Guest editorial

Introduction to the special issue on financial monitoring and its consequences

Introduction

It is human nature to act in our own self-interest. Unfortunately, the resulting actions may run in conflict with others, even those whose interests we are specifically tasked to protect or promote. In a financial setting, these conflicts have long been acknowledged with early work focussed on natural monopolies, the principal-agent problem between managers and shareholders, and the monitoring of firm creditworthiness by banks.

As time has progressed and capital market participation increased, we have seen growing awareness of the existence of conflicts of interest and how they can be detected and resolved. A quick search of a common research database (business – ABI) looking for the words "financial monitor" in the abstract of scholarly papers, revealed over 1,000 papers using these terms since 1970 with over 400 published in the most recent time span of 2010 to mid-2016 alone. An astonishing breadth of financial market participants are addressed in these papers including audit committees, institutional investors, legal counsel, central banks, venture capitalists, customers, and the media. While traditional monitors such as regulators and banks are still being discussed, we now see that the unique relationships that other capital market participants have with corporations may grant them access to novel information or a different set of tools to facilitate the monitoring of their activities.

The special issue

The six papers included in this special issue embrace a broad definition of what constitutes a financial monitor. We begin with two papers (Neave, 2016; Hussain, 2016) examining the monitoring occurring between borrowers and lenders and move to the article by Chamberlain *et al.* (2016), examining a proposed change to Securities and Exchange Commission (SEC) disclosure requirements for firms' short-term borrowings. While still in the credit context, Chamberlain *et al.* focus on the reaction of shareholders to the proposed requirements, which would increase access to information that could potentially improve their ability to monitor the firm. Related to information asymmetry problems, Gill *et al.* (2016) suggest social capital as a means for small firms to reduce information barriers and enhance access to debt finance.

The final two papers in this special issue return to the classic Jensen and Meckling (1976) agency problem of managers' propensity to act in their own self-interest and ways that this can be prevented. Shamsabadi *et al.* (2016) study dividends as a possible solution to reducing free cash flow, noting how payout differs depending on firm-level corporate governance and taxation regime while Li *et al.* (2016) ask whether corporate social responsibility (CSR) has become a vehicle for managers to promote their own public image at the expense of shareholders.

The papers

Our first paper by Neave (2016) examines the screening process of banks when the loans that they originate are subsequently distributed to other investors through the securitization process. A novel element of Neave's model is the acknowledgement that

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the incentives a bank has to screen vary over time. While there is always a tradeoff between the reduction of a loan's risk brought about by screening and the cost of the screening process, Neave suggests that there are times when the optimal choice for the bank is to forego screening entirely. This tends to occur when investors cannot detect a change in the screening process and when a bank maintains a relatively large market share. These insights lead Neave to propose the selling of securitization portfolios with recourse as a means to curbing banks' profit motive since otherwise their failure to screen harms subsequent holders of securitized products.

Also examining the interaction between various credit investors, Hussain (2016) asks whether the providers of syndicated loans change their use of covenants when the borrowers they fund begin to access public debt through an initial public offering of bonds. Accessing the public bond market significantly alters the capital structure of the firm bringing with it higher overall leverage, a new class of investors, and additional potential firm monitors such as bond rating agencies. *Ex ante* it is not clear whether this change will lead syndicated loan lenders to reduce or enhance the covenants associated with the loans they provide. Hussain finds evidence that syndicated loan covenants are used more extensively on a firm's loans once it accesses the bond market. His findings suggest that despite the potential increased scrutiny that accessing public debt may bring, syndicated loan lenders are not motivated to decrease their own level of monitoring through the reduction of covenants. They choose instead to use covenants more extensively thereby increasing the potential tools they have at their disposal for monitoring the firm.

While Neave and Hussain focus on the interaction between borrowers and lenders, Chamberlain *et al.* (2016) examine the interests of shareholders as they relate to the short-term borrowings held by the firms they invest in. Of course these interests are likely to differ depending on the level of borrowings, which tend to be much higher for banks and the ever-increasing variety of non-bank financial institutions compared to non-financial firms. Using an event-study methodology, Chamberlain *et al.* (2016) examine shareholder reaction to the proposed SEC short-term borrowings disclosure rule which would require more frequent and extensive release of debt holdings. While first indications were that shareholders welcomed the increased disclosure, the authors find that shareholders respond differently depending on how high they view the cost of compliance to be for each firm. Firms for which the information is readily available can disclose it with minimal cost, whereas small firms, or those for which the information may have not been previously collected, may find compliance a significant and costly burden. Regulation that serves to reduce information asymmetry and thereby enhance the ability to monitor a firm may struggle to provide benefits to the investors of companies for which compliance costs are disproportionately large.

Reducing asymmetric information is also a theme of the fourth paper by Gill *et al.* (2016). In stark contrast to increasing access to information through formal regulation, Gill *et al.* suggest it may occur through informal networks and connections with banks, politicians, and non-resident family members. The social capital resulting from these connections increases the level of trust among participants, making it easier for the firm to gain access to debt finance. Through the use of a survey of small firms in the Punjab State of India, Gill *et al.* find that non-resident family members can play a significant role in helping small firms to overcome financial constraints not merely through the direct provision of funds, but also by forming valuable financial and political connections which in turn can lead to increased access to capital.

In the fifth paper, Shamsabadi *et al.* (2016) examine dividend policy as a means of ensuring that profits are distributed to investors rather than consumed by management through private benefits. While committing cash flow to interest or dividends as a means of stemming agency problems has a long history of examination (i.e. Jensen, 1986; Easterbrook, 1984), novel in this paper is the interaction between dividend policy, corporate governance, and taxation in the Australian environment. It is not initially clear what the relation between firm-level governance and dividend policy should be. While well-governed firms may commit to high and stable dividend payments, they may also feel less need to limit management's discretion over cash flow. Using a variety of corporate governance indices, Chung *et al.* find a positive association between dividend payout and governance, however, the strength of this relation depends on tax environment.

In our final paper, Li *et al.* (2016) examine whether CEO power influences the magnitude of a firm's CSR activities. They argue that the CEO has the most to gain from a potential boost in reputation and public image that positive CSR activities may provide. As a result, powerful CEOs may have the ability to over-invest in CSR to the potential detriment of firm value and shareholders. The empirical results do not support this view, rather as CEO power increases, CSR activities decline. The authors suggest that CSR activities are therefore not motivated solely by the self-interest of managers but rather by their potential to enhance firm value.

Conclusion

The papers in this special issue illustrate that a common theme of financial monitoring is the fine balance between monitoring's costs and benefits. Ideally, the benefit of monitoring is that it reduces the tendency of parties to act in their own best interests at the expense of others or the firm's resources. The costs of financial monitoring may take many forms. They may involve direct expenses associated with the creation of screening processes or the collection of additional data. Reduced growth may also be a cost if covenants or high levels of dividend commitment curtail investment. Finally, enhanced monitoring may have a societal cost if it diverts resources away from socially responsible activities.

Establishing the net value created by financial monitoring is further complicated by the interaction of monitoring with elements of the environment in which it takes place. The value of monitoring a firm or management's activities may change depending on a firm's level of market share, its size, corporate governance structure, tax environment, industry, and level of information asymmetry associated with it. An important contribution of the papers in this special issue is that they begin to establish particular associations between firm characteristics and the value of financial monitoring. As a result, they provide guidance to boards of directors, regulators, and lenders on the exact trade-offs they face when choosing to increase or decrease financial monitoring.

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