The Influence of Corporate Governance Regulation on the Capital Markets Performance: the EU Case

The paper focuses on economic consequences of corporate governance regulation in EU countries. The study examines the impact of the introduction of new EU directives regulating corporate governance issues to the EU countries capital markets performance. The analysis is based on the Takeover directive. In order to assess capital markets performance changes before and after the transposition of abovementioned directive, the trends of stock-price indexes, market capitalization and turnover in selected EU countries were analyzed.

**Keywords**: corporate governance, regulation, capital markets, EU.

Introduction

The analysis of corporate governance policy is based on the understanding that the protection of the investors’ and other stakeholders’ interests is one of the essential factors striving to create effective and competitive financial markets and to maximize their benefit to the countries’ economies. It justifies the importance of corporate governance questions in the modern dynamic economy.

In the last decade of 20th century when markets became more global and it showed up the growing trend of companies to operate cross border in the markets, the corporate governance issues became an important topic in the countries’ political
The regulation policy in this field attracted much attention at the EU level, too. The aim of such a policy is to create an effective and reliable securities market in Europe. However, there are many discussions about the EU decisions in the field of corporate governance; it is not enough paying attention to the economic outcomes of these decisions.

It is remarkable that most of the researches analyze the influence of corporate governance on the companies’ performance and are concentrated on micro level. They show significant positive relation between firm level corporate governance and corporate performance. However, there is very few researches focused on macro level and analyzing corporate governance influence on capital markets performance. Thus, we raise a question whether the adoption of the directives at the EU level has equal influence on the EU countries capital markets. The results of the authors’ last research (Levišauskaitė et al., 2011) based on stock-price indexes’ reaction to the introduction of new EU regulation of corporate governance issues showed the need of further deeper analysis of long term impact on the capital markets in the countries.

The object of the research – corporate governance regulation in EU and capital markets performance.

The aim of the research is to investigate what is the influence of the new EU corporate governance directives introduction on the performance of EU countries capital markets.

The research methods used in the paper include a logical analysis, generalization of literature and a comparative analysis, based on statistical data of investigated capital markets performance. In order to evaluate capital markets performance changes before and after the transposition of the directive, the trends of stock-price indexes, market capitalization and turnover in selected EU countries were used. The data of the research have been statistically processed using “Microsoft Excel” software.

This study contributes to the literature, first of all, expanding a number of researches that investigate the relation between corporate governance and capital markets; and second, complimenting researches that examine the economic consequences of regulations. Our analysis of the relation between corporate governance regulation and capital markets proceeds as follows. The next section discusses the theoretical framework including presentation of prior researches. Subsequent sections detail the methodology, data and the results of the research. The final section concludes the paper with a discussion of causal interpretation of the results.

Theoretical framework

It is universally accepted that sound corporate governance is one of the essential preconditions that ensures the reliability and efficiency of the capital markets. A reliable and efficient market attracts more investment, so the quality of corporate governance defines the investment climate and the perspectives of the country’s economic growth.

The corporate governance quality in the countries in large part depends on the regulatory framework. The countries’ governments play an important role by creating the legal and political preconditions for proper performance and development of financial markets. Even if companies
can partially compensate for ineffective laws and enforcement by establishing good corporate governance and providing credible investor protection at the firm-level, however, “this adjustment mechanism is a second best solution and does not fully substitute for the absence of a good legal infrastructure at the country-level” (Klapper, Love, 2004). On the other side, there is a threat of overregulation. Increasing the number and severity of country level regulations may not always lead to effective performance. The corporate governance rules can be costly and the restraints of them can also limit managerial freedom of initiative, and thereby negatively affect companies’ performance (Bruno, Claessens, 2007). These findings justify the relevance of investigation of outcomes of corporate governance regulation.

The results of researches analyzing the influence of corporate governance on the companies’ performance show that there is a significant and positive relation between firm level corporate governance and corporate performance. Gompers et al. (2003) find that companies with stronger shareholder rights have higher firm value, higher profits, higher sales growth, and lower capital expenditures. Bebchuk et al. (2004) arrive at similar conclusions that better governed companies have better valuation results. Black et al. (2006) find a causal relationship between an overall governance index and higher share price in emerging markets.

Another direction of researches moves toward the investigations of an influence of country level corporate governance standards to the companies’ performance. In their widely cited papers, La Porta et al. show that higher investors’ protection at the country level is associated with greater access to finance, more capital market development, and higher company valuation. The results of their researches show that common law countries generally have the strongest and French civil law countries the weakest legal protection of investors, with German and Scandinavian civil law countries located in the middle (La Porta et al., 1997). They state that concentration of ownership of shares in the companies is negatively related to investor protection, consistent with hypothesis that small, diversified shareholders are unlikely to be important in countries that fail to protect their rights (La Porta et al., 1998). The authors also find that countries with poorer investor protection, measured by both the character of legal rules and the quality of enforcement, have smaller and narrower capital markets (equity and debt markets), and that firms in countries with better protection of minority shareholders have higher valuation (La Porta et al., 2002). Finally, they argue that the legal approach is a more fruitful way to understand corporate governance reform than the conventional distinction between bank-centered and market-centered financial systems (La Porta et al., 2000).

Baker et al. (2007, 2009) find that firms in top-rated countries according to corporate governance level have significantly better market valuations than other firms. They also find positive and significant relation between firm-level and country-level corporate governance ratings. Hence, they suggest that the first emphasis should be put on the country level corporate governance and only then on the firm level governance. The higher level of corporate governance in the country typically has positive effect on companies’ performance and herewith on countries’ capital markets development. These findings in prior researches of different
In order to investigate what influence corporate governance regulation has on the capital markets performance, empirical research is carried out verifying the following hypothesis:

**H1**: The introduction of EU directives dealing with corporate governance policy has positive influence on EU countries capital markets performance.

In the light of the newly emerged capital markets, that have short history of development and low liquidity, the following hypothesis is formulated and verified:

**H2**: The EU directive dealing with corporate governance policy has stronger influence on more developed capital markets performance.

Methodology and data

A sound framework for protection of shareholders and third parties, which properly achieves a high degree of confidence in business relationships, is a fundamental condition for capital markets efficiency and competitiveness. The communication from the European Commission „Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward“ (2003) indicates that „in particular, an effective regime for the protection of shareholders and their rights, protecting the savings and pensions of millions of people and strengthening the foundations of capital markets for the long term in a context of diversified shareholding within the European Union, is essential if companies are to raise capital at the lowest cost“. So, we can make the assumption that the efficient functioning of the capital markets depends on the level of investors’ protection in the country, forasmuch the effective protection of investors’ interests creates the attractive environment for the investments in the capital markets and hereby fosters their development.

In order to present our methodology and verify abovementioned assumptions, we have chosen the Takeover directive\(^1\), which deals with investors’ protection issues. The long-awaited Takeover directive was intended to be one of the main pillars of the economic reform boosting Europe’s competitiveness. The aim of this directive is to protect the interests of holders of the securities of companies when those companies are the subject of takeover bids or of changes of control and at least some of their securities are admitted to trading on a regulated market in the EU countries. The Commission’s proposal\(^2\) was based on the assumption that takeovers are beneficial for investors, allowing them to obtain higher return on their investments, and, as a result of this directive, the financial markets should benefit from higher liquidity.

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The Takeover directive was adopted in EU on the 21st of April in 2004 and had to be transposed to national legal acts no later than on the 20th of May in 2006. Thus, the choice of the Takeover directive was conditioned by two reasons. First of all, as it was mentioned above, this directive regulates investors’ protection issues that are one of the most significant parts of corporate governance content. Second, the transposition of this directive to national laws had to be finished till the beginning of the financial crisis, hereby helping in our research to avoid the influence of the financial crisis outcomes.

For the research we have selected three EU countries: Germany, United Kingdom and Lithuania. Germany and United Kingdom were selected as representing developed markets. Lithuania represents small emerging market. In order to check if all selected countries are in the same stage of economic cycle we looked at the annual changes of Gross Domestic Product (GDP) of these countries during sample period of our research (Table 1). The results show that all selected countries are in the period of economic growth, though the decrease of United Kingdom’s annual GDP in 2008 shows the beginning of the financial crisis.

Considering the findings of Rogers et al. (2008) that companies who adopt better practices of corporate governance have better performance in the economic growth cycle than companies that do not adopt them, the adoption of improved corporate governance regulation in the countries should lead to the better performance of the companies as well and thereby to the better performance in countries’ capital markets.

The Takeover directive is adopted at EU level and is binding for all EU countries. After the adoption of the directive at EU level every EU member country has to transpose it into national law. The directives set the date of transposition till that EU countries will bring into force the laws, regulations and administrative provisions necessary to comply with directives, however, EU countries transpose directives into national law at the different time. Remarkable that EU countries usually transpose directives not into one legal act. Different directives’ provisions are implementing by different national laws and regulations. Depending on this situation we choose as datum-line of transposition of the directive into national laws the date of the entry into force of the national legal act which transposed the most significant rules of the directive. The table 2 below presents the exact dates of entry into force of national legal acts transposed Takeover directive in each chosen country.

<table>
<thead>
<tr>
<th>Country</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>26.800</td>
<td>27.200</td>
<td>28.200</td>
<td>29.600</td>
<td>30.200</td>
</tr>
<tr>
<td>Changes(%)</td>
<td>1.49</td>
<td>3.68</td>
<td>4.96</td>
<td>2.03</td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>29.600</td>
<td>30.400</td>
<td>32.200</td>
<td>33.700</td>
<td>29.600</td>
</tr>
<tr>
<td>Changes(%)</td>
<td>2.70</td>
<td>5.92</td>
<td>4.66</td>
<td>-12.17</td>
<td></td>
</tr>
<tr>
<td>Lithuania</td>
<td>5.300</td>
<td>6.100</td>
<td>7.100</td>
<td>8.500</td>
<td>9.600</td>
</tr>
<tr>
<td>Changes(%)</td>
<td>15.09</td>
<td>16.39</td>
<td>19.72</td>
<td>12.94</td>
<td></td>
</tr>
</tbody>
</table>

Data source: Eurostat
In order to see the influence of new corporate governance regulation to capital markets we design a test-period timeline that includes a period before adoption of the directive transposing legal acts and a period after it. This timeline is illustrated in Figure 1.

The time of transposition of the directive into national law determines the sample periods of the research for each chosen country. All selected countries transposed Takeover directive in the same year – 2006. Thus, we investigate the changes in the capital market 2 years before the transposition of the directive into national law in each country (2004-2005) and 2 years after it (2007-2008). The period of 2 years is chosen considering that it is sufficient time to minimize the influence of economic cycle as well as using data of two complete economic years, thus enabling to see the tendencies of changes in capital markets.

Considering the fact that the Takeover directive applies for companies whose all or at least some securities are admitted to the trading on a regulated market, the improved regulation of investors’ protection should have long term effects on the liquidity and performance of capital markets; therefore we chose to examine these three indicators: the market capitalization, the market turnover and the changes of stock-price indexes. The data are collected using FESE (Federation of European Securities Exchanges) database considering the possibility to get homogenous data for all selected countries’ capital markets: London Stock Exchange (United Kingdom), Deutsche Börse (Germany), Nasdaq OMX Vilnius (Lithuania). The market capitalization, the turnover and stock-price indexes are calculated on the quarterly data basis in the period of 2004-2008.

<table>
<thead>
<tr>
<th>United Kingdom</th>
<th>Germany</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006/05/20*</td>
<td>2006/07/14</td>
<td>2006/07/23</td>
</tr>
</tbody>
</table>

* - transposition is not completed.

Source: the European Commission

**Figure 1. Timeline of research design**
Results

The capital market performance is dependent on many internal and external factors such as market forces and investors’ behavior, companies’ financials, government rules and regulations, economic and political conditions, etc. Thus, it is problematical to single out one or two factors that affect the price of the stocks as well as the movement of stock-price indexes, changes in market capitalization or trading volume. Therefore, we deal with the assumption that the transposition of the Takeover directive into national laws should lead to the better investment environment and thereby to the better capital markets’ performance in the countries investigated. As a result of this directive the stock markets should indicate the higher liquidity as well as the growth in market capitalization and turnover.

We started our research with the analysis of the dynamics of stock-price indexes in comparison to the changes of GDP. The assessment of the quarterly GDP changes was chosen to identify the cyclical movements in the countries. In the case of improving the overall economic situation, the stock markets should become more active, and, on the other hand, the development of stock markets accelerates countries’ economic growth. Thus, we can observe the similar trend of the movement of stock-price index FTSE100 and GDP in UK, while DAX – stock-price index of Deutsche Börse – is increasing much more rapidly than GDP in Germany (see figures 2 and 3). The analysis of market indexes and GDP fluctuations also reveal the controversial results after year of the transposition of the Takeover directive. Developed capital markets that represent London SE and Deutsche Börse demonstrate the increasing change tendencies of these indexes till the end of 2007 when the world financial crisis leads to a stock market crash. Changes in FTSE100 index record a rise respectively in 2 years before the transposition of the directive up

![Figure 2. Trend of changes in capital market performance before and after the transposition of the Takeover directive in UK](source: Federation of European Securities Exchanges, Eurostat)
to 23 % and in 2 years after the transposition of the directive – 20 %, meanwhile the GDP calculated in euro per inhabitant shows the stable growth but not so dramatic. Because GDP is growing at a slower rate as stock-price index, we may conclude that investigated capital markets should be affected not only by economic factors. It is likely that it might be the impact of corporate governance regulation, i.e. the transposition of the Takeover directive.

Dynamics of stock market capitalization and turnover indicate the similar strong increasing tendencies. We can observe the continuing growth in capital market capitalization and turnover till the beginning of the financial crisis in UK and Germany. It should be also noted that developed capital markets demonstrated a better performance immediately after the adoption of the Takeover directive on April 2004. Market capitalization and turnover of London SE went up approximately 10 % and 36 % in 2 years time period after the transposition of this directive, respectively market capitalization of Deutsche Börse grew up to 47 %, meanwhile its turnover increased by 62 %. Thus, we may conclude that these capital markets demonstrate reaction to the transposition of the directive.

Analyzing emerging capital markets behavior to the transposition of the Takeover directive, we use the Lithuanian case. The results presented in figure 4 indicate that the stock-price index OMXV calculated in Nasdaq OMX Vilnius reacts to the event independently from changes in real GDP. Its values are increasing constantly till the end of 2007 – approximately 76 % on the 2 years time period before the transposition of the directive and 16 % on the 2 years time period after the transposition of the directive.

Market capitalization and turnover of Nasdaq OMX Vilnius indicated ambiguity results. We can see the increasing market capitalization but remarkable fluctuations of turnover (values of turnover are going up or down within limits of average 46 %). We also find that changes in market capitalization have the same trend as the stock-price index OMXV while the volatility of

![Graph](image-url)

**Figure 3. Trend of changes in capital market performance before and after the transposition of the Takeover directive in Germany**

Source: Federation of European Securities Exchanges, Eurostat
turnover is uncertain. Hence, we assume that these findings could be determined by small and illiquid capital market.

The findings of our study conclude that corporate governance regulation, i.e. the transposition of the Takeover directive may have the positive influence to the capital markets' performance. Because of well-defined takeovers procedures investors should feel more safe when making their investments and it should lead to the fostering of capital markets' development. Consequently, we found that developed capital markets, represented by London SE and Deutsche Börse, indicated better performance comparing periods before and after the transposition of the Takeover directive, meanwhile the influence of the transposition of this directive on small emerging capital market that represent Nasdaq OMX Vilnius is not obvious.

**Conclusions**

Corporate governance policy, dealing with the protection of the investors' and other stakeholders' interests, is one of the essential factors striving to create effective and competitive capital markets. However, there are many discussions about the EU decisions in the field of corporate governance, it is not enough paying attention to the economic outcomes of these decisions.

The current paper tested hypothesis that the introduction of new EU directives dealing with corporate governance policy had positive influence on EU countries' capital markets performance. The analysis was based on the Takeover directive which deals with investors' protection issues. As a result of this directive the capital markets should benefit from higher liquidity
and the growth in market capitalization and turnover. For the research there were selected three EU countries’ capital markets: London Stock Exchange (United Kingdom), Deutsche Börse (Germany), Nasdaq OMX Vilnius (Lithuania). Dynamics of stock-price indexes and changes in market capitalization and turnover were investigated over the sample period, i.e. 2 years before and after the transposition of this directive into national law in each country.

The research results confirmed that developed capital markets, represented by London SE and Deutsche Börse, demonstrated the increasing change tendencies of their indexes and other performance indicators of these capital markets till the end of 2007 when the world financial crisis leads to a stock market crash. The continuing growth in capital market capitalization and turnover was also recorded after the transposition of the Takeover directive. Thus, the authors may conclude that these capital markets demonstrate reaction to the transposition of the directive.

The second hypothesis that the EU directive dealing with corporate governance policy has stronger influence on more developed capital markets performance was confirmed, as well. Research results showed that developed capital markets, represented by London SE and Deutsche Börse indicated better performance after the transposition of the directive, meanwhile the influence of the transposition of directive on small emerging capital market, represented by Nasdaq OMX Vilnius, is not obvious.

The limitations of the research are related with the limited number of the EU countries involved in this research. As the research shows the controversial results, in order to generalize the influence of corporate governance regulation on the EU countries capital markets the situation in more EU countries should be analyzed, especially with emerging capital markets. It should be also noted that there are more adopted EU directives dealing with corporate governance policy and the economic outcomes of these directives also should be examined.

References


korporatyvinio valdymo įtakos bendrovių veiklos rezultatams analizė. Vis dėlto, empirinių tyrimų, analizuojančių korporatyvinio valdymo reglamentavimo poveikį kapitalo rinkų veiklos rezultatams makro lygmenyje, pasigendama.

Straipsnyje siekiama nustatyti korporatyvinio valdymo reglamentavimo ES šalyse ekonominės pasekmes. Darbe analizuojamas naujų ES direktyvų, reglamentuojančių korporatyvinį valdymą, perkėlimo į nacionalinę teisę poveikis kapitalo rinkų veiklai ES šalyse. Analizė atliekama vienos iš naujai priimtų direktyvų, kuri susijusi su investuotojų interesų apsauga, pavyzdžiu – direktyva dėl įmonių perėmimo. Darant prielaidą, kad šios direktyvos įgyvendinimas ES šalyse turėtų užkirsti kelius pasirinktų ES šalių kapitalo rinkų likvidumą, rinkos kapitalizacijos ir apyvartos augimą, darbe atlikta analizė prieš ir po direktyvos įgyvendimą


Atlikto tyrimo ribotumus apsprendžia per maža ES šalių, įtraukti į tyrimą, ir ES direktyvų, reglamentuojančių korporatyvinį valdymą, imtis. Įtaka ES šalių kapitalo rinkų veiklai rezultatų, būtina praplėsti tyrimo imtis, ypač įtraukiant daugiau ES kapitalo rinkų. Šiame darbe buvo analizuota vienos direktyvos įvedimo į nacionalinę teisę įtaka kapitalo rinkoms, tuo tarpu ES yra priimta daugiau direktyvų, susijusių su korporatyvinio valdymu ir jo reglamentavimu, kurias būtų tikslinga įtraukti į tyrimą, siekiant nustatyti jų įgyvendinimo ekonominės pasekmes.