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“The asymmetric impact of investor protection rights on foreign stakeholders: A note”

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Standard asset pricing models using a representative agent predict that differences in investor rights and financial development should be capitalized in share prices such that investing in any given nation's stocks will be a fair investment regardless of that nation's level of investor protection (Dahlquist et al., 2003). However, as noted by Leuz et al. (2010), the key question is whether this price discount is sufficient for foreign investors that plausibly face information problems beyond those of domestic investors. Indeed, the prevalence of disproportionate investment in domestic assets – the so-called "home bias" puzzle – can be read as evidence of the asymmetric perception of asset characteristics by home and foreign investors thus breaking the representative agent hypothesis (Gehrig, 1993; Kang and Stulz, 1997). If foreign investors are more vulnerable to information asymmetry than domestic investors, then they might be more influenced by governance rules that reduce information costs.

In this work, we are interested in the impact of investor protection laws on stock and bond portfolios held by foreign investors. Previous work originating from La Porta et al. (1998) underlines how investor protection affects financial market development, that is, the supply of equity, leaving the demand side mostly unexplored. This latter perspective is relevant insofar as we account for heterogeneity across investors. For instance, Giannetti and Koskinen (2010) show that investor protection impacts financial market development by influencing the demand for equity, because different classes of investor, specifically controlling and outside shareholders, can differ in the benefits accruing to them and therefore in their willingness to pay for stocks. However, they assume that domestic and foreign outside investors face the same cost of participation in both domestic and foreign markets. This hypothesis is quite strong and admittedly at odds with the prolific empirical literature emphasizing the role of asymmetric information as a potential explanation for the home bias puzzle. Our perspective can be viewed as complementary to Giannetti and Koskinen (2010): while they split the universe of investors into inside and outside investors, we focus on outside investors only, in order to test if corporate governance evenly affects all portfolio investors or if it is instead particularly relevant to foreign investors. A perspective much closer to ours is taken by Leuz et al. (2009). They investigate the impact of firm-level corporate governance

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on foreign holdings and find that foreigners invest less in firms with poor outsider protection and opaque earnings.

We depart from previous works in that we investigate the effect of investor protection laws on foreign portfolio investment – debt and equity portfolios – accounting for the interaction of various governance mechanisms on stakeholders endowed with different rights and interests.

Within the corporation, the distinct interests of managers, stockholders and creditors coexist and are often in conflict with one another. It may be the case that legislation particularly favorable to one type of stakeholder turns out to be detrimental to others. Shareholder-manager conflict has received much attention in the literature, but important sources of conflict can also arise between shareholders and bondholders. These conflicts can give rise to interesting effects on portfolio decisions making on the part of foreign investors. Specifically, strong shareholder rights protection are likely to benefit foreign shareholders ("direct" effect) but may also deter foreign bondholders ("cross" effect) as shareholders are more prone to risk-taking activities than is optimal for creditors (Myers, 1976; Jensen and Meckling, 1976). On the other hand, strong creditor rights are likely to attract foreign bondholders ("direct" effect) but may deter stock investments ("cross" effect) if firms are induced to engage in risk-reducing processes such as acquisitions that are likely to be value-destroying (Acharya et al., 2008). Ultimately, the question of the impact of investor protection provisions on foreign stakeholders, the focus of the present paper, is an empirical one and depends on foreigners' perception of the balance among various interests.

Our results highlight that laws protecting the interests of different types of investors asymmetrically affect foreign stakeholders and, more specifically, that foreign portfolio investors more highly value corporate governance practices that are risk-reducing than do domestic investors. Foreign shareholders appear to appreciate strong creditor rights that potentially mitigate the riskiness of projects, while bondholders are negatively affected by strong shareholder rights that could induce the firm to engage in risky asset investments.

Finally, our findings also contribute to the literature that investigates the failure of legal convergence of rules and enforcement mechanisms toward some successful standard of effective investor protection (La Porta et al., 2000; Djankov et al., 2008). Our findings highlight that investor protection can be beneficial to one type of investor and detrimental to another. Accordingly, the level of investor protection in each country is endogenously determined by many conflicting forces, among which are the political choice to promote inward investment and to favour some classes of investor over others.

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