Financial Globalization, governance, and the home bias

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Financial globalization

- Since end of World War II, dramatic reduction in barriers to international investment.
- Neo-classical model predicts a flat world for finance: Extensive risk-sharing across countries and reduction in the role of countries.
- Since the early 1990s, formal barriers to international investment have been low.
- Neo-classical models predict that the home bias should have shrunk dramatically.

Home bias: 1994-2004

- On an equally-weighted basis across 47 countries, the home bias of U.S. investors has not shrunk.
- On a value-weighted basis across the same countries, the home bias has shrunk significantly.
- So, U.S. investors increased their allocations to countries with high market capitalizations, but not to the other countries.

Why?

- Portfolio choice theories of the home bias ignore the impact of governance on foreign equity investment
- Governance: The institutions that insure that investors can expect a return on their investment
- Direct effect of governance: Poor governance reduces the fraction of shares available to foreign investors because it leads to higher insider ownership
- Indirect effect of governance: Poor governance reduces the expected return of foreign investors relative to the returns of resident investors

Results

- Strong evidence on direct effect; weak evidence on indirect effect.
- Insider ownership has not fallen across countries on average
- Using U.S. data at the country level, we find that the home bias fell more in countries where insider ownership fell more
- Using Korean firm level data, we find the same result at the firm level

Roadmap

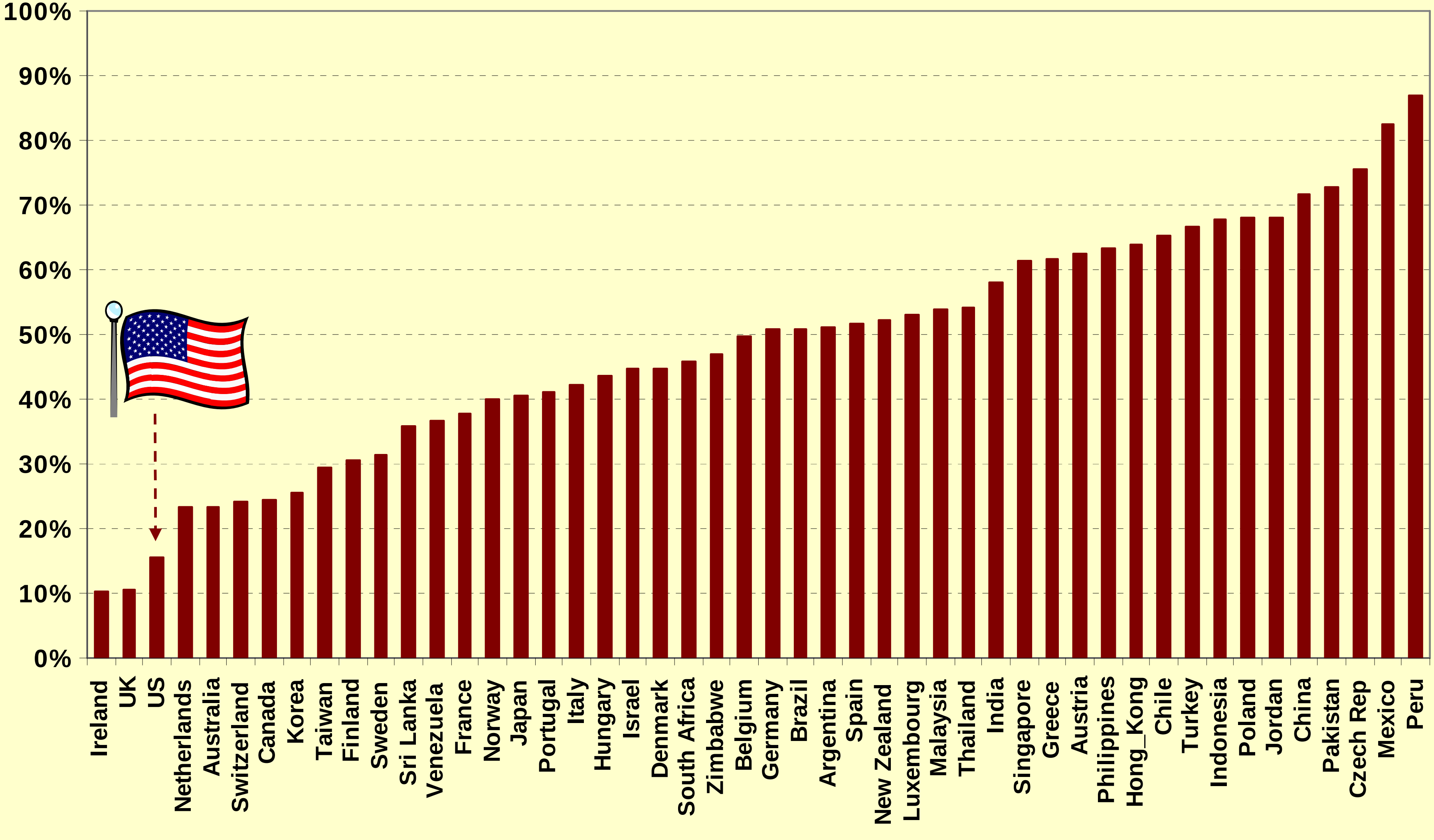
- The direct effect of governance on foreign equity ownership
- Insider ownership across the world
- The evolution of the home bias of American investors
- The home bias towards Korean firms and its evolution

Why the direct effect of governance?

- Poor governance means more private benefits for insiders
- Private benefits have deadweight cost
- Consumption of private benefits is less beneficial when ownership is higher because insiders steal more from themselves
- So, if insiders own more shares, they reduce deadweight costs of private benefits
- So, insider holdings are high when investor protection is low

Percentage of Outstanding Shares Held by Block Holders

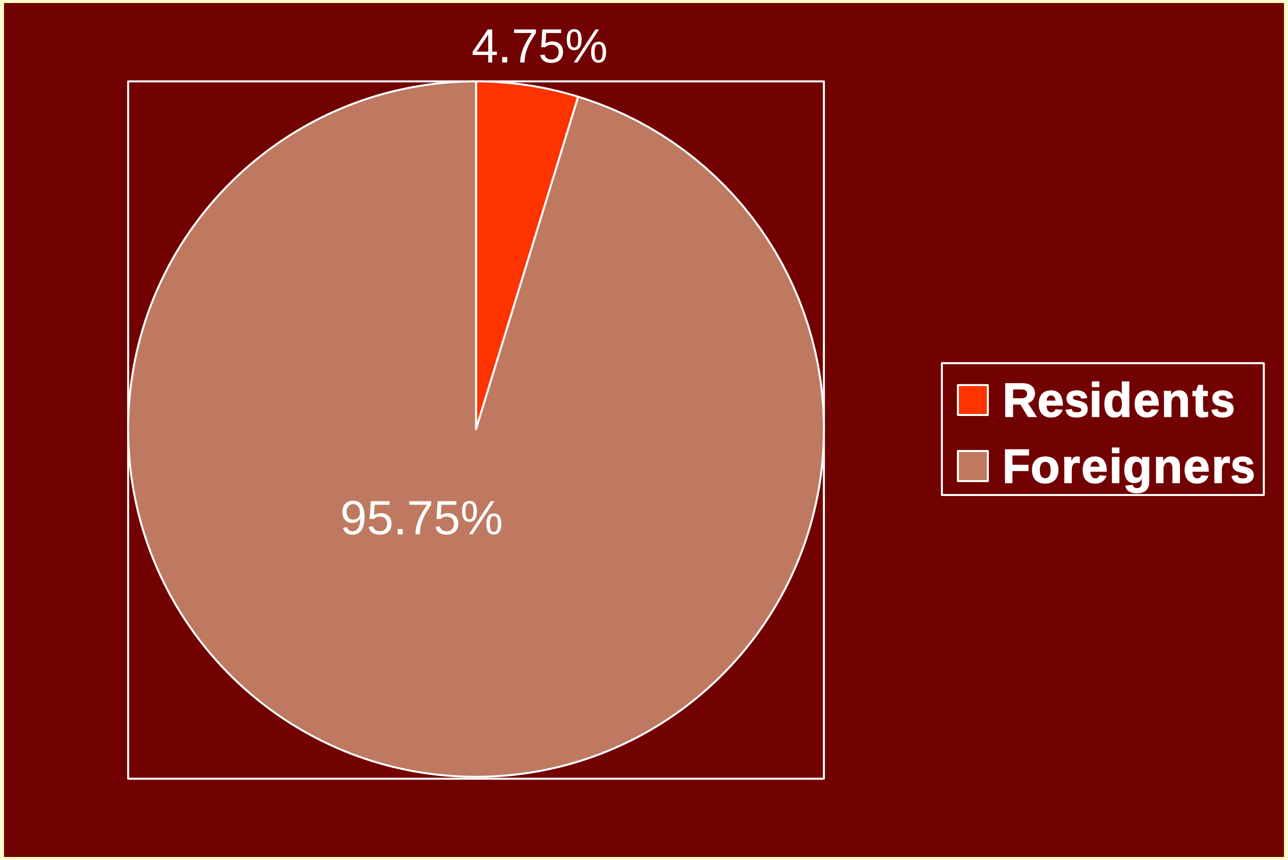
(48 countries in 2002; Source: Worldscope)



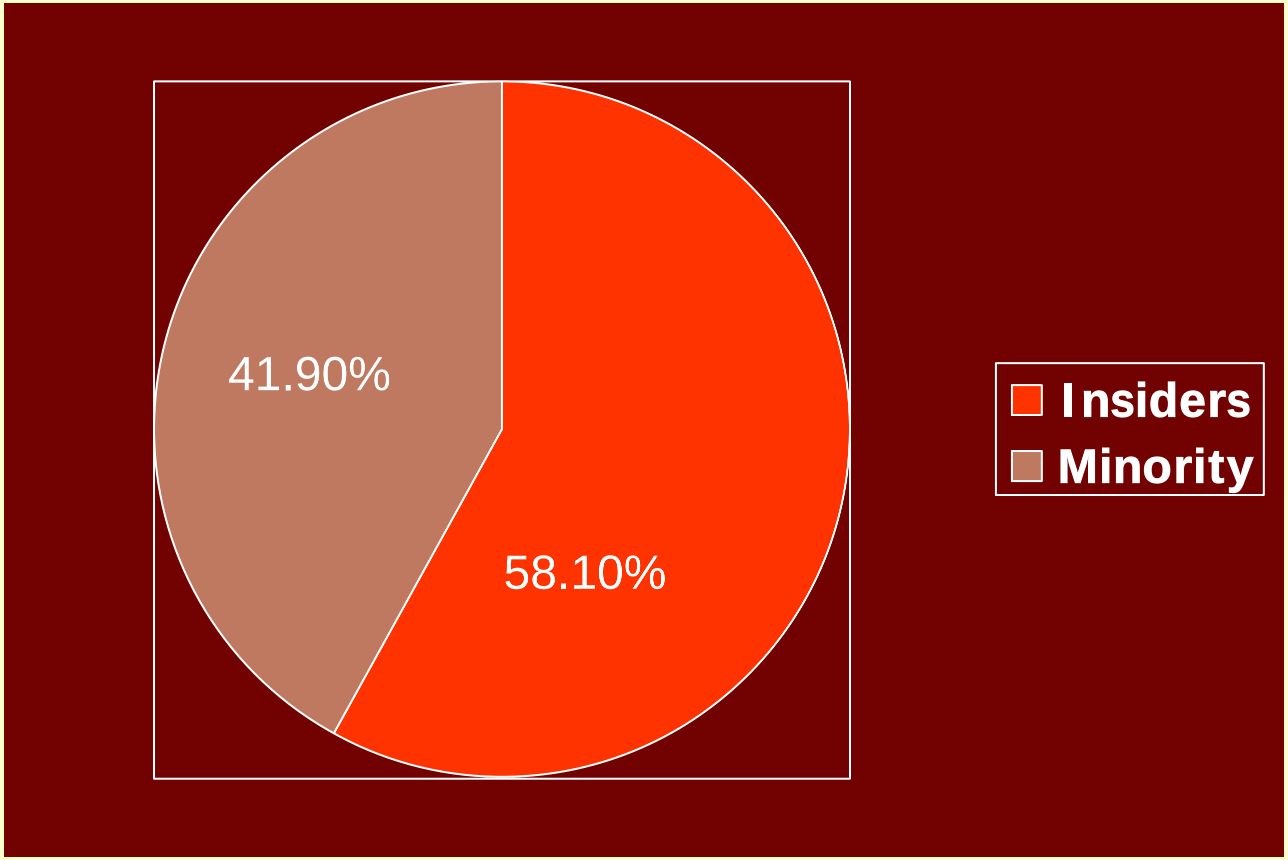
Implications for portfolio investors

- Portfolio investors can only hold shares not held by insiders
- Insiders are typically residents
- So, foreign portfolio investors can only hold shares not held by insiders
- For foreign portfolio investors to be able to increase their holdings substantially in many countries, insider ownership has to fall

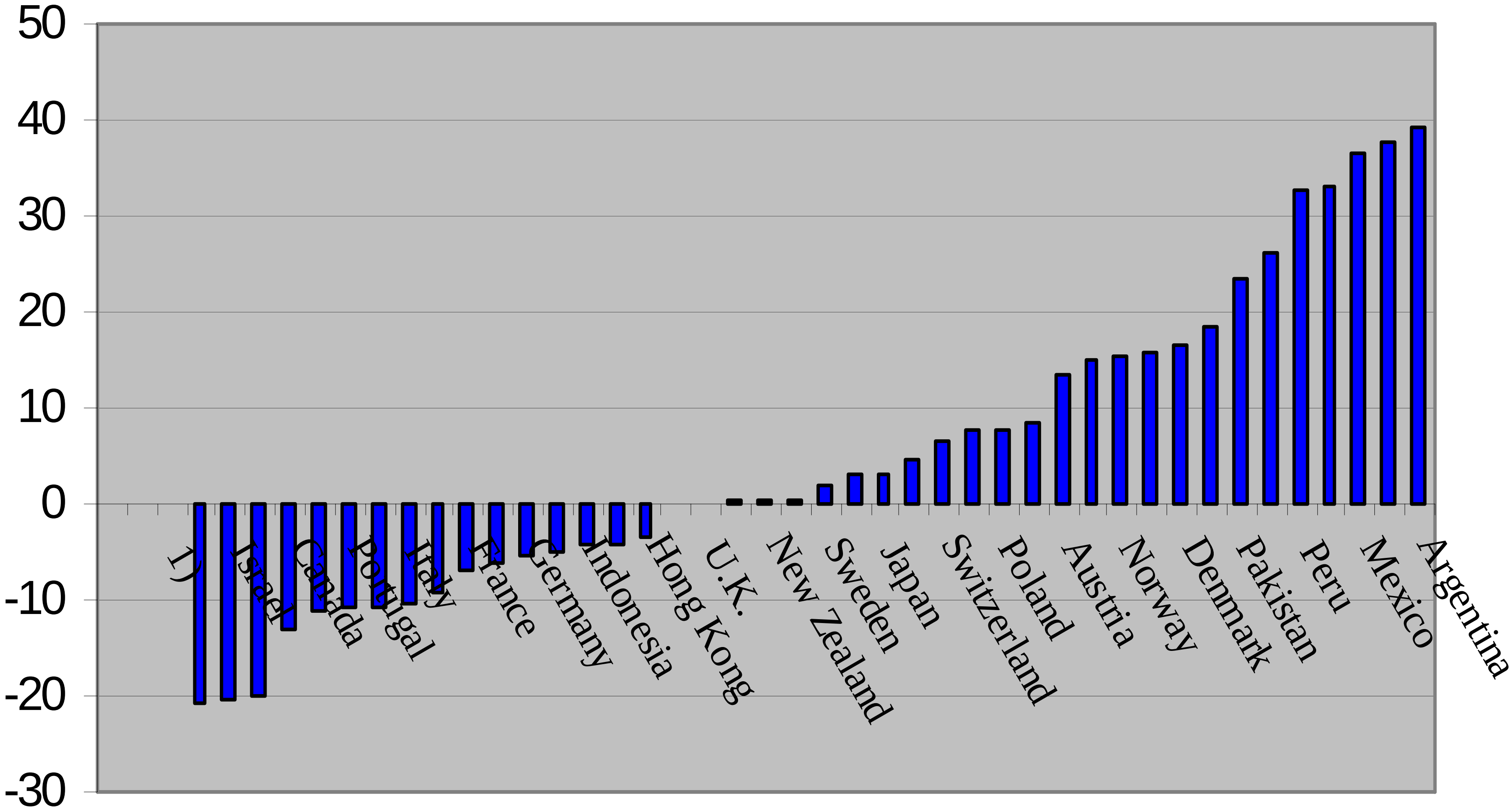
France: Portfolio theories



France: The real world



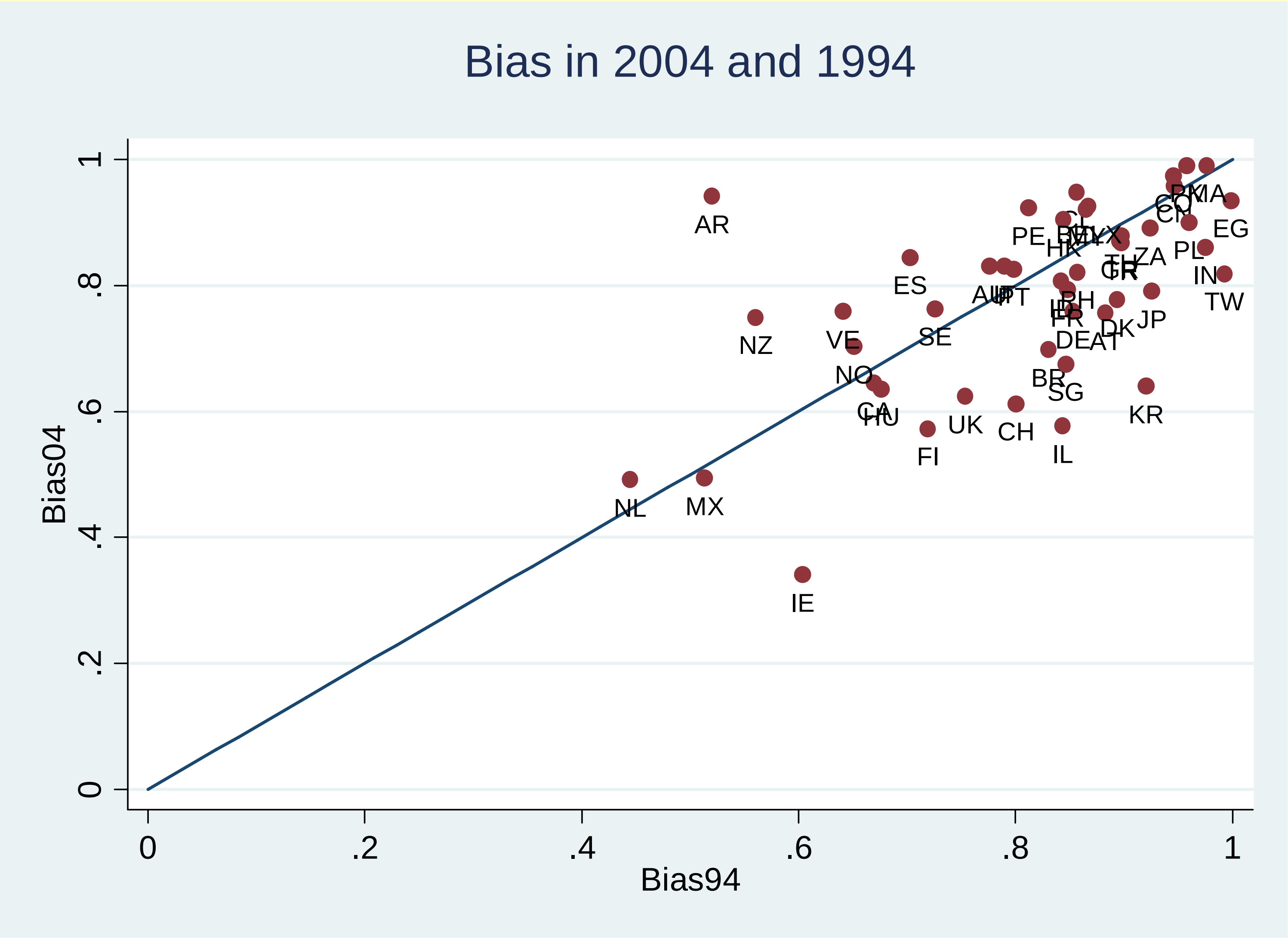
Value-weighted insider ownership change: 1994-2004



Home bias

- How to measure it?
- 1 – (share in U.S. portfolio)/(share in world portfolio)
- Which world portfolio? Float or not float?
- Only float is attainable.
- However, the total world portfolio is the correct portfolio to measure risk sharing.

Change in home bias



Averages

	Weight in World Market Portfolio		Weight in U.S. Equity Portfolio		Bias		
	2004	1994	2004	1994	2004	1994	Change
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Developed Countries	0.419	0.491	0.113	0.078	0.73	0.84	-0.11
Emerging Markets	0.126	0.132	0.021	0.020	0.83	0.85	-0.02
Total (above listed)	0.545	0.623	0.134	0.098	0.75	0.84	-0.09
Total Rest of World	0.580	0.631	0.153	0.102	0.74	0.84	-0.10
Equally Weighted Average	0.012	0.014	0.003	0.0021	0.787	0.814	-0.027
	(4.31)	(2.52)	(3.78)	(3.69)	(36.0)	(40.3)	(1.45)

Regressions: Equity market characteristics

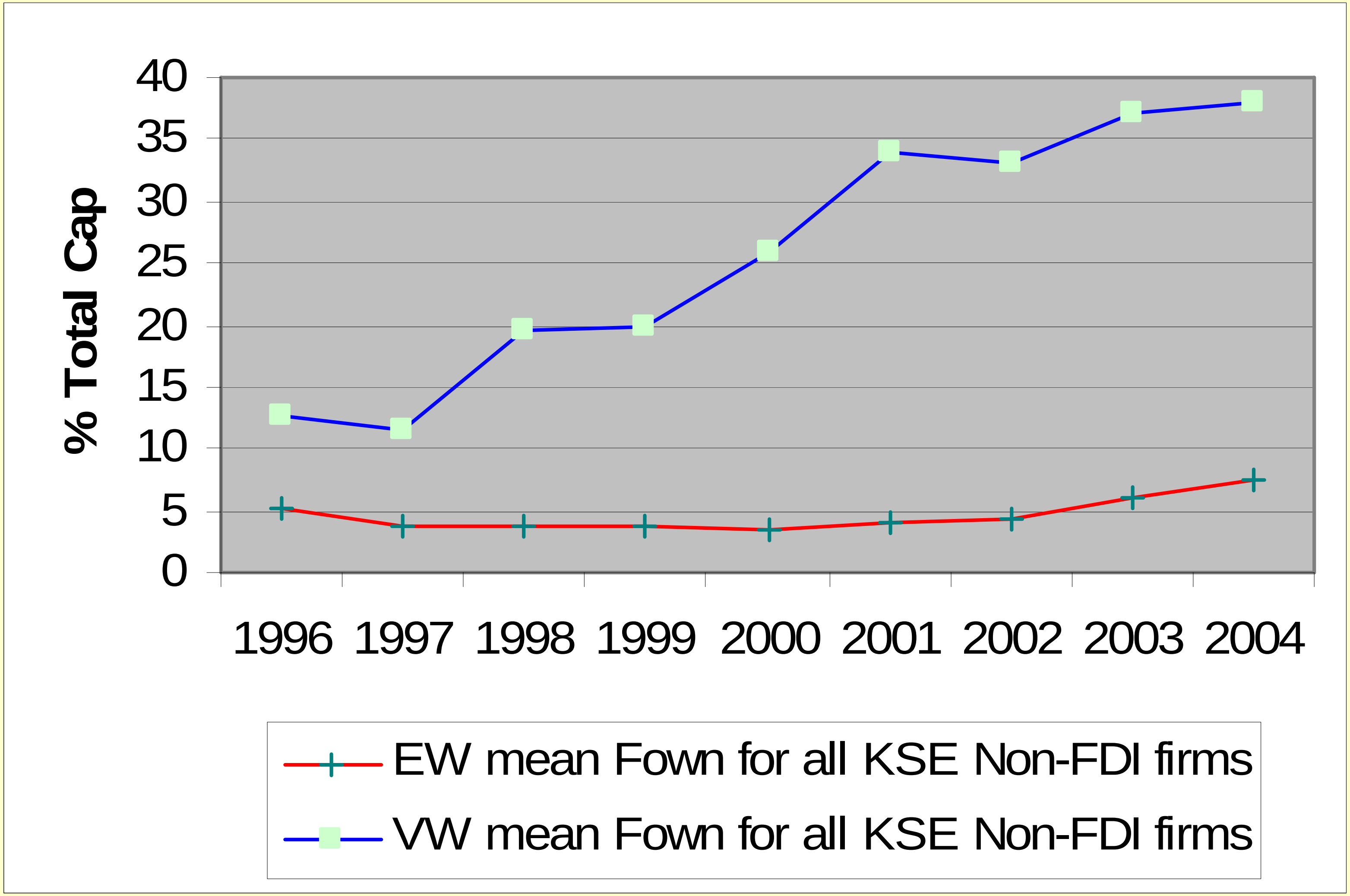
Panel A

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Bias 1994 (market capitalization)	-0.460	-0.108	-0.443	-0.457				
	(3.40)	(0.44)	(3.18)	(3.38)				
Bias 1994 (float)					-0.302	0.068	-0.462	-0.293
					(1.80)	(0.21)	(2.99)	(1.68)
Insider Ownership (1994)	0.399	0.406	0.396	0.464	0.179	0.360	0.059	0.239
	(3.97)	(4.04)	(3.80)	(3.84)	(1.14)	(1.41)	(0.37)	(1.30)
Insider Ownership (Change)	0.442	0.496	0.441	0.496	-0.242	-0.098	-0.587	-0.174
	(2.98)	(3.57)	(2.38)	(3.09)	(0.94)	(0.41)	(1.66)	(0.70)
Cross-Listing (1994)		0.356				0.559		
		(1.86)				(1.57)		
Cross-Listing (Change)		-0.095				-0.310		
		(0.85)				(1.96)		
Restrictions (1994)			0.019				0.397	
			(0.26)				(2.82)	
Restrictions (Change)			0.080				0.420	
			(1.08)				(3.13)	
Weight in World Market (1994)				1.841				1.711
				(1.61)				(0.99)
Weight in World Market (Change)				3.001				3.416
				(1.74)				(1.25)
R^2	0.469	0.602	0.486	0.507	0.186	0.430	0.306	0.214

Korea

- Data from 1996 to 2004.
- Limits disappeared for most companies in 1998.
- Look at 1998-2004.
- Differentiate FDI firms.

Foreign non-FDI investment



Level Regressions

	All of No FDI firms					
	(1)	(2)	(3)	(4)	(5)	(6)
Intercept	-3.027	11.174	19.438	-0.549	-13.466	-15.340
	(-1.73)	(8.96)	(11.91)	(-0.19)	(-11.99)	(-5.30)
100 – Insider	0.174					0.170
	(5.15)					(6.17)
Sole ownership		-0.149				
		(-4.36)				
Gov. % ranks			-0.225			-0.053
			(-9.52)			(-3.40)
Ownership parity				0.095		-0.068
				(2.69)		(-2.00)
Log size					5.349	5.367
					(15.73)	(16.17)
Adj. R^2	0.051	0.029	0.225	0.008	0.512	0.598
Nobs	557	557	449	557	564	444

Change Regressions

	Panel (1998–2004) Full Sample	Panel (1998–2004) Size> $100m	Changes (1998–2004) Full Sample	Changes (1998–2004) Size> $100m
Intercept	.	.	-18.600	-26.332
100 – Insider	0.106	0.324	0.141	0.520
Log size	2.675	4.462	5.623	8.471
Tobin's q	1.572	0.775	0.019	-3.758
Cash flow/assets	0.035	0.114	0.070	0.297
Ownership parity	-0.050	-0.235	-0.054	-0.273
Gov. % ranks	.	.	.	.
t(Intercept)	.	.	(-5.56)	(-3.36)
t(100 – Insider)	(4.91)	(4.37)	(4.14)	(5.65)
t(Log size)	(7.91)	(4.91)	(10.99)	(4.85)
t(Tobin's q)	(2.64)	(0.59)	(1.09)	(-0.83)
t(Cash flow/assets)	(2.88)	(1.46)	(0.52)	(1.65)
t(Ownership parity)	(-2.10)	(-3.23)	(-1.34)	(-2.41)
Gov. % ranks	.	.	.	.
Adj. R^2	0.471	0.502	0.474	0.457
Nobs	2,842	833	406	119

Economic significance for large firms:

-10% inside own.
+5.2% foreign

Conclusion I

- No reduction of home bias on equally-weighted basis.
- Home bias falls as insider ownership falls.
- Without FDI, foreign portfolio investment is bounded by insider ownership.
- Foreign portfolio investment increases as insider ownership falls.
- Some evidence that governance has an indirect effect as well, but harder to gauge.

Conclusion II

- Poor governance limits a country's ability to take advantage of the benefits from financial globalization
- The paper has focused on equity investments, but poor governance also affects the composition of foreign investment