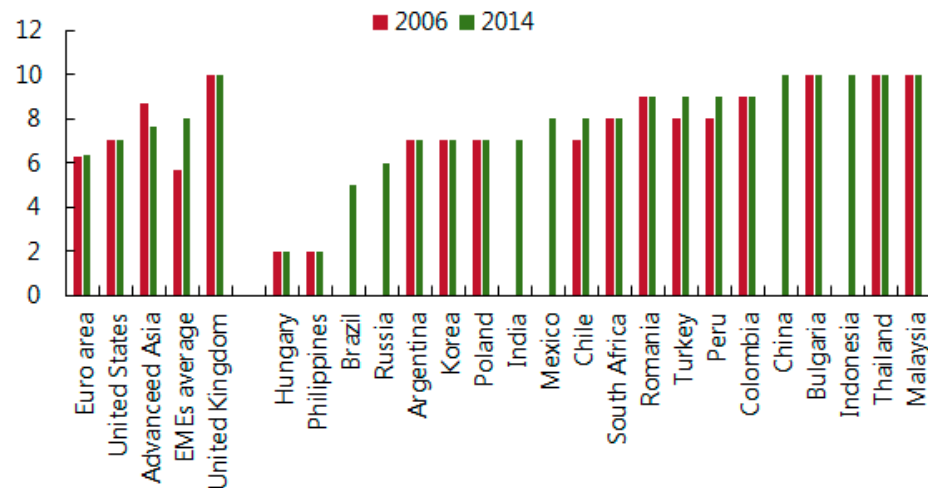
Protection of Minority Shareholders' Interests Index
(Index, higher value denotes stronger protection)



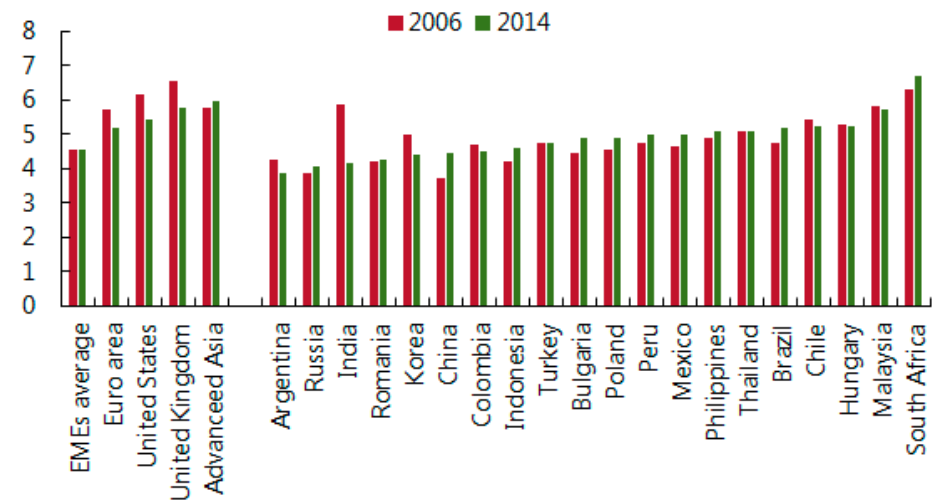
Governance and Investor Protection

Country-Level Corporate Governance and Investor Protection

Extent of Disclosure Index
(Index, higher value denotes greater transparency)



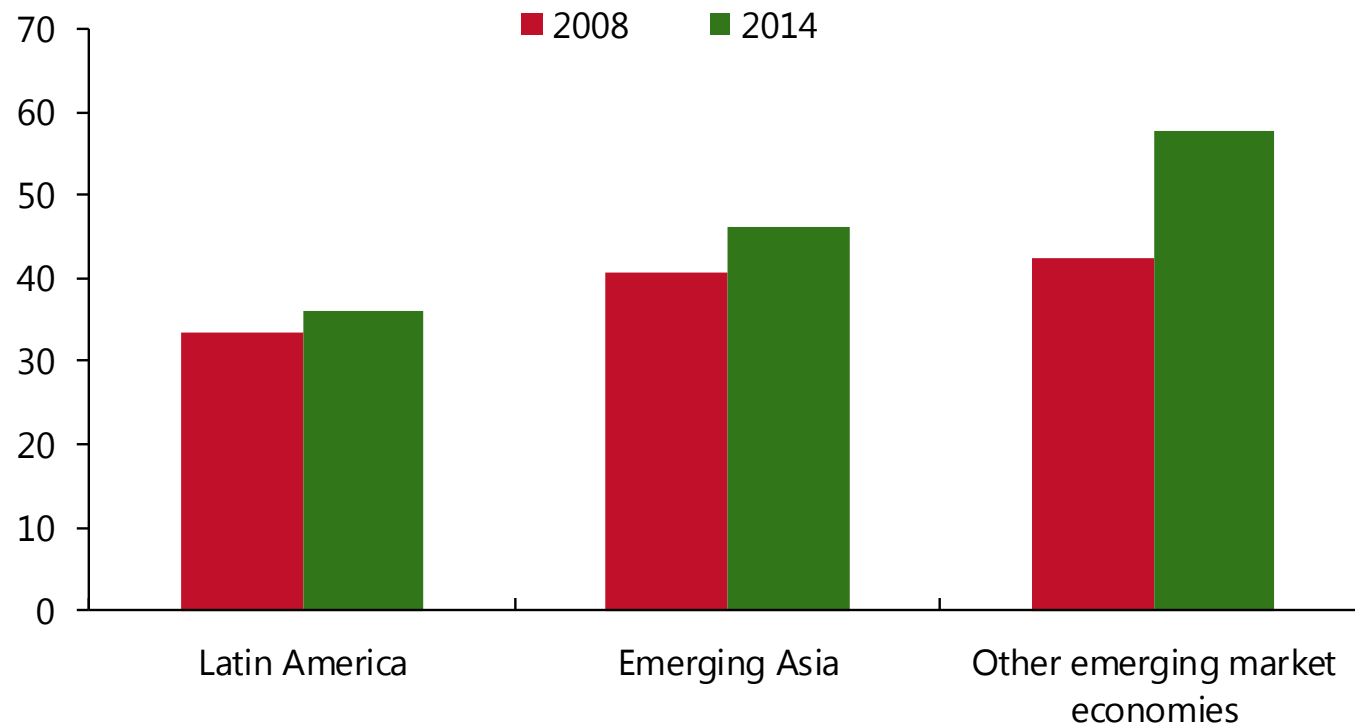
Strength of Auditing and Reporting Standards Index
(Index, higher value denotes greater transparency)



Improving Firm-Level Governance

Emerging Market Firm-Level Governance

(Percent; higher (median) value denotes a stronger governance)

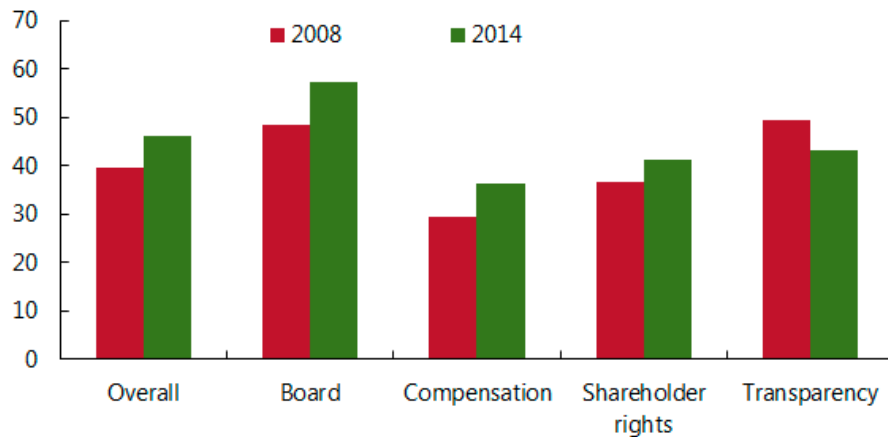


Sources: Thomson Reuters Datastream; and IMF staff calculations.

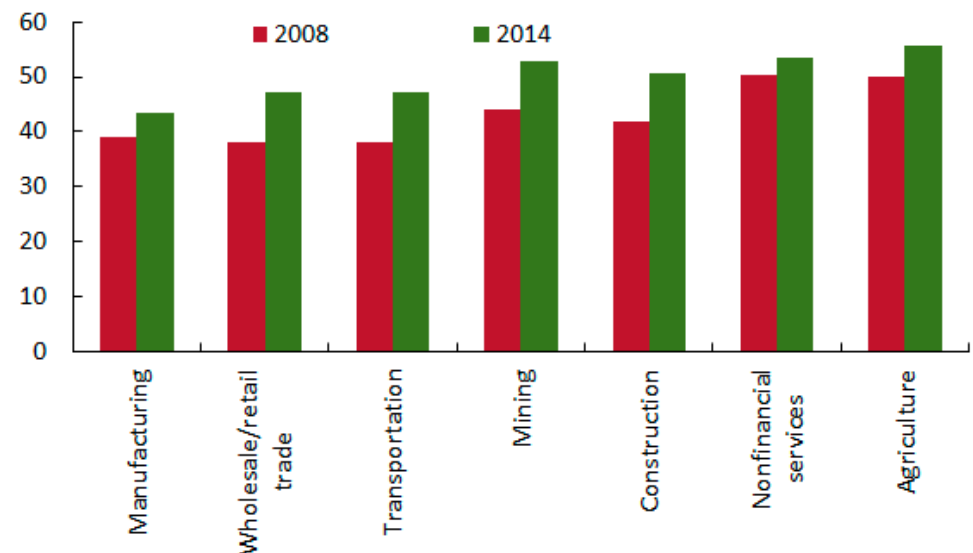
Improving Firm-Level Governance

Emerging Market Firm-Level Governance Index (Percent; higher (median) value denotes a stronger governance)

By Sub-index, 2008 versus 2014 Median



By Sector, 2008 versus 2014 Median



Sources: Thomson Reuters Datastream; and IMF staff calculations.

Governance and Firm Characteristics

Firm-Level Governance and Firm Characteristics

	ADR ¹	Other		SOE ²	Other	
Governance Overall Index	49.8	45.1	*	45.3	46.8	
Board	61.3	56.4	*	58.7	58.7	
Compensation	41.9	34.1	*	32.6	35.8	
Shareholder Rights	43.3	40.6	*	39.8	41.8	*
Transparency	45.0	42.6		42.1	43.4	
	Closely Held Shares ³	Other		Low Financial Dependence ⁴	High Financial Dependence ⁴	
Governance Overall Index	42.2	48.4	*	42.5	47.2	*
Board	52.2	60.5	*	53.1	58.1	*
Compensation	30.8	38.6	*	32.6	40.3	*
Shareholder Rights	39.2	42.4	*	37.8	40.5	*
Transparency	37.3	46.4	*	43.0	51.5	*

Sources: Bloomberg, L.P.; Thomson Reuters Datastream; and IMF staff calculations.

Note: Asterisk denotes a statistically significant difference of at least 10 percent.

¹ADR=American depository receipts.

²SOE = state-owned enterprises.

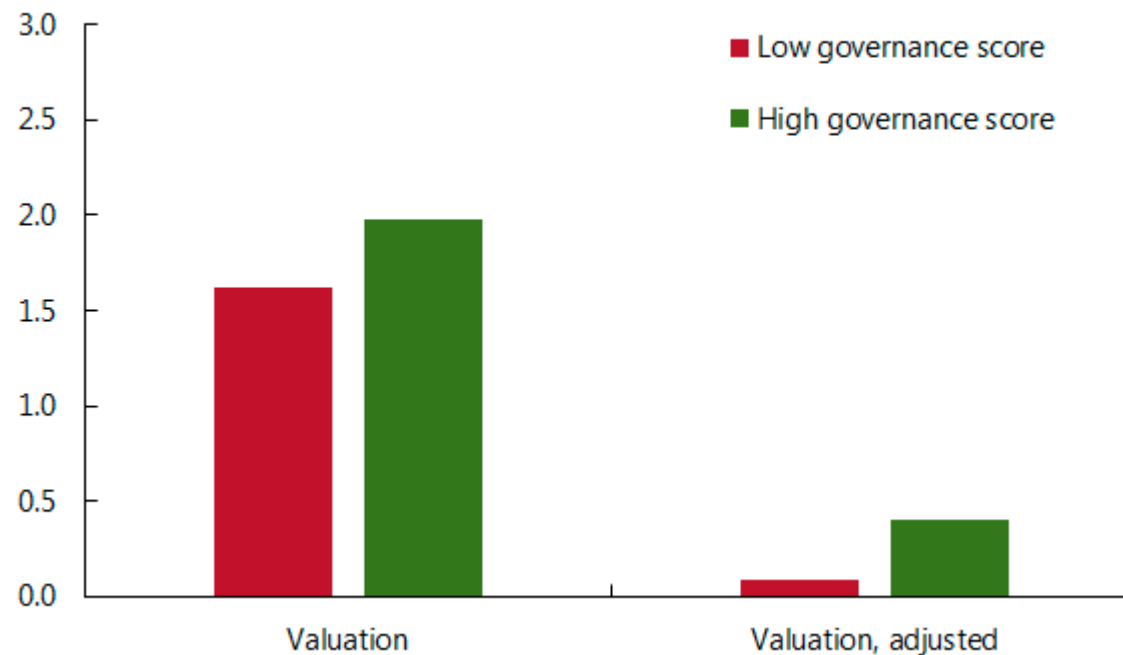
³Firms with above 10 percent closely held shares.

⁴High (low) financially dependent firms are in the top (bottom) quartile of the index developed by Rajan and Zingales (1998).

Governance and Valuation

Corporate Governance and Firm-Level Valuation (Ratio; average)

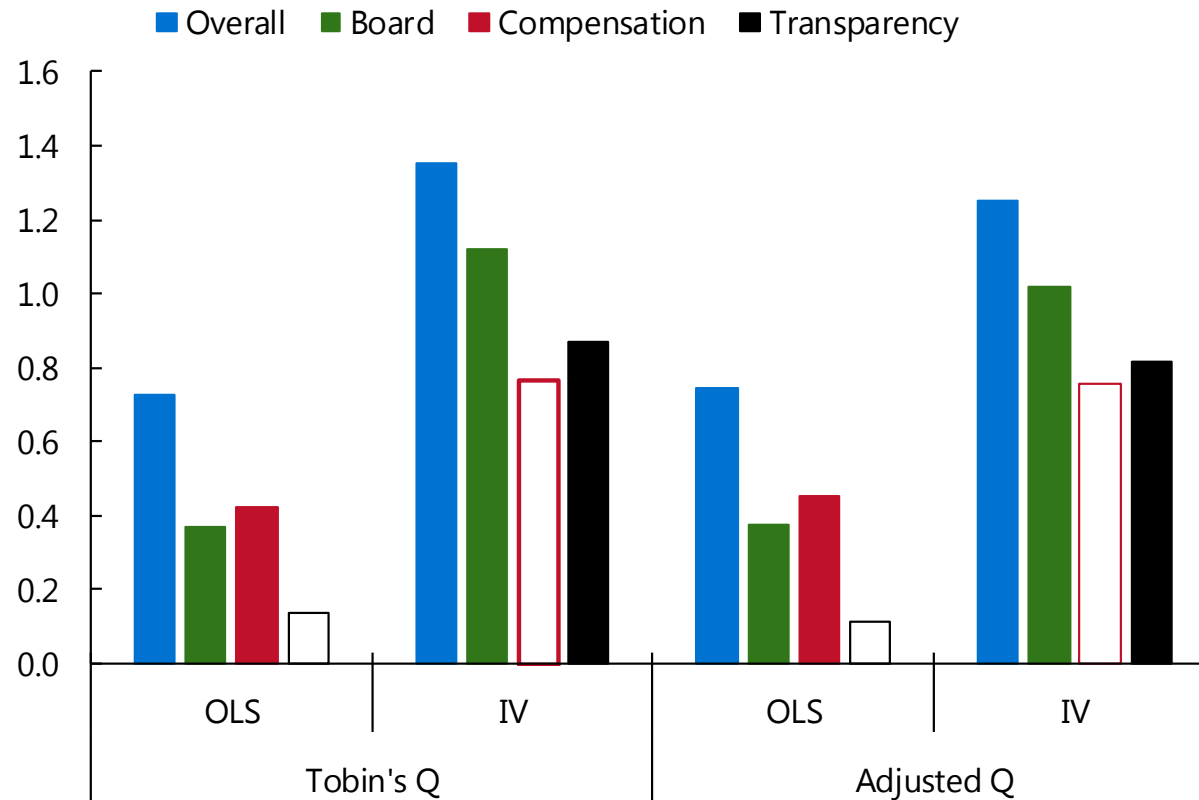
Country-Level Minority Shareholder Protection



Sources: Thomson Reuters Datastream; World Economic Forum, Global Competitiveness Indicators database; and IMF staff calculations.

Index Verification

Firm-Level Governance and Valuation (Percentage points)



Sources: Thomson Reuters Datastream; and IMF staff calculations.

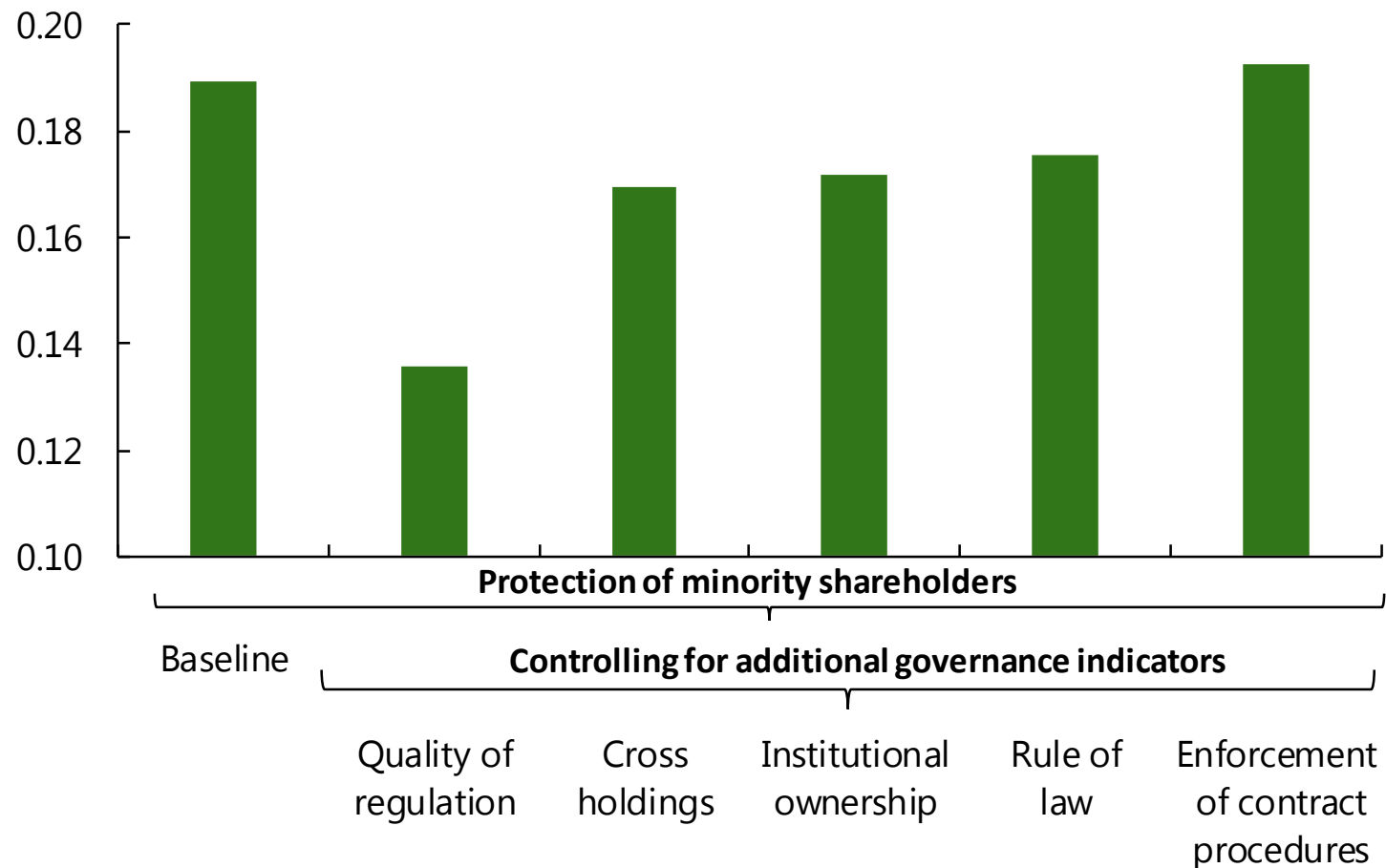
Governance and Financial Development

Corporate Governance, Investor Protection, and Capital Market Development

		Stock Market		Bond Market	
		Capitalization	Total Value Traded	Private Capitalization	Public Capitalization
All Countries ¹	Minority Shareholder Rights Protection	+++	+++	++	+++
	Corporate Transparency	+++	+++	++	+++
	Rule of Law / Property Right	+++	++	++	+++
Major EMEs	Minority Shareholder Rights Protection	+++	+	++	+++
	Corporate Transparency	+++		++	+++
	Rule of Law / Property Right	+++	+	++	+++

Sources: Guillén and Capron 2016; World Bank, Doing Business database, World Governance Indicators database, and Financial Development and Structure database; World Economic Forum, Global Competitiveness Indicators database; and IMF staff calculations.

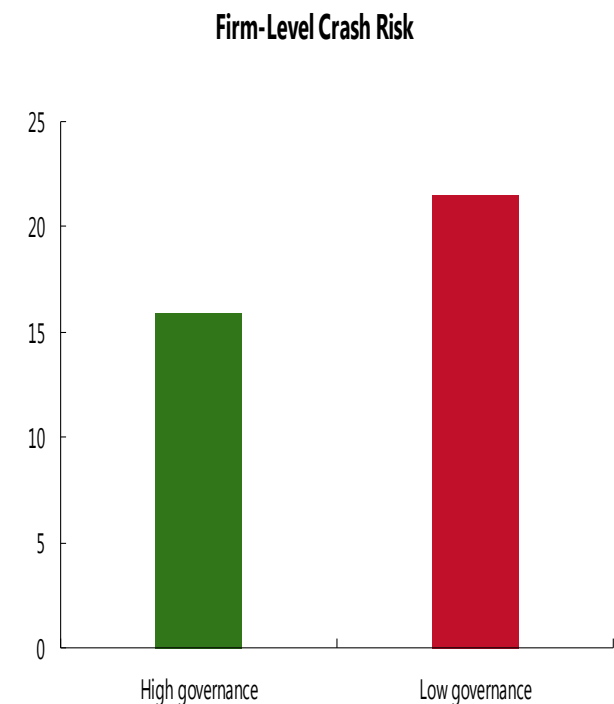
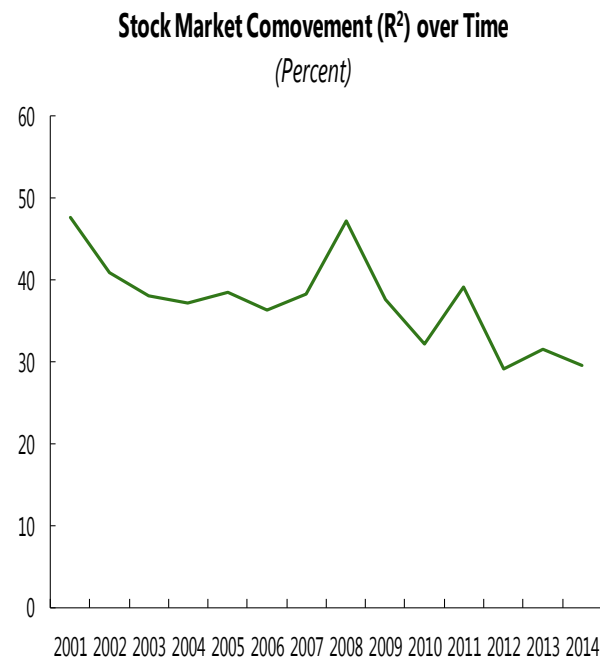
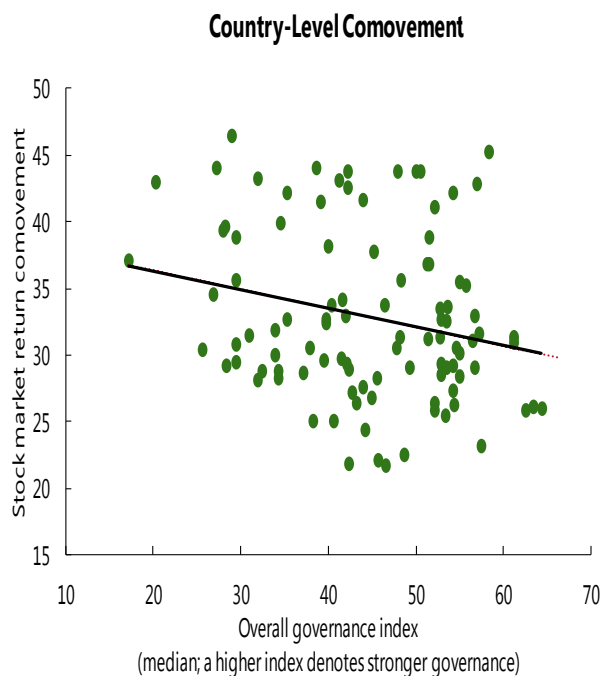
Governance and Market Liquidity



Note: In percent.

Sources: Brandão-Marques (forthcoming);

Stock Return Co-Movement and Crash Risk

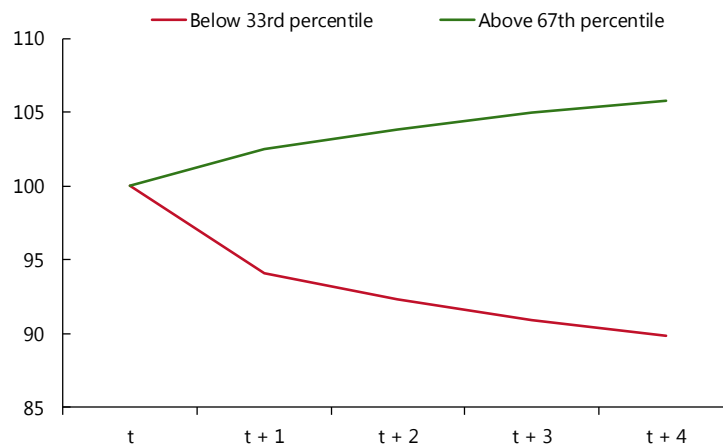


Sources: Bloomberg, L.P.; Thomson Reuters Datastream; and IMF staff calculations.

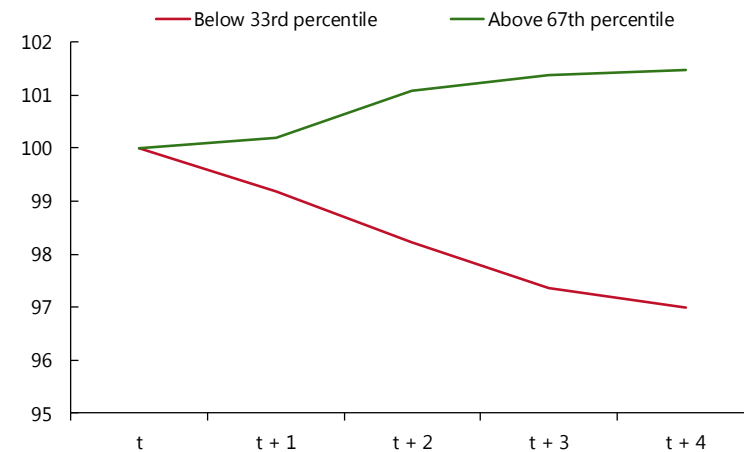
Role of Firm-Level Governance

Event Study: Firm-Level Governance and Equity Prices

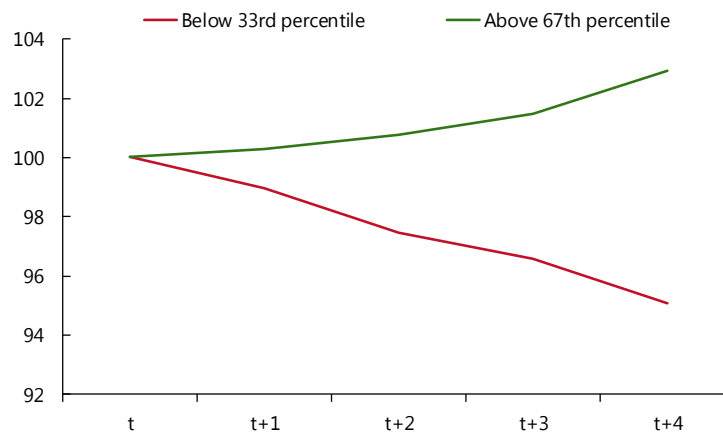
1. Global Financial Crisis



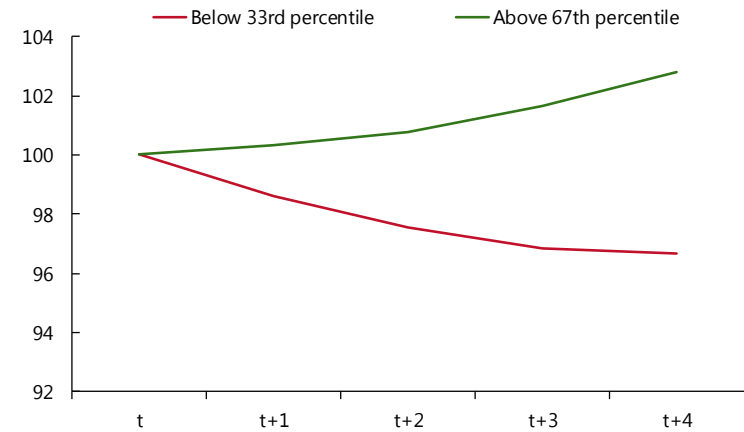
2. Taper Tantrum



3. January 2016 Stock Market Crash



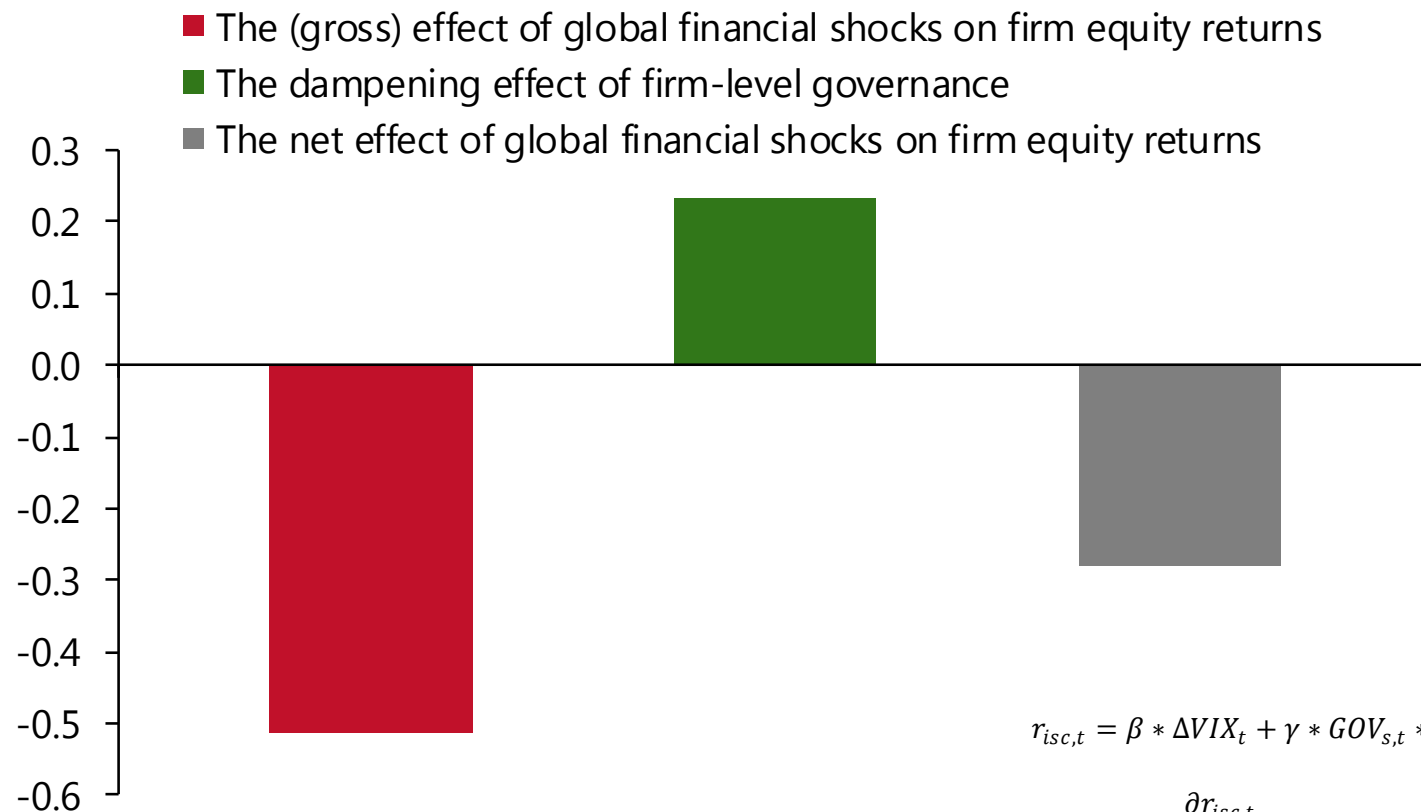
4. Brexit



Note: Index; $t=100$

External Shock Attenuation

Impact of Global Financial Shocks on Equity Returns (Percentage points)



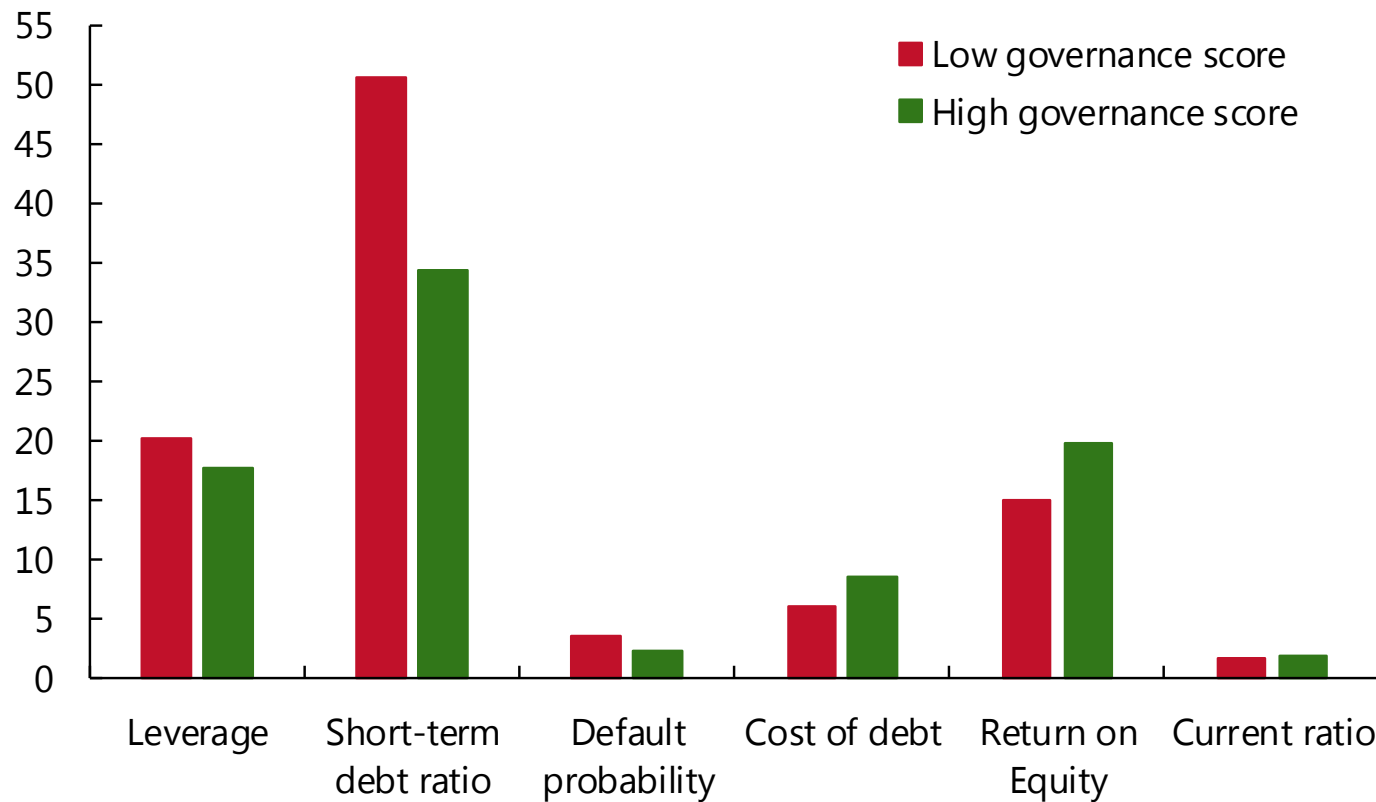
$$r_{isc,t} = \beta * \Delta VIX_t + \gamma * GOV_{s,t} * \Delta VIX_t + Other$$

$$\frac{\partial r_{isc,t}}{\partial \Delta VIX_t} = \beta + \gamma * GOV_{s,t}$$

$$H_0: \beta < 0 \text{ \& } \gamma > 0$$

Governance and Balance Sheets

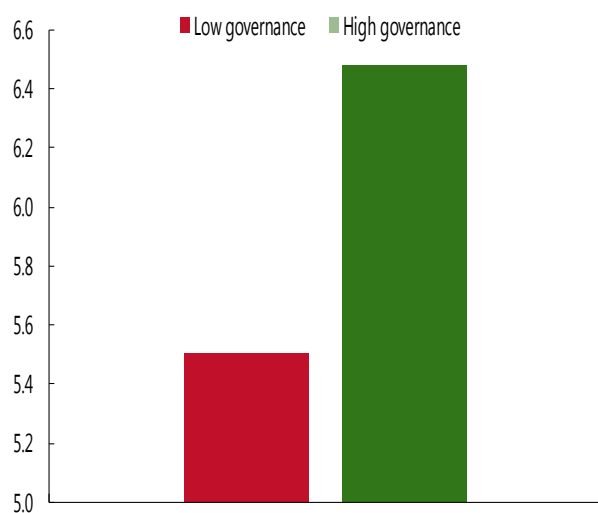
Country-Level Minority Shareholder Protection



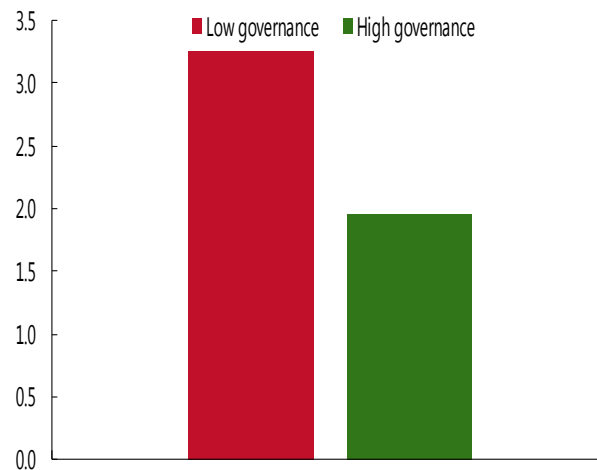
Note: In percent (firm-level averages).

Governance and Bond Characteristics

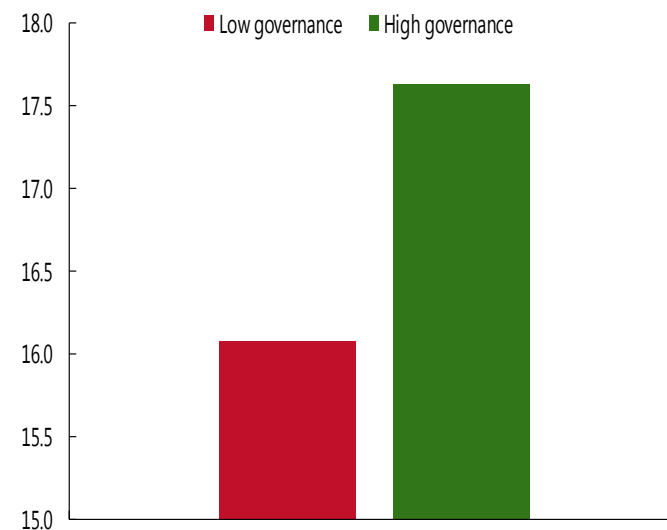
1. Bond Maturity
(Year; firm-level value-weighted averages)



2. Bond Spreads
(Percent; firm-level value-weighted averages, U.S. dollar-denominated bonds)



3. Bond Ratings
(Rating notches; firm-level value-weighted averages)

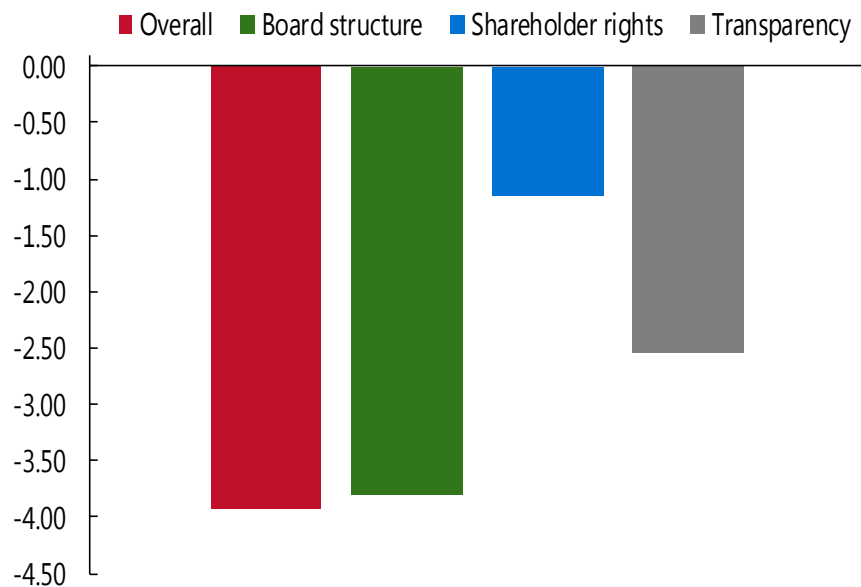


Sources: Bloomberg, L.P.; Dealogic; Thomson Reuters Datastream; and IMF staff calculations.

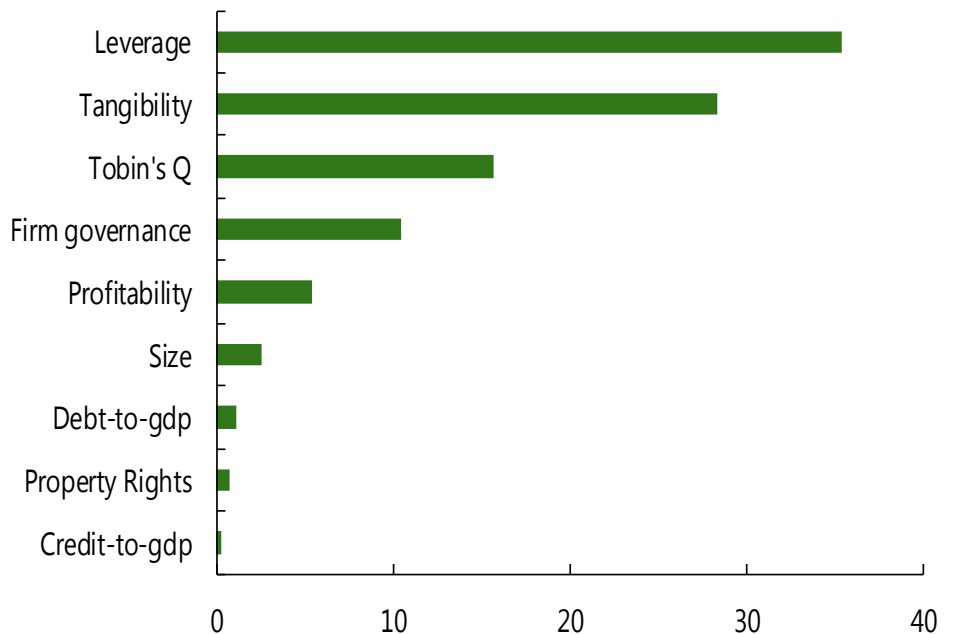
Governance and Solvency

Firm-Level Governance and Solvency

Short-term Debt Ratio
(Percentage points)



Short-term Debt: Relative Importance of Determinants
(Percent)



Summary

- Corporate governance has broadly improved over the past two decades for many EMs.
 - Scope to improve, albeit differences
- EMs with stronger corporate governance and investor protection frameworks tend to be more resilient to global financial shocks.
 - Deeper and more liquid capital markets,
 - Lower sensitivity to external shocks, co-movement, crash risk
- Stronger corporate governance and investor protection regimes are associated with stronger EM corporate balance sheets.
 - Lower short-term debt ratios, default probabilities, longer maturities

Policy Implications

- Overall, many EMs have made notable strides in improving their corporate governance frameworks.
- However, given that good corporate governance can bring financial stability benefits, reforms should continue:
 - Strengthen the legal, regulatory, and institutional frameworks,
 - Improve shareholder rights,
 - Bring disclosure requirements fully in line with best practices,
 - Foster greater board independence.



Thank you