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Independent Directors and Firm Extreme Risk: Empirical Evidence

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Abstract

This paper examines the efficacy of independent directors in the constraint of firms' stock return extreme downside risk. We find a significantly negative relation between independence of the board and subsequent firm-specific extreme downside risk in the equity market, implying that independent directors work to monitor and mitigate extraordinary risk of the firm. Moreover, longer tenure and larger numbers of companies served by independent directors enhance this extreme downside risk-decreasing effect, suggesting more familiarity with firm operation and expertise in relevant business help independent directors provide better monitoring and advising services. The results are robust to the influences of conventional firm-level risk characters including size, book-to-market ratio, leverage, and momentum. Our findings suggest that well-functioned independent directors are beneficial to shareholders in terms of avoiding stock plumps, and upholding the independent role and fiduciary duty sufficient firm information and good capability obtained by independent directors are a boost to such effect.

Keywords: Board independence; Extreme risk; Tenure; Number of companies served