Corporate Governance in Pakistan

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- **Introduction**
- The motivation of this study is comes first corporate governance problems loom large as explanation of poor performance of corporate sector in emerging markets (Stiglitz, 1999).

- Second, It is interest to see whether these problems are related to mismatch between ownership structure and protection of ownership rights provided by Corporate Governance Code.

- Third, the enterprises face problem in financing their needs, at the same time financial market is under-developed. The extent to which the firms are able to access external finance depends on the quality of shareholder and creditor rights.

- Fourth, In this study test the proposition of La Porta, Shleifer and Vishny, (1998) that *Does the law matters?* For the law on the books to affect corporate performance, law enforcement must be at least credible.

- Corporate governance as the set of mechanisms to reduce the agency costs they could be internal and/ or external in nature.

- Internal mechanisms deal with the composition of the board of directors, such as the proportion of independent outsiders in its membership and the distinction between the CEO and the chairperson, ownership structure etc.

- External mechanism on the other hand rely on takeover market in addition to regulatory system, where as the take over market act as a treat to existing controllers.

- we explore internal mechanism board composition, shareholding rights and transparency and external mechanism is the legal system is the only way to ensure good corporate governance

- **Objective**
- The main focus of the study is to examine does corporate governance matters in Pakistan equity market? What are its implications for **corporate valuation, corporate ownership and corporate financing**?

- Three dimensions
- Adoption of better corporate governance mechanisms positively associated with firm value

- The determinants of concentrated form of ownership structure in Pakistan, what type of ownership significantly effect the firm.

- To assess the determinates of firms to raise external finance through equity. The firms that rely more on external financing sources are performing better.

- **Corporate Governance in Pakistan**
- The code of corporate governance introduced by SECP in 2002
- In Pakistan, the closely held firms (family or state-controlled firms or firms held by widely corporations and by financial institutions) dominate the economic landscape Cheema, 2003)..
- The main agency problem is not the manager-shareholder conflict but rather the risk of expropriation by the dominant or controlling shareholder at the expense of minority shareholders
- The agency problem is that control is often obtained through complex pyramid structures, interlock directorship[, cross shareholdings, voting pacts and/or dual class voting shares that allow the ultimate owner to maintain (voting) control while owning a small fraction of ownership (cash flow rights).
- The dominant shareholder makes the decisions but does not bear full cost
- It is expected that in case of Pakistan, concentration of ownership, need of external finance, after controlling the profitable investment opportunities, size and leverage are related to the firms' decision to comply with the code of corporate governance.

- **Determinants of CGI**
- To assess the factors that determine the corporate governance practices adopted by firms, the model suggested by . Dunev and Kim (2006) is estimated:

$$CGI_i = \alpha + \beta_1 EF_i + \beta_2 Own_i + \beta_3 Inv_i + \beta_4 Size_i + \beta_5 Lev_i + \varepsilon_{it}$$

$$CGI_i = \alpha + \beta_1 EF_i + \beta_2 Own_i + \beta_3 Inv_i + \beta_4 Size_i + \beta_5 Lw_i * EF_i + \beta_6 Lw_i * Own_i + \varepsilon_{it}$$

- To deal with multicolinearity two models are estimated separately one with concentration of ownership other with external finance plus control variables

- To test the hypothesis that the firms with good corporate governance practices are valued higher, the model proposed by Black *et al.*(2003) is used

$$Perf_i = \alpha + \beta_1 CGI_i + \beta_2 Inv_i + \beta_3 Size_i + \beta_4 Lev_1 + \varepsilon_{it}$$

$$Perf_i = \alpha + \beta_1 CGI_i + \beta_2 Inv_i + \beta_3 Lev_i + \beta_4 Size + \beta_5 Lw_i * CGI_i + \varepsilon_{it}$$

- **Determinants of Ownership**
- The hypothesis tested is that there is association between concentration of ownership and quality of corporate governance practices following the model proposed by Pistor *et al.* (2003), Durnev and Kim (2006) and Klein *et al.,* (2003):

$$Own_i = \alpha + \beta_1 CGI_i + \beta_2 Inv_i + \beta_3 Size + \beta_4 Lev_i + \varepsilon_{it}$$

$$Own_i = \alpha + \beta_1 CGI_i + \beta_2 Inv_i + \beta_3 Size + \beta_4 Lev_i + \beta_5 Lw_i * CGI_i + \varepsilon_{it}$$

- The ownership concentration by top five shareholders of firm

- # Ownership and Performance

- The reason is that when major shareholdings are acquired, control can not be disputed and resulting concentration of ownership might lower or completely eliminate agency costs. To test the hypothesis that there is a relationship between concentration of ownership and firm performance, the model suggested by Pistor *et al.* (2003) and Klein *et al.* (2003):

$$Perf_i = \alpha + \beta_1 Own_i + \beta_2 CGI_i + \beta_3 Inv_i + \beta_4 Size_i + \beta_5 Lev_i + \varepsilon_{it}$$

$$Perf_{it} = \alpha + \beta_1 Own_{it} + \beta_2 CGI_{it} + \beta_3 Inv_{it} + \beta_4 Size_{it} + \beta_5 Lev_{it} + \beta_6 Lw_t * CGI_{ti} + \varepsilon_{it}$$

- **Identity of Ownership and Performance**
- Corporate governance literature gives importance to type of ownership. The concentration of ownership is split into separate groups: family ownership (Fam), financial institutional ownership (Fin), foreign ownership (Fore) and individual ownership (Indv). To avoid multicolinearity the managerial ownership (DIR) is not included in the model.
- The affect of managerial ownership on performance is also investigated separately. The following model proposed by Bolboil *et al.* (2003) is estimated.

$$Perf_i = \beta_0 + \sum_j \theta_j Own_{ijt} + \beta_1 CGI_i + \beta_2 Inv_i + \beta_3 Size_i + \beta_4 Lev_i + \varepsilon_{it}$$

$$Perf_i = \beta_0 + \sum_j \theta_j Own_{ijt} + \beta_1 CGI_i + \beta_2 Inv_i + \beta_3 Size_i + \beta_4 Lev_i + \beta_5 Lw * CGI_i + \varepsilon_{it}$$

$$Perf_i = \beta_0 + \beta_1 Dir_i + \beta_2 CGI_i + \beta_3 Inv_i + \beta_4 Size_i + \beta_5 Lev_i + \varepsilon_{it}$$

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$$Perf_i = \beta_0 + \beta_1 Dir_i + \beta_2 CGI_i + \beta_3 Inv_i + \beta_4 Size_i + \beta_5 Lev_i + \beta_5 Lw * CGI_i + \varepsilon_{it}$$

- **Determinants of External Finance**
- To test the hypothesis that the firms which are in need of greater external finance practice higher level of corporate governance, following La Porta, Shleifer and Vishny (1997) and Pistor Raiser and *Gelfer* (2003**)**

$$EF_i = \alpha + \beta_1 CGI_i + \beta_2 Own_i + \beta_3 Inv_i + \beta_4 Size + \beta_5 Lev_i + \varepsilon_{it}$$

$$EF_i = \alpha + \beta_1 CGI_i + \beta_2 Own_i + \beta_3 Inv_i + \beta_4 Size + \beta_5 Lev_i + \beta_6 Lw_i * CGI_i + \varepsilon_{it}$$

- A growing firm with large need of external financing has more incentive to adopt better governance practices in an attempt to lower cost of capital (Klapper and Love (2003) and Gompers *et al* (2003)).
- To investigate that the firms, which rely more on external finance are valued higher.

$$Perf_i = \alpha + \beta_1 EF_i + \beta_2 CGI_i + \beta_3 Inv_i + \beta_4 Size + \beta_5 Lev_i + \varepsilon_{it}$$

$$Perf_i = \alpha + \beta_1 EF_i + \beta_2 CGI_i + \beta_3 Inv_i + \beta_4 Size + \beta_5 Lev_i + \beta_6 Lw_i * CGI_i + \varepsilon_{it}$$

- **Data**
- The analysis is started from 2003 for our analysis because the Corporate Governance Code 2002 start implementation from 2003
- The data of 60 firms listed at Karachi Stock Exchange which are included in KSE 100 index are used.
- The data set is obtained from the annual reports of these firms for the year 2003 to 2008.
- The scores for CGI and sub-indices, Board, Shareholding and Ownership and Disclosure, Transparency and Audit are used which are developed by the authors in their study [Javid and Robina (2007)].
- The block holder is shareholding of 10 percent ,because 10% or more shareholding has the ability to block company's special resolution.
- The Category and Pattern of Shareholding report the names and holdings of large shareholders, directors, specifies any family relations between them, and identifies the owners of companies that are large shareholders as well intuitional holdings and related parties' holdings.
- With this data set the ownership categories directors' shareholdings, financial institution holdings foreign investor's holdings, and block-holder with 10 percent shareholding are constructed Ownership concentration is percentage of shareholding of top five shareholders.

- Percent Share held by Family
- Percent Share held by Foreign
- Percent Share held by directors
- Percent Share held by individual shareholders
- Percent Share held by Financial Institution ICP, NIT
- External finance is ratio of the stock market capitalization held by minorities to sales [La Porta et al (1998)]
- Data on rule of law has been taken from World Bank governance indicators.
- Tobin's Q is (book value of debt plus market value of common equity) divided by book value of assets
- Return on asset is operating profit divided by the book value of total asset.
- Return on Equity operating profit divided by the equity capital.
- Size (natural logarithm of total assets)
- investment opportunities (average sale growth).
- Leverage is book value of Long term debt/book value of total asset.

- **Construction of CGI**
- In order to construct corporate governance index a broad, multifactor corporate governance rating is done which is based on the data obtained from the annual reports of the firms submitted to SECP.
- The index construction is as follows: for every firm, there are 22 governance proxies or indicators are selected, these indicators are categorized into three main themes.
- The three categories or sub-indices consist of indicators: eight factors for the Board, seven for ownership and shareholdings and seven for transparency, disclosure and audit.
- **Weighting Criteria**
- The weighting is based on subjective judgments. The assigned priorities amongst and within each category is guided by empirical literature and financial experts in this area.
- The maximum score is 100, then, a score of 100 is assigned if factor is observed, 80 if largely observed, 50 for partially observed and 0 if it is not observed
- The average is taken out and we arrive at the rating of one sub-index. By taking the average of three sub-indices we obtain CGI for a particular firm

- **Sub-Index 1: The board of directors**
- Board Size (number of directors)
- Board Composition (Clear cut job description of all board members, composition of board of directors).
- Chairman CEO separation (if not any lead director).
- Outside directors available to board (independent directors, nominee directors)
- Board attendance (board meetings).
- Meetings of outside director attendance.
- Existence of the position of CFO.
- Directors representing minority shareholders.

- **Sub-Index:2 Ownership and Shareholdings**
- Presence of outside block holder (more than 10 % shareholdings).
- Do the CEO owns shares.
- Directors ownership (block ownership) other than CEO and Chairman.
- Chairman or CEO are Block Holder (10%).
- Concentration of ownership (Top five).
- Dividend Policy
- Staff benefits other than wages and salaries
- Presence of outside block holder (more than 10 % shareholdings

- Directors ownership (block ownership) other than CEO and Chairman.
- Chairman or CEO are Block Holder (10%).
- Concentration of ownership (Top five).
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Sub-Index 3: Transparency, Disclosures and auditing

- Does the company have full disclosure of corporate governance practices
- Does the company disclose how much it paid to its auditor for consulting and other work
- Does the company disclose full biographies of its board members
- Disclosure of internal audit committee
- Disclosure of board directors and executive staff members' remuneration
- Disclosure in the company's annual report) of share ownership according to the requirement of Code.
- Information of the executive management staff members ownership (employees ownership)

- **Determinants of Corporate Governance**
- The quality of CGI and Disclosure practices adopted by firms depends negatively on the concentration of ownership. This shows that shareholders with greater cash flow rights do not adopt better governance

- Positive association between need of external finance and corporate governance quality, because good practices are signal that insiders are adopting good practices.

- Good investment opportunities and large size provide more incentive to improve governance practices among firms in in Pakistan.

- No significant relationship with rule of law interacted with CGI and Disclosure scores which suggests that in legal environment which is less investor friendly firm specific factors matters more in choice of corporate governance practices.

- **Corporate Governance and Corporate Valuation**
- There is positive and significant relationship between and Tobin's Q, ROA, ROE supporting our hypothesis that good governance practices are valued higher by the market**.**

- The Board Composition and shareholdings have some significant influence on firm performance. However investors are not willing to pay a premium for companies that are engaged in open and full disclosure.

- The large-sized firm and firms with profitable investment opportunities are valued higher.

- The quality of legal environment the interaction terms of rule of law with corporate governance shows no relationship with firm performance; which suggests that even firms in weak legal environment can enjoy high valuation if they adopt better quality governance and disclose practices. (La Porta, 2000)

- **Determinants of Ownership**
- The results suggest that the widely held firm do not adopt better quality of corporate governance. These firm disclose less, however board composition has positive and significant role.

- When major shareholdings are acquired, control can not be disputed and resulting concentration of ownership might lower or completely eliminate agency costs.

- The owner shareholders of the firm with more profitable investment opportunities divert less for outside shareholders gain.

- However size has opposite effect and leads to delusion of ownership. It results in diverse ownership to get wider access to funds and share ownership and distribution of risk.

- No role of rule of law as it is response to poor legal protection of minority investors, concentration become a substitute for legal protection, as shareholders may need to own more capital in order to exercise control.

- **Evidence on Ownership and Performance**
- a positive and significant relationship between ownership concentration (top five shareholders) and firm performance implying that ownership concentration matters in determining firm’s value.
- The family shareholdings have positive and significant effect on firm performance, due to the fact that families control can reduce classical agency problem between owner and managers.
- foreign investors can complement the inadequate or inefficient monitoring of domestic institutions. Shareholders with a large stake in the company have a greater incentive to play an active role in corporate decisions because they partially internalized the benefits from their monitoring efforts.
- Financial institution ownership has no significant impact because firstly, the nominees on the board are typically bureaucrats and retired army officers with minimal expertise in corporate matters
- The owner-managers shows positive and significant impact on the firm performance. Owner managers have a strong incentive to manage their companies well. they have the greatest stakes (in tangible as well in intangible terms) in the success and failures of their companies. They have also excellent knowledge of the firm.
- the firm that practice good governance and disclose more achieve superior performance compared to other firms
- The results reveal that large size firms, more investment opportunities outperform
- performance is not affected by rule of law.

- **Determinants of External Finance**
- The firms which need more equity financing practice good governance.

- The concentration of ownership is negatively associated with need of external financing, which is consistent with argument that in Pakistan where shareholders rights are not well protected, the investor compensate this deficiency of financing by taking controlling stakes in a firm (Shleifer and Vishny (1997).

- The firms with high growth and large in size are in more need of external finance.

- The firm specific factors matters more in influencing the need of external financing when the legal environment is less investor friendly.

- **External Financing and Firm Performance**
- These firm adopt better governance practices and disclose more in order to access less costly financing sources and these factors adds to their performance.

- The large-sized firms with better investment opportunities that are likely to grow faster usually rely more on external resources and are valued higher

- The results of interaction term of rule of law with corporate governance external financing do not have any significant impact on the valuation of the firm.

- **Conclusion**
- The results show that Corporate Governance Code potentially improves the governance and decision making process of firms listed at KSE.

- The quality of corporate governance is positively related to growth in investment opportunities, size, need for external financing and negatively concentration of ownership.

- These findings suggest that pro-growth polices generate more profitable investment opportunities, stimulate the external financing needs, dilute ownership and the firms are more likely to adopt better governance practices.

- When legal environment does not provide sufficient protection for outside investors and external financing is not easy to access, entrepreneurs and original owners are forced to maintain large positions in their companies which resulted in concentration of firm ownership.

- As firm level factors affect more, therefore can argue that adequate firm-level governance standard can not replace the solidity of the firm. It requires implementation of corporate governance reforms at most at par with real sector and financial sector reforms.

- The results adds an important link to the explanation of the consequences weak legal environment for external financing, corporate valuation, ownership concentration and corporate governance.