DOES THE WELL GOVERNED FIRM PERFORM BETTER? REGULATORY IMPLICATIONS FOR SMES IN THE FINANCIAL SECTOR

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Abstract

Although bad corporate governance has been identified as one reason for the failure of financial companies in the current financial crisis, the discussion almost exclusively refers to big players so far. This paper therefore investigates SMEs in the financial sector. Against theoretical assumptions and previous findings for big companies, in regressions for 21 SMEs in the German financial sector we find compliance with the German Corporate Governance Code (as a proxy for "good" corporate governance) not to affect performance significantly positively. This opens the discussion whether the existing rules of "good" corporate governance in Germany do also fit to SMEs and which actions have to be taken into consideration by politics, financial authorities and regulators to solve the situation.

Keywords: Financial sector, good corporate governance, performance, SMEs, regulation, Germany

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Introduction

Not only in the highlight of the current financial and economic crisis, a sound financial sector is critical for the performance of an economy. Providing integral functions, banks and financial services providers play a major role in today's modern economies. This seems even more relevant for Germany, where they traditionally play a more important role in funding the economy than in other economies. Banks and financial services providers borrow and lend by means of debt contracts, with different maturity and bank loans are one of the most important sources of funding and allocating resources. They often decide, which projects will be funded, so they have also an initiatory function in many economies (Schumpeter, 1911; Dietrich, 2009). Nevertheless, when discussing the current financial crisis, often almost (Hau and Thum, 2009) exclusively big players of the financial sector were taken into consideration so far (Vaubel, 2009) and bad corporate governance/shortcomings in corporate governance have been identified as one reason for their failure (Stiglbauer, 2010; Rötheli, 2010). This opens the discussion whether good corporate governance is also critical for the success and soundness of smaller players in the financial sector and whether rules of good corporate governance do also fit to SMEs in the financial sector obviously they were established with a focus on big companies (Oser et al., 2004). In Germany, compliance towards the German Code of Corporate Governance (GCGC) is often used as a proxy for good corporate governance (Bassen et al., 2006). This is in line with the corporate governance definition of Parum, that corporate governance "is a set of principles concerning the governance of companies and how these principles are disclosed or communicated externally [and used internally]" (Parum, 2005: 702). The GCGC provides recommendations to listed companies for good and responsible corporate governance. German listed firms have to declare yearly whether they hold them or not. This understated "comply or explain" principle is founded on the assumption that the market will monitor code compliance and efficiently adjust the allocation of capital according to its beliefs on governance quality. The capital market has two functions in this regard: (a) evaluation of possible deviations and (b) enforcement. It is, after all, in their direct interest to assess the significance of deviations (Seidl et al., 2009). Accordingly, the opinion of policy makers is still, that those companies who dare not to comply with the code shall be punished by the capital market (Cromme, 2002). Since the establishment and usefulness of these regulations within SMEs are still open and the German Corporate Governance Code requests that each listed company has to declare its code compliance, we decided to focus on those SMEs in the financial sector that are incorporated as joint-stock companies and are listed at the Frankfurt Stock Exchange. Drawing on data about 21 SMEs, we explore how far these companies are in line with the existing standards of good corporate governance and what reasons may influence this. Furthermore, we test whether being in line with the code's recommendations has any effects on operating and capital market performance for those companies. Based on our results, we find some regulatory implications how "good"

corporate governance may be established for SMEs in the German financial sector and for SMEs in general.

Theoretical perspectives

Agency theory for sure is the most often used approach with respect to corporate governance research (Dühnfort et al., 2008). It proposes that adequate monitoring or control mechanisms need to be established inside and outside companies to protect shareholders, other investors and creditors (Shleifer and Vishny, 1997). Some effectively structured board, up-to-date accounting practices and transparent information policy exemplify internal mechanisms that encourage active monitoring of managerial decision making processes (Kiel and Nicholson, 2003). The market for corporate control (Easterbrook and Fischel, 1991) and the managerial labour market (Fama, 1980) exemplify external mechanisms. Thus, corporate governance is a complex model of monitoring, controlling and information mechanisms to balance various interests. Consequently, companies that are able to balance those interests better than other companies are usually considered to outperform (Blair and Stout, 1999). Hooghiemstra et al. (2008) were among the first to propose institutional theory as an adequate approach to examine corporate governance. Concerning the fact, that companies are always embedded in an institutionalized environment, e.g. by national law, soft-law such as corporate governance codes or economic culture, this provides “a context in which individual efforts to deal rationally with uncertainty and constraints often lead, in aggregate, to homogeneity in structure, culture, and output” (DiMaggio and Powell, 1983: 147) - from this point of view, companies are argued to be “isomorphic” as to their corporate governance practices. By recommending a comprehensive set of norms, corporate governance (best) practices and codes have become part of this institutional environment in which listed companies operate (Aguilera and Cuervo-Cazurra, 2004). Especially for large(r) corporations, their environment must be considered as much institutionalized, compared to smaller companies - the public scrutiny and pressure as a result of investors’, analysts’ and creditors’ expectations is much more developed here (Achleitner et al., 2005).

Data and method

Among the 644 companies listed at Frankfurt Stock Exchange in June 2006, 21 companies of the financial sector (Table 1) exceeded the limits we defined for SMEs.

Table 1. Sample

Sample	
AIG International Real Estate KGaA (x)	Greenwich Beteiligungen AG
Arxes NCC AG	MWB Wertpapierhandelshaus AG (x)
Berliner Effektengesellschaft AG	Sinner AG
bmp AG (x)	SM Wirtschaftsberatungs AG
Concord Effekten AG	SPARTA AG
Deutsche Balaton AG	Spütz AG
DEWB AG (x)	TFG Capital AG
Deutsche Real Estate AG	Themis Equity Partners GmbH & Co KGaA
DKM Wertpapierhandelsbank AG	Value Management & Research AG
Finanzhaus Rothmann AG	Webac Holding AG
FORIS AG	
Prime Standard: (x)	

These limits are also used by the German Federal Ministry of Economics and Technology in line with its policy for SMEs (Tappe, 2009) - annual turnover lower than 50 mio. €, staff number lower than 500 and no constraint concerning balance sheet total (Günterberg and Kayser, 2004). Four of those companies belong to the Prime Standard and 17 to the General Standard. Nowak et al. (2004) point out that the studies about code compliance significantly differ amongst each other according to the numbers of recommendations observed (e.g. Peltzer, 2002; Seibt, 2002). Therefore, we decided to do a systematic analysis of the GCGC evaluating each sentence for the term “shall”, which is generally an indication for a recommendation. As a result we found 82 recommendations in the 2005 GCGC version (Table 2).

Table 2. Variable definitions and sample characteristics

Abbr.	Description	Min.	Max.	Mean	Std. Dev.
ROE	Return on equity	-85.670	85.080	-2.282	34.440
SPD	Share price development (01.01.2007 - 31.12.2007)	-65.000	119.830	10.777	38,662
GCGC I	Shareholders and the General Meeting (5 recommendations)	0.000	1.000	0.838	0.356
GCGC II	Cooperation between Management Board and Supervisory Board (5 recommendations)	0.000	1.000	0.762	0.344
GCGC III	Management Board (18 recommendations)	0.000	1.000	0.730	0.345
GCGC IV	Supervisory Board (32 recommendations)	0.000	1.000	0.662	0.230
GCGC V	Transparency (9 recommendations)	0.000	1.000	0.751	0.346
GCGC VI	Reporting and Audit of the Annual Financial Statements (13 recommendations)	0.000	1.000	0.729	0.317
Size	Number of employees	0	481	47.050	106.479
Bsize	Number of members of the Management Board	1	4	2.330	0.966
Remun	Total Remuneration of the Management Board	0.000	1.700	0.454	0.381
Close	Closely -held shares	0.000	0.690	0.127	0.180
Growth	Growth in sales (2007 / 2006)	-0.652	4.289	0.562	1.065
Debt	Debt ratio	0.012	1.746	0.544	0.442
Index	Dummy: Company in Prime Standard: 1; 0 otherwise				

Using content analysis we examined each most recent declaration of conformity. All rules have been weighted equally (fulfilling a recommendation: 1; not fulfilling: 0) which results in a potential maximum score of 82. Moreover, we differentiated those scores according to the GCGC's main subcategories, namely I) shareholders and the general meeting, II) cooperation between management board and supervisory board, III) management board, IV) supervisory board, V) transparency, and VI) reporting and audit of the annual financial statements in order to get a more precise picture on the impact of different corporate governance mechanisms on performance. Data of other variables often used in corporate governance research (e.g. Bassen et al., 2006; Bress, 2008), performance measures and dummies were collected from Thomson Financial Datastream, Worldscope, companies' annual reports, balance sheets and income statements, Deutsche Börse Group and the German Federal Financial Supervisory Authority (BaFin).

Empirical results

We conducted an OLS estimation using the predictive analytics software SPSS-PASW Statistics 17.0 to generate least squares parameter estimates and our models fitted the data very well (Table 3).

Table 3. OLS regression results

	Model 1: Dependent Variable ROE			Model 2: Dependent Variable SPD		
	Standardized Coefficients			Standardized Coefficients		
	Beta	t	Sig.	Beta	t	Sig.
(Constant)		1.264	0.242		0.661	0.533
GCGC I	-1.081	-1.087	0.309	-1.969	-1.412	0.208
GCGC II	-2.081*	-2.089	0.070	1.194	0.737	0.489
GCGC III	0.332	0.562	0.590	-0.193	-0.247	0.813

GCGC IV	2.615*	2.089	0.070	-0.896	-0.412	0.695
GCGC V	0.184	0.292	0.778	0.794	0.964	0.372
GCGC VI	0.266	0.304	0.769	1.122	0.986	0.362
Size	-0.607*	-1.900	0.094	-0.187	-0.375	0.720
Bsize	-0.859**	-2.780	0.024	0.135	0.227	0.828
Remun	0.267	0.902	0.393	-0.114	-0.271	0.796
Close	0.023	0.087	0.933	-0.146	-0.408	0.698
Growth	-0.224	-0.843	0.424	-0.034	-0.087	0.933
Debt	0.605*	1.924	0.090	-0.264	-0.484	0.645
ROE				0.548	1.174	0.285
Index				0.001	0.002	0.998
R	0.814			0.760		
R-Square	0.663			0.578		

Model (1) confirms a weakly significant, negative impact of GCGC II (Cooperation between Management Board and Supervisory Board) and a weakly significant positive impact of GCGC IV (Supervisory Board) on ROE. Furthermore, Model 1 shows a weakly significant, negative size effects and significant, negative board size effects on ROE. Debt has a weakly significant, positive impact on ROE. Against, theoretical assumptions of the Code Commission which developed the GCGC and some previous findings (e.g. Goncharov et al., 2006) high rates of compliance towards single categories of the GCGC do not show a significant, positive impact on SPD (Model 2).

Conclusion and regulatory implications

According to the traditional pecking order theory of capital structure (Myers and Majluf, 1984), it should be expected that small and young companies that tend to be less well-known to the capital markets than larger firms, rely on either internal capital streams that follow the firms' profitability or on debt capital. Emphasizing the information asymmetry that may affect SMEs' financing relationships to a stronger degree than larger firms Niskanen and Niskanen (2007) report that close lending relationships are growth enhancing for firms of all size brackets, while only larger firms benefit from higher banking competition. Surprisingly, we didn't detect compliance towards the GCGC rules neither as a value driver, by bringing good news to the market nor as a driver to improve operating performance, e.g. by acquiring cheaper money (may it be debt or equity) or solving agency problems better for German SMEs. Thus, we conclude missing potential of the existing GCGC to differentiate from other companies. Moreover, finding some significantly negative impact of compliance towards specific categories of the GCGC (GCGC II: Cooperation between Management Board and Supervisory Board with its 5 recommendations, which is in the heart of splitted top management responsibility in the German insider two-tier system and GCGC IV: Supervisory board with its 32 recommendations) a bigger number of GCGC rules even seems to be destructive for SMEs in the German financial sector and do not seem to fit very well for most of them. Thus, we find some regulatory implications how "good" corporate governance may be established for SMEs in the German financial sector and for SMEs in general.

First, the compliance with the GCGC among listed SMEs in the German financial sector must be considered problematic. However, common explanations obviously fail to rationalize this situation. In line with earlier studies in this field, German listed SMEs do considerably differ from larger enterprises with respect to their code compliance (e.g. Nowak et al., 2004). While Von Werder and Talaulicar (2006), for instance, found some compliance rates well above 90 percent among the companies listed in the HDAX index of Deutsche Börse Group at the Frankfurt Stock Exchange, our sample only showed an average compliance rate of 73.88 percent. If the GCGC is dedicated to all listed companies, then a considerably lower compliance rate among listed SMEs should not be neglected. This point is even stressed by the fact that short-handed explanations like size (adaptation costs of GCGC rules are assumed to decrease when size increases) and (reporting) cost problems (Claussen and Bröcker, 2002; Von Werder and Talaulicar, 2003) obviously run short (Ergo, 2003; Graf and Stiglbauer, 2008). However, as was pointed out above, those points indeed can not be denied but they do definitively not explain the whole story. There must be structural differences in SMEs and regulation has to give answer to those differences.

Second, low compliance rates among listed SMEs of the German financial sector are often in line with the characteristic, problematic aspects of corporate governance in German SMEs in general. Our results indicate several problems that obviously parallel earlier critics about corporate governance in German SMEs, e.g. a strong sense of autarky in SMEs with an entrepreneurial feeling, mistrust towards outward transparency or a widespread deficit of controlling/risk management

institutions and their connection to corporate planning (Vitols, 2001; Henschel, 2003). Although, listed SMEs constitute a subset of all SMEs, however, they obviously mirror a considerable range of problems typical for the whole sector. Thus, we propose a SME-specific corporate governance code to change the rules of the game, as a consequence of the significant function of SMEs within the German economy. Furthermore, SMEs are affected by globalization and international product and factor markets as well as big companies. Last but not least, SMEs differ remarkably form big companies, e.g. in financing preferences, ownership structure, capital resources and as stated above their attitude towards outside transparency and management. Hence, recommendations of big companies are not simply transferable to SMEs (Pfohl, 2006).

Third, the problematic code compliance behaviour of listed SMEs in the German financial sector constitutes a considerable pressure for action for the responsible institutions. Herein they are faced with a particular regulative dilemma. No question that the code compliance behaviour described above calls for action. This addresses first of all the responsible institution, namely the Frankfurt Stock Exchange authority. The Vienna Stock Exchange, for instance, has an explicit listing rule for companies within the prime market that the issuer is obliged to include a declaration in the annual report regarding compliance or non-compliance with the Austrian Code of Corporate Governance and shall publish it on its website. Meanwhile, the compliance statement in Germany is only regulated by law (§ 161 German Corporation Act) in a fairly general manner. There is still a long way to go to increase market-orientation of the German system in order to strengthen trust in German listed SMEs, because "timely and accurate disclosure of information regarding the governance of the company improves common understanding of the structure, activities and policies of an organization. Consequently, the organization is able to attract investors" (Junarso, 2006: 4). This point is even stressed by the fact that SMEs from an investor's point of view in any case represent investment objects with higher risk than bigger companies as they normally are less diversified concerning products and services, customers or technology (Börner, 2006).

Fourth, this change of mind is easier said than be done. There exists a veritable dilemma, depending on what reason is perceived to be the source of the present problem. On the one hand, our results can be taken as a clear indicator for a widespread deficit of "good" corporate governance among listed SMEs in the German financial sector, following the assumption of the Code Commission of the GCGC (Cromme, 2002). With this in mind, stock exchange authorities would be forced to take concrete actions. Namely, they could engage in more strict controls regarding corporate governance that is not even in line with existing law (e.g. companies that do not issue any code compliance declaration or that hide it against the public). This would also include some regular evaluation and documentation of the corporate governance behaviour in general as well as the code compliance in particular of those companies, similar to what is usually done with respect to larger corporations. Moreover, stock exchange authorities would also need to consider further (regulative) steps that could help to close the gap between the current company (mis-)behaviour and the existing models of "good" practice.

Fifth, on the other hand, one could argue that our results show that the GCGC is only weakly adapted to the particular characteristics and the situation of listed SMEs (Claussen and Bröcker, 2002; Graf and Stiglbauer, 2007). By this, SMEs' code compliance behaviour could be excused with reference to misleading or even badly fitting code requirements. Moreover, this would prevent the stock exchange authorities from taking direct actions against SMEs. However, it would (re-)open the discussion in the third implication about the development of an alternative code for SMEs as proposed by several authors in the past (e.g. Hausch, 2004; Strenger, 2004; Uhlaner et al., 2007), which could be developed with the help of experts from all relevant institutions of the field. Such a code should include some standards and recommendations regarding ownership structure, creditor structure, financing preferences, accounting and disclosure, management and control and incentive systems (Hausch, 2004). Furthermore, it should contain recommendations on a supervisory board with external members, a planning and risk management system, a top-management succession planning, as well as a human resource management (Strenger, 2003).

Sixth, it seems clear that listed SMEs in the German financial sector and their lobbying institutions would not agree with either of those suggestions (Bernhardt, 2003; Steger and Hartz, 2006). Maybe this will get stock exchange authorities to remain inactive and to wait for better times to come. However, especially small, young and internationally less-known companies often lack a financial track-record which hinders a quantitative evaluation of them. Not surprising, German SMEs in comparison to their international counterparts lack equity capital (Schumann, 2007). So, signalling "good" corporate governance could help them to attract investors (Achleitner et al., 2001; Börner, 2006). Thus, conserving the current situation would also mean to take risks for being trapped sooner or later by an increase of corporate scandals in the field and/or by other institutions (e.g. government authorities) to take actions.

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