THE EFFECTS OF OWNERSHIP STRUCTURE ON CORPORATE GOVERNANCE AND PERFORMANCE: AN EMPIRICAL ASSESSMENT IN INDIA

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EXECUTIVE SUMMARY

The corporate governance issues have received considerable attention because of their apparent importance for the economic health of companies and society at large especially after plethora of corporate scams and debacles in the recent times. The U.S., Canada, the U.K., other European Countries, the East Asian countries, and even India for that matter have witnessed severe strain on their economies together with the failure of several leading companies in the last two decades or so. This has resulted in greater emphasis and attention on the corporate governance issues.

In a narrow sense, corporate governance specifies the relationship among various primary participants (shareholders, directors, and managers) in determining the directions and performance of corporations. In a broader sense, it delineates the rights and responsibilities of each primary stakeholder and the design of institutions and mechanisms that induce or control board directors and management to best serve the economic interests of shareholders (and other stakeholders) of a company. Many of these other stakeholders also play a role in monitoring the behaviour of the board/management.

The part of any organization that has the most control over governance is the board of directors and the board is the 'soul' of a company – the foundation of all business decisions and the origin of corporate culture of the whole entity. The essence or attributes of good corporate governance include ethics, managerial discipline, independence, protection of shareholders' rights, fairness, transparency, board responsibilities, accountability, and social awareness. One major corporate governance principle of OECD is to "focus on the company rather than on one group of people." Most corporate governance rating agencies use some or most of these attributes for measuring the corporate governance scores on a corporate level.

Theoretical and applied work on corporate governance systems point to the importance of the structure of ownership and control in setting the background for the corporate governance issues that can arise in reality. Three aspects that need to be considered are the structure of ownership and its concentration; the instruments of control and exercise of control. The connection between ownership structure and performance has been the subject of an important and ongoing debate in the corporate finance literature. The debate goes back to the Berle and Means (1932) thesis, which suggests that an inverse correlation should be observed between the diffuseness of shareholdings and firm performance. Their view has been challenged by Demsetz (1983), who argues that the ownership structure of a corporation should be thought of as an endogenous outcome of decisions that reflect the influence of shareholders and of trading on the market for shares. The empirical studies about the relation between both variables seem to have yielded conflicting results. Further, it has been observed that the general features of the legal and regulatory system, and that the historical factors and experiences have contributed to the current corporate governance system and are still playing an important role.

Until very recently, studies in corporate governance were almost exclusively connected with advanced market economies with sophisticated capital markets. Yet the problem of corporate governance is arguably more serious and important in transitional and emerging economies. The paucity of knowledge about corporate governance in the East is a concern, particularly since foreign investment in India has increased significantly during the past decade. India's

growth rates have been amongst the highest in the world since its economic reforms in the 1980s. Its market infrastructure has advanced while corporate governance has progressed faster than in many other emerging market economies. This growth brings with it an acute need to understand the dynamics of corporate governance within an international context. An examination of corporate governance issues especially those concerning ownership structures and performance could yield important insights into the topic and provide a fresh perspective on what has become an increasingly international debate.

The legal and regulatory system of a country plays a crucial role in creating an effective corporate governance mechanism in a country, the development of markets and economic growth. The regulatory framework of corporate governance consists of the Companies Act, the Securities and Exchange Board of India (SEBI) Act, 1992, the Securities Contracts (Regulation) Act, 1956, Sick Industrial Companies (Special Provisions) Act, 1985 and the Listing Agreement. It is quite evident that the regulatory bodies in India have advocated comprehensive and rigorous corporate governance reforms which emphasize the importance of the credibility and integrity of the listed companies, the responsibilities of minority shareholders, and the necessity for information disclosure.

Empirical evidence presented in this study underlines the importance of ownership structure both in terms of distribution and the types of large shareholders for corporate governance. The ownership structure was mapped out for 134 companies of BSE 200 Index for six financial years from FY 2000-2001 to FY 2005-2006. Consistent with some recent studies, the data supports the findings that companies in India, unlike several other emerging markets, typically maintain their shareholding pattern over time. This is especially true for the overall proportion of shares held by promoters and nonpromoters.

In India, ownership is concentrated with Indian promoters, thus the traditional culture of big corporate family owned houses prevail. On an average the Indian promoters together with persons acting in concert held around 34 percent of the total outstanding shares from 2001 to 2006. Furthermore, Indian promoters have the highest stake in 54 percent of all cases, and were also more often than any other owner type the second, third, fourth and the fifth largest. The foreign promoters held around 12 percent shareholding for the said period. The ownership structure by industry type for 2006 corroborated a shareholding of 32 percent and 37 percent respectively for manufacturing and service sector by the Indian promoters in concert with other persons. Additionally, the proportion of shares held by foreign promoters was significantly less for the service companies in comparison to the manufacturing companies. Overall, the results reveal that the management teams of companies under study were primarily monitored by their promoters.

Although India has a tradition of equity ownership by promoters, a phenomenon of institutionalization of wealth wherein institutional investors especially foreign institutional investors are consolidating their holdings is quite apparent from the study. During the six-year period, the share of foreign institutional investors has phenomenally increased by 164 percent. This is the outcome of the persistent efforts of the Indian government to open its markets to trade and investment. In the 1998/99 budget, foreign institutional investors were allowed for the first time to invest in Indian primary and secondary markets. The equity caps for foreign portfolio investment are generally identical to the FDI equity caps, with the exception of a few specific sectors. Foreign institutional investors tend to operate on the principle of portfolio diversification with typically no other relation to the company except

for their financial investment. In addition, the share of 'others' i.e., shares in transit (NSDL and CDSL), GDR's, nondomestic company, international finance corporate, foreign companies, non-promoter director, trust, foreign national, foreign bank etc. has increased from 3 percent in 2001 to 5 percent in 2006. Evidence shows insignificant shareholding of individuals in the sample companies. Individual shareholders have no incentive and no capability to monitor and influence the behaviour of the management. Furthermore, the proportion of outstanding shares held by banks, insurance companies, and corporate bodies have decreased from 2001 to 2006. In contrast to findings on other emerging economies in Asia, affiliations with banks and institutions are not a pronounced feature of Indian corporates.

The results highlight that the ownership concentration both in terms of the fraction of shares held by the largest shareholders and Herfindal index increased for the average company over the study period. The cumulative holding underlines that on an average, the two largest owners collectively neared a blocking super-majority and a coalition of the five largest owners closed to almost a majority. It is, therefore, contentious as to the extent efforts at improving corporate governance would succeed in face of high equity stakes in hands of few owners.

Using a data set of 117 publicly listed companies of BSE 200 Index for the FY 2003-2004 to FY 2005-2006, this study has found some interesting relations between ownership structure (shareholding pattern) and other dimensions of corporate governance, such as ownership concentration, board size and board composition by invoking cross-sectional and pooled regression analyses. The current research found significant positive effect of institutional ownership on company profitability. There is evidence for the fact that higher promoters' ownership (both Indian and foreign) leads to higher corporate performance. The results are further confirmatory to findings regarding insignificant effect of non-institutional investors on performance. These non-institutional investors comprise individual investors, bodies corporate and others who constitute minority class of shareholders. As expected these non-controlling minority shareholders cannot be expected to wield any influence on the performance of the company. Some of the control variables had a significant effect on the corporate performance.

The results also highlight the fact that ownership concentration has no significant influence on company performance. Some authors have argued that if stock ownership is concentrated, then it is much easier for shareholders to coordinate their actions and demand information from managers to assess their performance. Increasing the proportion of independent directors on the board can improve monitoring, but no significant effect were found for this factor, and thus have no conclusive evidence to support the effect of monitoring on company performance. Consistent with some recent studies that have been conducted in the East Asian business context, the present study found no significant effects of board size and board composition on company performance.

It is evident that the regulatory bodies of India have proposed comprehensive and rigorous corporate governance reforms which lay emphasis on the significance of the credibility and integrity of listed companies, the responsibilities of directors and management, the protection of minority shareholders, and comprehensive disclosures. However, there are major gaps and lapses in the implementation of governance rules. The lax governance environment can be attributed to weak enforcement mechanisms. As pointed out earlier the development of a

corporate governance system by itself would not deliver every reform goal until and unless related changes are not brought about at the macro- and micro-levels. Firstly, the Government of India should establish a definite mandate for each regulatory agency, thereby strengthening the enforcement mechanisms.Secondly, there is an urgent need to revamp the judicial system so as to deliver fast justice and increase judicial efficiency. Thirdly, there is also a need to implement more robust bankruptcy laws so that they are predictable, transparent and affordable. Lastly, effective government reforms also require determined efforts by government to clamp down on corruption.

Since India embarked on liberalization in the early 1990s, it has increasingly integrated into the global economy. A phenomenon of institutionalization of wealth wherein institutional investors especially foreign institutional investors are consolidating their holdings is quite apparent from the study. This growth of shareholding is expected to have a pervasive influence on corporate governance.

Effective corporate governance mechanisms include both internal mechanisms, such as board of directors and its major committees, and external mechanisms such as hostile takeover bids, leveraged buyouts, proxy contests, legal protection of minority shareholders, and the disciplining of managers in the external labour market. The corporate governance reforms in India have mainly focused on internal governance mechanisms, emphasizing the responsibilities of directors and management and the necessity of transparency. There is further absence of the phenomenon of activism by shareholders as a factor influencing change in corporate governance. The extremely high ownership concentration makes hostile takeovers and leveraged buyouts unlikely to occur. So as long as the management can appease the dominant shareholders effective implementation of governance reforms cannot be expected in India.

The major governance challenge in India is unaddressed conflicts between the dominant shareholders and the minority shareholders. The findings underline that promoters (together with persons acting in concert) are dominant shareholders followed by institutional investors. The individuals were the least significant investor type in terms of large stakes. Since board derives its power from dominant shareholders, disciplining the latter by the former is not unfeasible resulting in the ineffectiveness of the board. No doubt the empirical results put forth inconclusive affect of board composition on corporate performance. There thus exists a dual challenge of resolving conflict between not only the shareholders and management but also between dominant shareholders and minority shareholders.

The study suggests that it is not only the distribution of ownership but also the types of large shareholders that have a significant impact on performance. There is evidence that higher promoter (both Indian and foreign) ownership is beneficial to the company as it improves firm performance and positively affects value. It seems the ownership structure of Indian companies reduces agency conflicts but can result in selfseeking behaviour and pursuit of private gains of control. Some of these private benefits impose no costs on minority shareholders, while others may dilute the value of their stock. The more important the latter type of benefits is in a particular company, the greater are the risks that a controlling shareholder will make decisions that will undermine the value of the firm. Corporate governance policy should therefore aim to strengthen the non-diluting private benefits and restrict the scope for dilution.

The major part of the debate on corporate governance pertains to board composition especially board size and independence. Firstly, there is the question of enhancing the independence of the board of directors. The introduction of independent directors is an important arrangement in monitoring the effectiveness of board of directors. The study puts forth inconclusive effect of board independence on corporate performance. It is therefore imperative to improve effectiveness of independent directors in monitoring managers especially to strengthen their independence. A major issue, however, is the limited availability of trained independent directors who are well versed with the procedures, tasks and responsibilities expected of them. Further, independent directors have to be motivated to carry out due diligence by making their liabilities credible. Secondly, regarding the board size, the study recommends smaller boards. Rather than having a large number of board members, it is suggested to bring in a few with the required expertise and knowledge to efficiently run the company.

Notwithstanding the limitations, the study is relevant and timely given the increasing importance of corporate governance across the globe in general and India in specific. The findings provide researchers and others valuable understanding regarding the effect of differences in the shareholding pattern on governance and performance.

Many recent studies have suggested that national culture may have a significant effect on corporate behaviour and performance. Therefore, studying the effects of culture on corporate governance can provide interesting and reliable information enabling better understanding of governance issues in India. It may be then feasible for the field to contribute ideas to improve the confidence and wellbeing of investors at large.