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The Impact of Internal Governance Mechanisms on the Share Price Volatility of Listed Companies in Paris Stock Exchange

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Abstract

This paper investigates the impact of internal governance structure on firm-level stock return volatility in Paris Stock Exchange based on our study of a sample of 65 firms for the daily period from January 2010 to December 2012.The research has sixth hypotheses. To test each hypothesis; a model was defined based on dependent variables employed to measure the share price volatility. Our findings reveal different results by using different models of multivariate regression. The empirical results show no statistically significant relationship to any components of ownership structure. However, the results also show that the components for the board structure reduce volatility. Indeed, we document a statistically significant negative relationship between the board independence, the CEO Duality, the board size and the share price volatility. Hence, the board structure is not expected to cause severe volatility in the stock prices, which in turn, is consistent with the results of this study.

JEL classification numbers: G12, G15, G32
Keywords: Share price volatility, Ownership Structure, Board structure, Paris stock exchange

1 Introduction

The recent global financial crisis has led to sharp decreases in the asset prices and to higher volatility in many financial markets, perhaps as the consequence of destabilizing speculation, as was indicated in the study of Kaldor (1939). Moreover, according to the financial instability hypothesis, instability, which is often characterized by increased volatility of stock prices, is endogenous in financial markets (Minsky, 1992; Kregel, 2007). Besides, transparency in markets reduces instability and consequently leads to less uncertainty, which is often measured by stock prices volatility. From the perspective of

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the efficient market and the hypothesis of informational asymmetries, the expected outcome of better corporate governance is more transparency, less uncertainty, and therefore lower stock returns volatility. Within this framework, this study sets out to examine the stock return volatility of the Paris stock exchange. More specifically, it is examined whether the corporate governance, such as the ownership structure and the board structure, could provide an explanation for stock prices volatility.

The paper presents a problem which is the continuous fluctuation of the company's market price as a result of several variables, including the changes in governance structure (ownership structure and board structure).We deal with a number of questions in order to determine the impact of the internal governance structure on the daily volatility of the equities of companies listed in the Paris Stock Exchange. More specifically, do the components of the internal governance structure have an impact on the volatility of market prices of the company equities?

This study considers an important variable also for the French financial market. Since the ownership structure may (or may not) affect daily volatility of the market prices, the examination of the internal governance structure (ownership structure and board structure) effects on the volatility of market equities prices of the companies listed on the Paris Stock Exchange is an interesting research topic. Indeed, few works have studied the impact of the board structure (board independence, duality and board size) on firm-level stock return volatility. Our study attempts to contribute to the development of these relationship given the lack of studies focusing on the link between these mechanisms and the volatility of stock prices.

This study is structured as follows: Section 1 presents a review of the literature. Section 2 presents the data and methodology. Section 3 discusses the results. Section 4 concludes.

2 Literature Review

The mechanism of governance structure, which was opened in efficient markets, currently integrates new more markets. Mintz (2005) believes that the mechanisms of corporate governance contain methods and approaches that may cause the sustaining of the interests of shareholders and optimum use of funds owned by them in the process of operating activities of the company.

Under the hypothesis of asymmetric information, the corporate governance is improved for the reason that more transparency reduces informational asymmetries, thus allowing for economic growth and more efficient allocation of funds. The perspective of asymmetric information influences the way in which it affects markets results in deviations of stock prices from their fundamental values and the decisions of the market players. Better corporate governance practices and transparency may help reduce the information asymmetries in the market and partly eliminate these difficulties. Thus, prices in general and stock prices specifically may become more efficient (Diamond and Verrecchia, 1991; Baumann and Nier, 2004). By reducing the asymmetries of information, the trading volume increases, the bid-ask spreads, and the stock-return volatility decreases (Leuzand Verrecchia, 2000).

In addition, the discovery of the price efficiency ensures stability in the financial markets. For example, it is generally considered that poor corporate governance can

increase uncertainty and volatility (Claessens, 2006). Morck et al. (2000) argue that weaker corporate governance and less transparency reduce the price discovery in stock markets, thereby increasing the volatility of stock prices. Consequently, from the hypothesis of the efficient markets, it makes sense to improve more transparency and better governance practices in the market, because these practices contribute to better functioning of financial markets, leading to financial development and economic growth.

Mugaloglu and Erdag (2013) examine the stock return volatility of ISE corporate governance constituents. More specifically, their study investigates if public disclosure by these companies through the electronic public disclosure platform lowers stock return volatility. They also examine if recent and past news have persistent effects on stock return volatility. As a result, they indicate that the public disclosure did not lower the volatility of stock returns with the exception of two shares. On the contrary, the stock return volatility increased in the case of eleven shares. This was evidenced by significant positive dummy coefficients in the model. There could be several explanations for these findings although they are not within the scope of the present study. One explanation could be the inefficiencies in the corporate governance rating process, which may result in measurement errors.

Morcket al. (1988) reveal that the larger shareholders have their own interests that sometimes are not consistent with the interests of other shareholders. This may explain the positive relationship between the concentrated corporate ownership and the volatility of share prices. The concentrated ownership structure (owned by the biggest shareholder) has a positive effect on stock price volatility. Thomsen and Pedersen (2000) also found a positive and significant relationship between the concentrated ownership structure and the economic performance. Agrawal and Mandelker (1990) refer to the hypothesis proposed by Shleifer and Vishny (1986) to show that the presence of large shareholders in the company led to better monitoring of managers and better performance. Similarly, Morck et al. (2000) confirm the disciplinary role played by the shareholders in Japan. In the emerging markets, the high concentration of ownership has a positive impact on their performance (Wruck, 1989), In fact, Xu and Wang (1997) find that the ownership concentration has a positive and significant effect on the performance of Chinese companies.

Sadeghi and Panjehshahi (2008) found that the percent of the largest shareholder's ownership negative affects performance. Sadeghi and Bahadori (2009) examined the effect of ownership structure on the DPR (Dividend Payout Ratio) and found that the percent of ownership of the largest shareholder has a positive effect on the DPR. Ezazi et al. (2011) show that there is no relation between the percent of top 5 shareholder's ownership and the volatility of stock prices. Sadeghi and Panjehshah (2008) found no relationship between the ownership owned by the five largest shareholders and performance. However, Sadeghi and Bahadori (2009) found a positive relationship between the five major shareholders and the DPR.

In addition, Ezazi et al. (2011) show that there is no relation between the institutional ownership and the volatility of stock prices. But, in the study of Sadeghi and Panjehshahi (2008), there is an impact of institutional ownership on a firm’s performance. Furthermore, the power of control exercised by the institutional investors, as well as its impact on firm performance, has been studied by a number of researchers. However, this impact is ambiguous (Denis et al., 1997). McConnell and Servaes (1990) found a result that confirms the predictions of the agency theory, according to which the percentage of institutional shareholders influence positively the performance of firms. However, the

intensity of this relationship depends on the behavior of investors, which have an effect on the performance of the company unless they are actively involved in corporate governance.

The results of Namazi and Kermani (2008) showed that there is a negative relationship between the ownership of individual shareholders and price volatility.

Thomsen and Pedersen (2000) argue that, in the case of dispersed ownership, shareholders can't contribute in the governing of the companies which leads to the reduction of optimal performance. Sadeghi and Panjehshahi (2008) found no link between the individual ownership and performance. They confirmed the negative effect of dispersed ownership on performance.

The relationship between the managerial ownership and the corporate performance has received considerable attention in economics and finance. Indeed, this relationship has been studied by several authors, including Jensen and Meckling (1976) among others.

However, the nature of this relationship is still a matter of discussion. Thus, the assumption of agency costs (Jensen and Meckling, 1976) states that the incentive to undertake unprofitable projects may be reduced when insiders have a significant share of capital. On the other hand, reducing the percentage of equity held by insiders can lead to a divergence of interest with the new shareholders. These can create the adverse selection problem and consequently affects the volatility of stock prices. Sadeghi and Panjehshahi (2008) and Ezazi et al. (2011) rejected the hypothesis of the existence of a relationship between the managerial ownership and performance. Namazi and Kermani (2008) found that the managerial ownership affects the performance of the company in a negative and significant way.

The agency theory states that the presence of outside directors on the board of directors may reduce the agency costs and increase firm performance. Using a sample of UK companies during the period 1996-2000, McKnight and Mira (2003) show that a firm's performance is influenced positively by the number of independent directors. They argue, however, that a low level of agency costs is recorded as a board dominated by independent directors. Indeed, the presence of independent directors is particularly important for the sustainability of the board (Fama, 1980). In contrast, Morck et al. (1988) and Bhagat and Black (2002) show the existence of a neutral relationship between board independence and firm's performance. In other words, the presence of independent directors on the board of directors does not cause any performance improvement. Better governance structure and transparency also may help reduce information asymmetries in the firm and increase the level of performance. Thus, a lower information asymmetry can have an effect on price volatility. Very few studies have focused on exploring the relationship between the board independence and the stock price volatility in the French context.

The relationship between the board structure and the firm performance has also been the subject of controversy in the literature. In accordance with the arguments set forth in the agency theory, the results of some studies (Daily and Dalton, 1993; McKnight and Mira, 2003) have shown an advantage in favor of the separation of the functions of Chairman of the Board of Directors and the CEO. On the contrary, Donaldson and Davis (1991) and Godard and Schatt (2000) have shown a positive relationship between the accumulation of functions and performance of the firm.

A set of empirical studies advocate the lack of relationship between the board structure and firm performance. Indeed, Chaganti et al. (1985) were among the first that proved

empirically the lack of relationship between the board structure and the firm's performance. However, several studies suggest that a single person should not hold simultaneously the role of a chairman and a CEO. The combination of function is, at first glance, the intersection of conflicts of interest (Zahra and Pearce, 1989).Such an intersection could have increased the level of uncertainty and therefore stock returns volatility.

For agency theorists, the size of the board promotes high dominance of the leader by raising coalitions and group conflicts. The result is the existence of boards which have difficulties to operate efficiently and reach a consensus on important decisions. Thus, Hermalin et al. (2003) argue that a small size of the board will be more able to make decisions for the benefit of shareholders. Therefore, it can reduce information asymmetries in the firm and stock-return volatility. Ginglinger (2002) confirms the ineffectiveness of a large board in the exercise of executive control. Despite the advantages of building expertise, Yermack (1996) highlights a deterioration in performance, particularly marked from five directors. In contrast, Bhagat and Black (2002) failed to prove the existence of a relationship between the board size and firm's performance for U.S companies[3].

Based on the literature review and the linkages that have been considered, the following hypotheses are formulated:
-The first hypothesis: The concentration of ownership is related to the volatility of the market equities prices
-The second hypothesis: The managerial ownership is linked to the share price volatility of the company.
-The third hypothesis: The institutional ownership is connected to the share price volatility of the company.
- The fourth hypothesis: the Board independence is associated with the volatility of the market equities prices.
- The fifth hypothesis: there is an effect of CEO duality on the price volatility of the company.
-The sixth hypothesis: the size of board is related to the share price volatility of the company.

3 Data and Methodology

This study uses the multivariate regression approach. This will be iterated for a number (n) equal to 65companies listed in the Paris Stock Exchange. These companies represent a sample of the three major sectors in the stock market i.e., banking, services and the insurance sector.

[3]It is to notice that there are also other sources of stock market volatility. See for instance Papadamou et al. (2014) for the role of central bank characteristics on stock market volatility.

The data were collected from the website of the Financial Market Authority (FMA) manually, from January 2010 to December 2012; in a daily sample (T) including different numbers of trading days. The dependent variable (y) will be represented as (yit) where i=1,…,n denotes companies and t=1,…,T the time period.

In this research the governance structure (ownership structure and board structure) is considered as an independent variable for which five indexes are considered leading to five hypotheses:

- The concentration of ownership is the dummy variable taking one if the percentage of capital owned by the largest shareholder is greater than or equal to 20%, zero otherwise.
- The managerial ownership is the percentage of shares owned by managers and directors.
- The institutional ownership is the percentage of shares held by institutional investors.
- The board independence is the percentage of independent (nonaffiliated) outside directors on a firm's board (number of outside directors/board size).
- The CEO Duality is the dummy variable taking one if CEO is also the chairman of the *board*, and is 0 otherwise.
-The Board Size is the number of directors on a board for each firm.

Share price volatility (VOLATILITY) is the dependent variable measured by the variance of stock returns.

We also consider several control variables such as firm's size (SIZE) and Return On Assets (ROA). There are different indexes for estimating the size of the firm such as the firms' assets, the selling, and the number of staffs and firm's market value and the logarithm of total assets.

In this research the following model will be used to examine the effect of the independent variable (ownership structure and board structure) and controlling variables (company size and ROA) on the dependent variable (Volatility in the equity prices).

For each hypothesis an equation is formed and the influence of each separate independent variable on the dependent variables is determined. The key equation is formed as follows:

$$Y_{it} = \alpha + \beta X_{it} + \gamma F_{it} + dZ_{it} + e_{it} \qquad (1)$$

Where Y_{it} stands for share price volatility, X_{it} is a vector including the ownership structure (ownership concentration, managerial ownership, institutional ownership); F_{it} is a vector including the board structure (board independence, board size and CEO duality), Z_{it} denotes the control variables, such as company size and ROA.

4 Results

Table 1 reports the descriptive statistics of the main regression variables. Volatility ranges between 0,000013 to 0,0139063with a standard deviation of0,013%.Indeed, a higher volatility means that prices can change dramatically over a short time period which leads to interruption of confidence of shareholders and leads to the appearance of many issues. The average proportion of managerial ownership is 27,63%, of which 14,41% is by institutional ownership and 34,65% by outsiders. In addition, Table 2 shows that ownership in the French stock market is relatively concentrated, with an average of 79,63%.The table also shows that 74,24% of firms are consistent with the CEO duality structure.

Table 1: Summary statistics of variables

Variables	Mean	Std Dev	Min	Max
Variance	0,0003804	0,0012743	0,000013	0,0139063
ManagOwn	27,63372	31,04277	0	96,26
OwnConc	0,7929293	0,4062338	0	1
InstOwn	14,41308	21,20798	0	86,5
Boardindep	0,3465742	0,2146121	0	1
CEO Duality	0,7424242	0,4384076	0	1
Board Size	9,151515	3,926646	3	18
Firm Size	5,778574	1,074459	2,170262	8,398145
ROA	0,0205099	0,0882382	-0,6542	0,27518

Variance is the proxy for firm-level stock return volatility, **Manag Own** is the aggregate percentage of managerial ownership. **Own Conc** is the aggregate percentage of ownership concentration.**Inst Own** is the aggregate percentage of institutional ownership. **Board Indep** is the aggregate percentage of independent outside directors on a firm's board.**CEO Duality** is the dummy variable taking the value of one if the CEO is also the chairman of the board, and 0 otherwise. **Board Size** is the average of the number of directors on a board for each firm.**Firm Size** is the natural logarithm of total assets at the end of the fiscal year.**ROA** (Return On Assets) denotes Total Assets at the end of the fiscal year to Net Outcome.

Before testing our research hypotheses, we should deal with the problem of multicollinearity. This problem arises when two variables are highly correlated. Multicollinearity refers to a situation in which two or more independent variables in a multiple regression model are highly correlated. Kervin (1992) states that a problem of multicollinearity is present when the correlation coefficient is greater than 0, 7.The results show the presence of a critical correlation that can present a serious problem of collinearity between the firm size and ROA. These findings allow us to apply multivariate regressions by taking into account this problem of multicollinearity between these two variables of control. Table 2 presents the correlation coefficient associated with independent variables used in our model.

Table 2: Correlation coefficients of the explanatory variables

	Managerial Ownership	**Ownership Concentration**	**Institutional Ownership**	**Board Independence**	**Duality**	**Board Size**	**Firm Size**	**ROA**
Managerial Ownership	1,0000							
Ownership Concentration	0,0436	1,0000						
Institutional Ownership	-0,0845	0,2205	1,0000					
Board Independence	-0,0527	-0,4266	-0,0735	1,0000				
Duality	-0,1334	-0,2643	-0,3592	0,2760	1,0000			
Board Size	-0,0664	0,0266	0,0980	-0,0735	-0,154	1,0000		
Firm Size	-0,2356	-0,3248	0,0025	0,2578	0,3193	-0,3370	1,0000	
ROA	-0,2747	-0,2340	-0,0338	0,2709	0,4344	-0,082	**0,7211**	1,0000

Morck et al. (1988) reveal that large shareholders have their own interests thatsometimes are not consistent with the interests of other smaller share holders. This may explain the positive relationship between the concentrated corporate ownership and the volatility of share prices. Agrawal and Mandelker (1990) refer to the hypothesis proposed by Shleifer and Vishny (1986) to show that the presence of large shareholders in the company led to better monitoring of managers and better performance. The first hypothesis was about the relation between the ownership concentration and the share price volatility, as you see in Table 3, it is rejected. This is consistent with the results of Ezazi et al. (2011) that there is no relation between ownership concentration and stock price volatility. However, this result contradicts with the finding of Alzeaideen and AL-Rawash (2014).Indeed, these authors proved that there is a positive relation between focused ownership structures (largest) and share prices volatility.

We can also see the neutrality of the relationship between the managerial ownership and the share price volatility given the absence of a significant correlation between these two variables. Furthermore, testing the third hypothesis, we show that there is no relation between the institutional ownership and the share price volatility that is in accordance with the results of Ezazi et al. (2011) and Alzeaideen and AL-Rawash (2014).

Moreover, we demonstrate a negative relationship between the board independence and the stock price volatility. This result can be explained by the idea that the presence of outside directors on the board of directors may reduce agency costs increasing transparency and thus reducing price volatility. Indeed, the board independence may help reduce the information asymmetries in the firm and decrease the level of share price volatility. Thus, a lower information asymmetry can have an effect on price volatility.

The fifth hypothesis was about the relation between the CEO duality and the share price volatility. This latter hypothesis is validated. Of course, our results show that the CEO Duality has a significantly negative effect on the share price volatility.

Finally, concerning the sixth hypothesis, we show that there is a negative relation between the board size and price volatility. This result can be explained by the idea that over the board is large it will be more able to make decisions for the benefit of shareholders. This can lead to a reduction of information asymmetries in the firm and thus

stock-return volatility decreases. This is contradictory to the idea of an ineffectiveness of large board in the exercise of executive control, despite the advantages of building expertise as presented by Ginglinger (2002).

5 Conclusion

In this study, a number of hypotheses examined the impact of internal corporate governance on the volatility of equities prices were tested for the case of the French stock market. The results showed no statistically significant relationships to any components for ownership structure. Furthermore, our estimates show a statistically significant and negative relationship to components for board structure. Concerning CEO duality, it is shown that the combination of functions seems to improve the performance of the company in reducing the level of uncertainty by reducing the volatility of equities prices. Finally, we show that the board size decreases stock return volatility. According to our results there is an important role for components related to board structure and further investigation for other stock markets could possibly reinforce our findings relevance.

Table 3: Impact of internal governance structure on share price volatility

	Model 1	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**
Constant	**0,00214*** (5,03)**	**0,0026*** (4,54)**	**0,00252*** (4,68)**	**0,0006*** (2,64)**	**0,00229*** (4,31)**	**0,00169*** (5,07)**
Managerial Ownership	-2,43e^{-O6} (-0, 72)	- 1,31e^{-06} (-0,39)	2,79 e^{-07} (0,09)	1,89 e^{-06} (0,56)	-	-
Ownership Concentration	-0,000034 (-1,43)	-0,0003 (-1,31)	-0,00029 (-1,33)	-0,00031 (-1,35)	-	-
Institutional Ownership	8,12e^{-07} (0,17)	1,37e^{-06} (0,29)	1,17e^{-06} (0,25)	-2,40e^{-06} (-0,50)	-	-
Board Independence	**-0,00079* (-1,67)**	-0,00053 (-1,06)	-	-	-0,0002 (-0,47)	-0,00045 (-1,04)
CEO Duality	**-0,00046** (-2,15)**	**-0,00039* (-1,75)**	-	-	**-0,0004* (-1,82)**	**-0,0005** (-2,25)**
Board Size	**-0,00009*** (-3,41)**	-0,00005 (-1,45)	-	-	-0,00005 (-1,46)	**-0,00008*** (-3,57)**
Firm Size	-	-0,00017 (-1,33)	**-0,00033*** (-3,90)**		-0,00018 (-1,45)	
ROA	0,001 (0,97)	-	-	0,00023 (0,22)	-	0,00063 (0,63)
N	**198**	**198**	**198**	**198**	**198**	**198**
R-Squared	**10,15**	**10,54**	**8,46**	**1,27**	**9,43**	**8,62**
Fisher Test (Prob F)	**3,0667 (***)**	**3,198 (***)**	**4,4588 (***)**	**0,6222**	**5,015 (***)**	**4,5505 (***)**

The relation between volatility and internal governance structure: Baseline regression. The dependent variable is the proxy for firm-level stock return volatility: the variance of stock returns (**Variance**). **Manag Own** is the aggregate percentage of managerial ownership, **Own Conc** is the aggregate percentage of ownership concentration. **Inst Own** is the aggregate percentage of institutional ownership. **Board Indep** is the aggregate percentage of independent outside directors on a firm's board, **CEO Duality** is the dummy variable taking one if CEO is also the chairman of the board, and is 0 otherwise. **Board Size** is the average of the number of directors on a board for each firm. **Firm Size** is the natural logarithm of total assets at the end of the fiscal year, **ROA** (Return On Assets) is the Total Assets at the end of the fiscal year to Net Outcome. *, **, and *** indicates a statistically significant value at 10%, 5% and 1%, respectively.

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