Asset Pricing Implications of Risk Governance

THORSTEN LEHNERT
Luxembourg School of Finance

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ABSTRACT
Some of the world's poorest countries have demonstrated that political leadership and practical policies make a difference. Good governance could help to strengthen accountability, enhance participation and break down inequalities. Furthermore, a country's quality of government has a positive effect on the development of its financial market and equity returns. In particular, it lowers equity volatility and, therefore, the costs of equity financing, which further helps to reduce inequalities. While price jumps are prevalent in stock markets all over the world, previous literature provides little guidance about the international nature of jumps and its relationship with country characteristics. Jumps are found to be far less systematic than the smooth (non-jump) component of country price indexes. Hence, if jumps are more idiosyncratic, risk governance should primarily affect the jump risk component of stock market volatility. This is good news for international investors, because diversification provides insurance against jumps. Relying on an equilibrium asset-pricing model in an economy under jump diffusion, I decompose the moments of the returns of international stock markets into a diffusive (systematic) risk and a (idiosyncratic) jump risk part. Using stock market data for a balanced panel of 52 countries, my results suggest that risk governance is an important determinant of (idiosyncratic) jump risk. Stock markets in poorly governed countries are characterized by higher volatility and more negative return asymmetry, primarily driven by the higher jump risk. Among the different governance indicators analyzed, the regulatory quality, the government effectiveness and the control of corruption appear to be most important. Results are robust to the inclusion of various controls for other country- or market-specific characteristics. My results have important policy implications.

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