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Corporate Governance and Market Value: Evidence from Turkish Banks

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Abstract

Corporate governance is one of the most talked-about topics in business and academic world, and has received considerable attention especially after corporate scandals and crises. Numerous studies have examined the relation between corporate governance practices and firm performance, but mostly in developed markets. Accordingly, this study aims to examine the relation between corporate governance and firm value in an emerging market and assess the corporate governance practices of listed banks in Istanbul Stock Exchange (ISE). Using main measures used in other studies such as ownership, board structure and disclosure practices as corporate governance indicators and ROA and share price for performance, the regression showed that banks with lower governance ratings deliver higher share value due to their higher risk, while banks with higher governance ratings generate lower share value because of their lower risk. The result suggests that stock prices fairly reflect the higher risk of poorly governed firms and lower risk of well-governed firms.

Keywords: Corporate governance, performance, share price

1. Introduction

Corporate governance has been a recent source of interest to investors, policy makers, and corporations. Especially after recent corporate scandals, investors have asked what must be done to get corporations to maximize shareholder value. Consequently, researchers, corporate managers, and shareholders are interested in the relationship between corporate governance and firm value.

There is widespread evidence that good corporate governance is associated with greater firm performance. Mitton (2001) found that firm level differences in corporate governance have significant influence on firm performance and that higher price performance is related to higher disclosure quality, higher outside ownership concentration, and with firms that are focused rather than diversified. In conjunction, Brown and Caylor (2004) looked at 2327 U.S. firms, and

found that better governed firms are also more profitable, more valuable, and pay higher dividends. Corporate governance is also positively correlated with operating performance and market valuation (Black, Jang & Kim, 2006). In many studies, specific governance attributes such as board structure or ownership structure, are associated with higher firm performance. According to Mallette and Fowler (1992), boards are the agents of the shareholders and exist to monitor management performance and to protect shareholders' interests. Thus, Bauer, Guenster and Otten (2004) find that governance-based portfolios yield excess returns in the UK markets, which suggests that any difference in corporate governance might already be reflected in current stock prices.

The objective of this article is to extend the analysis to Turkish banks using Istanbul Stock Exchange (ISE) data. Turkish banks present a fascinating case due to recent developments in the industry. During the early 2000's, after the economic turmoil and crisis period, the Turkish banking sector realized 10 mergers and 14 takeovers which created a significant change in the capital structure of this sector. The 13 of 14 takeovers are from foreign capital entry. As of the end of 2009, 49 banks, which is composed of 32 deposit banks, 4 participation banks, 13 development and investment banks, constitute the Turkish banking sector.

The entry of foreign capital to the industry facilitated the improvement and the development of the sector and this meant for many investors a signal of better governance and auditing system. Hence, it is interesting to investigate whether better governance expectations are effectively priced in the stock market.

The rest of the paper is organized as follows. Section 2 takes a brief look at the relevant literature then informs about the 2000 and 2001 crisis in the following section. The fourth section explains the data and methodology used in the study. Section 5 examines the results and section 6 concludes the paper.

2. Literature and Variables

Ownership structure and characteristics

Many studies have documented the role of ownership structure on firm performance. In particular, management ownership is found to have a strong association with the firm's profitability and market value. Morck, Shleifer and Vishny (1988) and McConnell and Servaes (1990) show that firms performance increases with the ownership of corporate insiders but they also warn that entrenchment can occur at intermediate levels of ownership.

A series of studies finds that concentrated ownership may lead to more active monitoring, resulting in better corporate governance (Weiss and Nikitin, 2004) which seems to be more difficult to exercise in state owned banks. Institutional investors have the incentives to exercise control over management and the power to initiate change in case of poor performance. McConnell and Servaes (1990) confirm that their impact on firm valuation is generally positive.

Bhagat, Black and Blair (2004), however, do not find evidence supporting a positive association between ownership concentration and firm performance.

Besides ownership structure, the board structure has also to be taken into account.

Board Structure

Board size is posited to have a negative effect on performance, as it seems to hinder the discussion of sensitive issues. Yermack (1996) provides evidence that US firms with smaller boards achieve higher market values. Mak and Kusnadi (2005) single out board size as the most significant factor in explaining the valuation of Malaysian firms.

The number of independent directors is also often cited as proxy for good governance. Independent directors play major roles in US and UK public companies. Bhagat and Black (2002) report that most large US public companies have independent directors making up a high proportion of the board. Faccio and Lasfer (1999) report that on average, non-executive directors make up 43 percent of boards in the United Kingdom. Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) found that the market rewards firms for appointing independent directors. Hermalin and Weisbach (2001) argue that board independence is an important condition for the critical evaluation and monitoring of managers' performance. Rosenstein and Wyatt (1990) observe a positive market reaction to the appointment of independent directors.

In contrast, several researchers have raised concerns that outside directors lack the necessary time, expertise, and incentives and thus may not be able to make a meaningful contribution to shareholder wealth creation (Patton and Baker, 1987). Agrawal and Knoeber (1996) find a negative relation between the proportion of outside directors and firm performance among US firms. They posit that a political process within firms influences the selection of outside directors, and the directors may be less effective as they are beholden through the selection process. Klein (1998) finds no association between a firm's committee structure and firm value. Bhagat and Black (2002) find no relationship between the proportion of independent directors and various indicators of firm performance. Thus, the evidence relating to board independence and firm value varies.

In this study, we use the proportion of executives and auditors on the board as an indicator of monitoring. The proportion of outside directors unaffiliated with the firm's major trading partners, shareholders and creditors is also hypothesized to be positively associated with firm performance.

Disclosure Practices

Disclosure and transparency practices can also influence the extent and quality of a firm's corporate governance practices. Bushman, Piotroski and Smith (2004) define corporate transparency as the availability of firm-specific information to outside investors and stakeholders. Accordingly, transparency and the quality of information released by firms are

expected to exhibit a positive correlation with their performance, one reason being that good performers are more willing to disclose information. In addition, recent studies (e.g., Durnev, Morck & Yeung, 2004) emphasize the role of information in relation to efficient capital allocation and growth. Several attributes are used to reflect the quality of disclosure. The number of auditors' comments in the annual report is considered negatively correlated with information quality, and hence negatively correlated with firm performance (Dharan and Lev, 1993).

The timeliness of reporting and shareholder meetings held outside the most concentrated dates can be taken as an evidence of the firm's concern for its investors, which in turn is assumed to be correlated with the firm's performance. Indeed, Chambers and Penman (1984) find that the release of earnings earlier than expected is associated with greater excess returns. Givoly and Palmon (1982) show that the stock volatility of firms with early reporting is also significantly higher compared with firms with late reporting. These findings suggest that timely disclosure is valuable to investors. So, a quantitative evaluation of a firm's website based on the number of auditors' comments and timely disclosure is included in the analysis.

3. Banking Sector in Turkey in the Crisis Period

In 2000, Turkey had a high current deficit, overvalued TL and increased short term external debt. Especially, the open positions of the banks were approximately 20 billion US dollars at the end of 2000. In fact, the large amount of Bonds and Treasury bills in their portfolio made it difficult for them to deal with their open positions. In order to close their open positions, they used the daily repurchase agreements (REPO) while preferring to stay in liquid position. So, the need for liquidity was increasing; however, the Central Bank was rejecting to inject extra liquidity according to the new monetary program. Hence, interest rates rose sharply, the foreign banks broke down the agreements in which the public borrowing papers were given as a guarantee, eventually, the lack of the foreign exchange was increased to cover open positions. The expiration of this program was, in other words, the November Crisis (BRSA, 2009).

The efforts to arrange the liquidity structure and to establish the stability could not prevent the February 2001 crisis. Economical reasons of these two crises are largely discussed in the banking literature, however, in this study, the consequences of these crises are indicative. After the crises, foreign banks had the opportunity to take over the Turkish Banks cheaply with a diversity of factors attracting their entry to Turkey such as reforms in the investment environment, lower interest rates, inflation rates with single digit, Basel II Agreement, better auditing and regulation system and so on. Banking sector saved itself with 10 mergers and 14 takeovers which created a significant change in capital structure of this sector.

4. Data and Methodology

In order to analyse the impact of better corporate governance provided by the foreign equity and foreign board membership on the share prices, the data is collected from the database of

BRSA (Banking Regulation and Supervision Agency) as well as the Banks Association of Turkey (Türkiye Bankalar Birliği) with a time covering 2003 to 2009 covering the banks' governance: its board composition, ownership structure and the ISE data. Financial data refer to the end of the year. The total number of banks varies from year to year due to the several mergers and acquisitions over the same time period. To investigate whether corporate governance is fully reflected in stock prices, we grouped stocks in different groups depending on their ownership structure and analyze their returns over the period 2003-2009. The ownership structure is measured at a single point in time, and they are used to group banks and other variables covered board size, number of auditors in the board, proportion of independent directors on the board. Concerning the disclosure practices, number of auditors' comments and the time of disclosure are used. Performance is measured using share prices and ROA. In addition to the descriptive statistics, ANOVA, t-tests and regression analysis is used.

Deposit Banks are considered for the analysis and they are subdivised in four categories according to their ownership structure: State-owned banks, private-domestic banks, private-foreign banks and foreign banks. When considering state banks, the state controls the main part of the stakes, whereas the private-domestic banks owners are the Turkish investors without the participation of foreigners. A closer look at the private foreign banks shows that the ownership structure of these banks reflects foreign joint-equity in which a foreign institution holds the majority of the shares. Finally, foreign banks are banks that are 100% owned by foreign institutions and investors.

The participation banks that do not have the all pertinent information as well as development and investment banks that can perturb the significance of the analysis are excluded from the analysis.

5. Results

The first step is to construct governance-sorted groups. First, we used the ownership structure to form our groups: the state, the private-domestic, the private-foreign and the foreign banks so, following Brown and Caylor (2004), we categorized banks into 4 groups according to their ownership structure. We also checked if the management ownership can be categorized as institutional ownership, cross-shareholder or corporate insider. The average number of board members is between 10 and 11 members, which represent an optimal size according to Lipton and Lorsch (1992). A majority of boards are controlled by corporate insiders. The proportion of independent directors is relatively small (11.3%), and for the auditors, the average is 4.

The information disclosure timeliness and quality showed that the average time before the release of annual reports is 13 days and the average number of auditors' comments is 5.3.

The relation of governance variables and its components with firm performance and share prices is investigated. The performance is evaluated by return on assets (ROA) and share price. ROA is measured by operating profits scaled by total assets. Among board attributes, size and proportion of auditors are seen to have a significant negative influence on performance,

whereas the proportion of independent directors appears to have a positive effect. The regression results also indicate that the ratio of auditors to board members is significantly associated with performance. The negative effect of board size on both profitability and valuation is consistent with previous results (e.g., Yermack, 1996). The large impact of board independence on the firm's value, but mixed influence on its profitability confirms the conflicting findings of Rosenstein and Wyatt (1990) on one hand, and Bhagat and Black (2002) on the other hand. Ownership structure appears to be an important determinant of performance.

Concerning disclosure practices, low concern for shareholders through untimely release of annual reports is associated with both lower profitability and firm value. Number of auditors' comments is also negatively correlated with both measures of firm performance.

Another finding is that the private-foreign banks with foreign shareholders significantly underperform the other groups. However, this result essentially stems from the high valuation of well-governed firms and low valuation of poorly governed banks. This conclusion indicates that the implications of (good) corporate governance in terms of (lower) risk and (higher) performance are fairly reflected in current stock prices so that stock screening based on governance ratings can only generate insignificant excess returns. The results are similar to those of Bauer, Guenster and Otten (2004) concerning UK firms, but differ from those of Gompers, Ishii and Matrick (2003) and Drobetz, Schillhofer and Zimmermann (2003), private-foreign banks exhibit an apparently lower performance relative to private-domestic banks. The average monthly return is -0.83% and +1.13%. This difference in returns may derive from exposure to various risk factors. As the period of investigation which overlaps Turkey's economic recovery after a period of consecutive crises, might have influenced the outcome by boosting the share price of poorly performing firms, to ensure that the results have not been distorted by the particular sample period or the exceptional performance, we repeated over the period 2004-2007 and the results remain broadly similar and support the assertion that stock prices reflect the higher performance and lower risk associated with better corporate governance.

6. Conclusion

Corporate governance is widely associated with better performance, whether the direction of causality stems from governance towards performance, or because high performers choose to operate under better governance rules. A large number of empirical studies confirm this association.

In this study, we investigated the case of Turkish banks using groups formed by ownership structure to reflect the firm's board size and characteristics, disclosure practices effect on performance and share price. The 4 groups' monthly returns are analyzed over the period 2003-2009. Contrary to the results of Gompers, Ishii and Matrick (2003) and Drobetz, Schillhofer and Zimmermann (2003), but in line with Bauer, Guenster and Otten (2004), we find that returns are insignificant across all 4 ownership groups. In fact, banks with lower governance ratings

achieve higher returns, but this is explained by their higher exposure to the book-to-market risk factor. In other words, banks with lower governance ratings deliver higher returns essentially because of their higher risk, while banks with higher governance ratings generate lower subsequent returns because of their lower risk.

We check whether the lack of return to well-governed firms could be due to the specific period under study. Indeed, with the economic recovery under way, firms with lower governance ratings may have seen their market value recover rapidly.

As in every research, this research has also some limitations. One limitation of this study could be the fact that ownership structure is not updated over time. As a result, firms are allocated to the same group for the whole sample period. However, this constraint is not a major inconvenience. Migration from one group to another would require each firm to experience a merger; acquisition or a take-over and most of these changes are realized in the industry between 2001 and 2003, so the time period used in the study eliminates this problem. So, after 2003, there is no change of governance attributes in the sample.

The governance-performance relation could be further investigated by controlling for industry sectors and other characteristics known to affect firm performance. For example, leverage or dividend payout can be seen as alternative governance mechanisms (Jensen, 1986; Easterbrook, 1984). However, the objective of this paper was not to assess the robustness of the governance-performance relationship, but to examine whether stock prices adequately reflect governance quality. Overall, the conclusion appears to be that the stock prices fairly reflect the lower risk of well-governed firms and higher risk of poorly governed firms.

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