Institutional Investors and Corporate Governance in India

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Abstract

Using nineteen measures of corporate governance, we develop a corporate governance index in this paper. We find that this corporate governance index is positively associated with financial performance measures like Tobin's Q and industry-adjusted excess stock returns. We find that the development financial institutions have lent money to companies with better corporate governance measures. We also find that mutual funds have invested money in companies with better corporate governance record. Using a simultaneous equation approach we find that this positive association is both because the mutual funds (development financial institutions) have invested (lent money) in companies with good governance records, and also because their investment has caused the financial performance of the companies to improve. We finally report the findings of a survey that we conduct on the major findings of the paper.

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* The views expressed in this paper are of the author and not necessarily of NSE.

Institutional Investors and Corporate Governance in India

The role that the institutional investors can play in the corporate governance system of a company is a controversial question. While some believe that the institutional investors must interfere in the corporate governance system of a company, others believe that these investors have other investment objectives to follow.

Those who believe that institutional investors need not play a role in the corporate governance system of a company, argue that the investment objectives and the compensation system in the institutional investing companies often discourage their active participation in the corporate governance system of the companies. Wharton, Lorsch, and Hanson (1991) argue that institutional investors need not take active interest in the corporate governance of a company because the institutional investors have their primary fiduciary responsibility to their own investors and beneficiaries, which can lead to a conflict of interest with their acting as owners. Similarly, Drucker (1976) has once commented that "...it is their job to invest the beneficiaries' money in the most profitable investment. They have no business trying to *manage*. If they do not like a company or its management, their duty is to sell the stock..." (Emphasis added).

Admati, Pfleiderer and Zechner (1994), Black (1990), Coffee (1991), and Monks (1995) have argued that absence of appropriate incentives and free rider problems hinder institutional activism efforts. The free rider problem comes because even when one institutional investor interferes, the other investors get the benefits. Hence, the costs associated with active monitoring are borne by only one investor and this discourages active intervention.

Del Guercio and Hawkins (1997), Gillan and Starks (1995), John and Klein (1994), Karpoff, Malatesta and Walkling (1996) have observed that institutional activism has negligible impact on the performance of the companies.

Marsh (1990) has argued the short-term performance measurement does work against the active monitoring by the institutional investors. The performance of fund managers is evaluated over a shorter time period. Hence they act under tremendous pressure to beat some index. So when they find a case of bad governance, they find it economical to sell the stock rather than interfere in the functioning of the company and incur monitoring costs. Mohanty (1998) has also found that in India the short-term performance measurements of the fund managers force them to become very short term oriented.

Charkham (1994) divides the institutional investors into two categories, which he calls Type A and Type B. Type A institutions have a portfolio of a very small number of companies. Their stake in each individual company is very large. These institutions also keep a close relationship with the companies. Type B institutions, on the other hand, manage a widely diversified portfolio. These

companies treat the shares as commodities with no intrinsic qualities other than that of being tradable commodities. According to Charkham, corporate governance system fails because most institutions fall in the Type B category. Here only the Type A institutional investors have got an incentive for active monitoring for it directly affects the portfolio value.

The way mutual funds (Type B institutional investors) are created and managed, it prevents (or discourages) the fund manager from getting actively involved in the corporate governance system of the companies. Current finance theory suggests that large mutual funds can be managed either as an active fund or as a passive fund, and neither of it allows it to behave as an owner. There are broadly two types of mutual funds. All the index funds belong to the first category. The active funds are ones where the fund manager tries to beat the market. In both the cases, the mutual fund creates a diversified portfolio and this discourages the funds from getting involved in the corporate governance system of the companies.

The above arguments are based on the premise that the investment objectives and the compensation system in the institutional investing companies often discourage their active participation in the corporate governance system of the companies. Another reason often cited by these people is that the institutional investors are not competent enough to interfere in the activities of the companies. Cordtz (1993) has argued that the institutional investors lack the expertise and ability to serve as effective monitors. Similarly Charles Wohlstetter, former CEO of Contel, for example, wrote in a paper titled "The fight for good governance" published in the Harvard Business Review in January-February, 1993 that "... in sum, we have a group of people with increasing control of the Fortune "500" who have no proven skills in management, no experience in selecting directors, no believable judgment in how much should be spent for research or marketing - in fact, no experience except that which they have accumulated controlling other people's money".

There are others, however, who strongly believe that if the corporate governance system in the companies has to succeed then the institutional investors must play an active role in the entire process. Shleifer and Vishny (1986) observe that institutional investors by virtue of their large stockholdings would have grater incentives to monitor corporate performance since they have grater benefits of monitoring. Most of the reports on corporate governance have emphasized the role that the institutional investors have to play in the entire system. The Cadbury committee (1992), for example, states that "because of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders' Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the code" (para 6.16). The working group on corporate governance of Harvard Business Review has, similarly, concluded "the

institutional investors of public companies should see themselves as owners and not as investors.[†]" In India, the CII report on corporate governance has also brought out the importance of the role that the institutional investors can play in the corporate governance of a company. The Kumar Mangalam Birla committee on corporate governance (henceforth SEBI committee) similarly emphasizes the role that the institutional shareholders can play in the corporate governance system of a company. "... in view of the Committee is that, the institutional shareholders put to good use their voting power... "

These reports raise one interesting question that must be answered before we can comment on the role that the institutional investors should play in the corporate governance system of a company. Institutional investors are answerable to their investors the way the companies (in which they have invested) are answerable to their shareholders. And the shareholders do invest their funds with the institutional investors expecting higher returns. The primary responsibility of the institutional investors is therefore to invest the money of the investors in companies, which are expected to generate the maximum possible return rather than in companies with good corporate governance records. Most of the Corporate Governance reports ignore this aspect when they expect the institutional investors to play the role of an active investor.

In this paper we take a different stance on this issue. We start by questioning the very premise that is used by these corporate governance reports in expecting the institutional investors to play an active role in the corporate governance system of a company. The main function of any company (manufacturing or otherwise) is to maximize the wealth of its shareholders. Period. This role applies as much to TISCO as to IDBI. While judging the performance of any institutional investor, we do not need to look at the corporate governance record of the companies in which the institutional investor as invested. We should rather look at the returns that the institutional investor has generated for its investors.

Some recent research however shows that companies with good governance system have actually generated risk-adjusted excess returns for their shareholders and hence if an institutional investor invests in companies with good corporate governance records, it actually will help its own shareholders. Sengupta (1998) found a positive association between quality of corporate disclosure and bond ratings. Many research papers also find a positive association between institutional stake and corporate governance. Ajinkya, Bhojraj, and Sengupta (1999) found a positive relationship between financial analysts' ratings of corporate disclosure practices with institutional stock ownership. Brickley, Lease, and Smith (1988) find that the institutional investors are more likely to vote against harmful amendments that reduce shareholders 'wealth.

[†] See Harvard Business Review, July-August 1991, pages 142-144.

Agarwal and Mandelkar (1990) find a positive relationship between institutional ownership and shareholders wealth effects of various anti-takeover charter amendments. McConnell and Servaes (1990) found a positive relationship between institutional ownership and productivity, as measured by Tobin's Q. However, Holderness and Sheehan (1988), and Denis and Denis (1994) found no evidence to suggest that there is any relationship between corporate governance and institutional holdings.

If companies that create shareholders' wealth are the ones with poor corporate governance practices, then one really cannot blame the institutional investors for having invested in such companies. For, after all, a fund manager will be evaluated on the basis of stock returns he creates for the unit holders and not on the basis of the corporate governance records of the company he invests the money in. If however, one finds that companies with poor corporate governance practices are the ones, which have consistently destroyed shareholders' wealth, then the contention that the institutional investors need not look at corporate governance records cannot be justified.

In this paper we make an attempt to understand the role of institutional investors in the corporate governance system of a company in India. Prior research shows that institutional investors in India have played a passive role in the corporate governance system of Indian companies. (See Khanna and Palepu (1999) and Verma (1997)). Sarkar and Sarkar (2000) have similarly observed that the development financial institutions (DFIs) play a passive role (when their combined holding is less than 25%) in the corporate governance system of the companies. However Sarkar and Sarkar have found that when the debt holdings of the DFIs are high, they play an active role in monitoring the performance of the companies.

We start our project by asserting that the fundamental objective of an institutional investor is the maximization of its shareholders' wealth and not monitoring the activities of the companies in which it has invested. We first make an attempt to understand the financial performance of the companies with good and poor corporate governance records[‡]. This is where our approach differs from the approach adopted by the other authors. In most of the work on corporate governance, a measure of financial performance (like Tobin's Q) is usually used as a proxy for corporate governance. However, we have developed a new measure of corporate governance and then make an attempt to understand the relationship of this corporate governance measure with some financial performance measure.

It is pertinent to ask the following question here. "What are the characteristics of the companies with good corporate governance practices?" Many people emphasize on the structure of board of directors to answer this question. In fact a substantial portion of the SEBI committee report

[‡] If we find that institutional stake and financial performance are not related, then we cannot blame the institutional investors for having ignored corporate governance issues. However, if we find a positive association between stake and performance, then we can no longer ignore corporate governance issues while analyzing the performance of the institutional investors.

is devoted to explain the importance of board and the different committees in the corporate governance system of a company. One can look at the composition of the board of a company to see if the board has been constructed as per the guidelines of SEBI committee. However Varma (1997) and Dalal (2001)[§] show that the members of the board do not play the role that they are supposed to play. Therefore the existence of audit committees, etc do not by themselves guarantees good governance systems in a company[**].

If a company has got a good governance system then it must get reflected in certain outcome. While observing the governance system of a company we have decided to look at what we suppose to be the outcome of good governance system. Our approach is based on the argument that if the processes are in order, then we must observe certain desirable outcome. If on the other hand these outcomes are not present, then the existence of a mere process does not amount to anything. Thus for example the mere existence of an audit committee does not imply that all the accounts are in order. However, if we observe that the accounts are in order (or at least we do not find any evidence to the contrary) then we can be reasonably assured that the company has got good governance practices. Therefore instead of looking at the process of governance, we have made an attempt to observe the outcome of good corporate governance while developing the measures of corporate governance[††].

While developing the different measures of corporate governance, we have kept in mind the responsibility of the company to the different stakeholders. Following SEBI committee, we define the objective of corporate governance as the maximization of shareholders' wealth keeping in mind the interests of the other stakeholders[‡‡]. These are measures, which in our view are the outcomes of a good corporate governance system. These measures include factors like transparency in accounting policies, excise and corporate tax evasion, environment pollution, etc. Once we develop the different measures, we have made an attempt to develop a corporate governance index combining all the measures into one composite measure. While developing the corporate governance index, one actually requires information on all the measures of corporate governance. Since this requires collection of exhaustive data from different sources, we restrict our preliminary analysis to 113 companies[§§].

Subsequently we make an attempt to find the financial performance of these 113 companies. We use excess stock returns for the next one year, and Tobin's Q as two measures of performance. Using both the measures we observe that companies with excellent corporate governance records

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[§] Visit http://www.indian-express.com/columnists/such/.

[**] They are nevertheless very important for the success of corporate governance of a company. However they are by no means sufficient conditions.

[††] Many authors of course consider factors like quality of earnings as a process rather than an outcome of corporate governance.

[‡‡] We have discussed these issues later.

[§§] Initially we made an attempt to construct the corporate governance index for all the companies in our sample. However lack of data forced us to restrict the sample size to 113 for the preliminary analysis. This has been explained in a latter section.

(with highest possible corporate governance index) have actually outperformed the stocks of companies with poor corporate governance practices.

To study whether the institutional investors play a key role in the corporate governance system of a company or not, one needs data on the minutes of the board meetings in the companies.[***] Since such data are not easily available to the public, we study the corporate governance practices in companies in which the institutional investors have invested. If one finds that companies in which the institutional investors have invested are the ones with very poor corporate governance record then it will prove that the institutional investors do not bother about corporate governance.

We find that mutual funds other than UTI have invested in companies with good corporate governance records. We also observe a positive association between the debt holdings by the development financial institutions and corporate governance records. We also find that banks and UTI have largely invested in companies with poor governance records.

Subsequently we redefine corporate governance taking a very narrow perspective by only looking at the responsibility of a company to the shareholders. This allows us to increase the sample size considerably to carry out the statistical tests rigorously. There is another reason why we feel confident about taking a narrow perspective on the subject. Our previous analysis shows that companies with good corporate governance index (constructed based on a wide range of factors) have in fact generated higher returns for the shareholders. Therefore one can look at the returns that the company has generated for its shareholders and use the same as a proxy for corporate governance.

Following Sarkar and Sarkar (2000), we decide to use spline regression method to observe the relationship between corporate governance and institutional investors' stake in the companies. Sarkar and Sarkar (2000) have made an attempt to find the impact of institutional shareholding on the value of the companies. This test was however done at an aggregate level. We repeat the experiment at an individual institutional investor level.

To begin with we do not find any uniform spline knots for the different institutional investors. It is as low as 6% for the mutual funds, and as high as 34% for the insurance companies. We therefore use a simple OLS regression to observe the relationship between financial performance and institutional stake. Our results here are very similar as we find earlier.

We find that excepting the mutual funds and the financial institutions[†††] there is no positive link at all between the performance of the companies and the institutional investors' stakes in the companies. We also find a negative link between the shareholding by banks and financial

[***] This will tell us what the nominee directors are actually doing in the board meetings.
[†††] The positive link is only with their debt portfolio and not their equity portfolio.

performance of the companies. We use simultaneous equation method to find out whether the institutional investors have invested in companies with good governance practices or it is their interference that has resulted in good performance by the companies.

The rest of the paper is organized as follows. Section II discusses the construction of the corporate governance index. It also discusses the sample and data source. It also deals with the relationship between the corporate governance index with financial performance and institutional stake. Section III deals the relationship between corporate governance and institutional stake with a narrow focus on only shareholders and bondholders of a company. Finally section IV deals with certain related issues on the role of institutional investors in the corporate governance of the companies. It finally concludes the paper.

Section II

Sample: Initially we start with all non-finance companies[##] for which the relevant data are available in the Prowess database as on 31 March 2001. We therefore start our analysis with a sample size of 4392 companies. We further restrict our sample to all those companies for which the relevant data on institutional stake holding, stock prices and the accounting variables are available in the Prowess database. This leaves us with a sample size of 2636 companies.

Development of Corporate Governance Index

As already mentioned we have used the outcome of good governance system as the measure of corporate governance system rather than the different processes. Before explaining the different measures of corporate governance, we must explain what exactly we mean by corporate governance.

Different people define corporate governance differently. The definition may be very narrow in focus. For example, some define corporate governance in terms of a formal system where the management is accountable only to the shareholders. Others draw a very wide boundary and discuss the responsibility of the management to the entire society. The Anglo-American system of corporate governance tends to focus on shareholders and various classes of creditors. According to Shleifer and Vishny (1997), for example, corporate governance deals with the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment. That is "how do they make sure that managers do not steal the capital they supply or invest in bad projects". The CII report on corporate governance has also adopted this attitude when it says "*Corporate Governance deals with laws, procedures, practices and implicit rules that determine a company's ability to take managerial decisions vis-à-vis its claimants - in particular, its shareholders, creditors... There is a global consensus about the objective of good corporate governance: maximizing shareholders' value*."

[##] We exclude finance companies because there are separate regulatory bodies to monitor the activities of the finance companies. Thus we do not study the corporate governance practices at the institutional investing companies.

On the other hand, the corporate governance systems in continental Europe, Japan, and South Korea are based on the belief that companies should also discharge their obligations towards employees, local communities, suppliers, ancillary units, and so on.

In this paper we have adopted the definition from the SEBI committee report namely that *"... the fundamental objective of corporate governance is the enhancement of shareholders value keeping in view the interests of other shareholders... "*[§§§]

As is obvious from the above definition, our primary concern is about the responsibility of the company towards the shareholders. However, we must also ensure that the interests of other shareholders are not getting affected in the process.

It is important to understand one point at this juncture. Some authors argue that there is no conflict of interests between the interests of the different stakeholders in a company. A company that ignores the interests of other stakeholders will not be able to maximize the shareholders 'wealth (see Copeland, Koller, and Murrin (2000)). However in the short run it is possible that a company can take certain decisions that can transfer wealth from other stakeholders to the shareholders. Thus for example, if the riskiness of the business increases after a company issues bonds at a certain coupon rate, the shareholders gain at the cost of the bondholders. Therefore in the short run, a company can temporarily transfer wealth from other bondholders to the shareholders. This is however against the interests of the shareholders in the long run since in the future the bondholders will demand higher coupon rate from the company for lending money to the company. Secondly to the extent that the bondholders know that there is a possibility of such transfer of wealth, they will factor this risk in the calculation of bond yield at the time of the issue of the bond itself.

In the long run therefore there is no conflict of interest between the shareholders on the one hand and the other stakeholders. In the short run however, some conflict can arise. Therefore, we consider all the stakeholders and not just the shareholders while defining the objective of corporate governance. In this paper we have looked at the following stakeholders.

- Shareholders
- Bondholders (This includes all the lenders to the company including the preference shareholders)
- Employees
- Customers
- Suppliers
- Government

[§§§] To begin with, we make a distinction between the objective of financial management and corporate governance. While the former is all about the responsibility of the company to the shareholders,. the latter is also concerned about the other stakeholders.

? Society

If the company has got appropriate corporate governance practices in place, then it must get reflected in how the company deals with the above stakeholders. Thus for example, if a company has got a good governance system, it will ensure that the company does not evade the payment of excise duties or corporate income tax to the government.

The behavior of the company with respect to the above stakeholders can take any of the following three forms.

? ***Positive Form***: The company takes extra care (more than legally necessary) of the stakeholders. Here a company is not required to take this extra care. But it does it nevertheless to show that it cares.

? ***Neutral Form***: The company does exactly what is legally necessary while dealing with the stakeholders.

? ***Negative Form***: Here the company either does not perform the basic minimum things it is supposed to do legally or it tries to avoid the responsibility (though sometimes this behavior is not found to be illegal). The key feature of the negative form is that some of the stakeholders get hurt while dealing with the company, either directly or indirectly.

Tables 1a, and 1-b explain our measures of corporate governance.

Table 1a: Framework of Corporate Governance

Stakeholders ?	Positive-Form	Neutral-Form	Negative-Form
Shareholders			
Bondholders			
Employees			
Customers			
Suppliers	**NA**		
Government			
Society			

Table 1-b: Details of the Nineteen Measures of Corporate Governance

Measure	Description	Data Source
Shareholders (Positive Form)		
Providing valuable and timely information to the shareholders	Use of US GAAP in India, Giving information regarding brand value, and value of human resources, providing information on how to dematerialize the shares, remedies that are available to the investors in case the shares do not get registered in their name or in case the shareholders face any problem during the shares transactions	Vans Database, IBID database
Exceeding projections made at the time of issue of shares	Actual sales and/or profit being higher than what was projected at the time of issue of shares (both IPOs, and rights issue)	ERC database
Shareholders (Negative Form)		
Asymmetric treatment of shareholders****	Preferential allotment of shares to the promoter at a price below the market price, making rights issue at a premium to the market price††††, issuing naked warrants to the promoter, company giving counter-guarantee (or guarantee) on loans taken by sister concerns or companies controlled and owned by the promoters and directors	Vans database, and IBID database
Poor quality of earnings	A company is said to have poor quality of earnings if it does not adhere to the generally accepted accounting principles, does make frequent changes in its accounting policies, etc. After consultation with some practicing chartered accountants and studying the relevant literature‡‡‡, it is decided to categorize a company as one with poor quality of earnings if it has got at least one of the following five features. a) It has got adverse auditor's report in at least one of the years during 1998-2000. Companies get adverse auditor's report when they do not adhere to the generally accepted accounting principles. b) It has made discretionary changes in the accounting policies that have resulted in an increase in the net profit of the company. Sometimes, companies change the accounting policies due to statutory requirements. Such changes have not been considered here. c) It makes arbitrary changes in the accounting year-end. Some companies change the accounting year due to considerations like mergers. Some other companies changed their accounting year-end to March 31 in the sample period. Such changes are not arbitrary and hence have not been included here. d) It delays the release of the annual report. Usually, companies delay	IBID database, Vans database, and Notes to accounts from Prowess database

**** Varma (1997) reports that one of the key issue in corporate governance in India is the suppression of the majority shareholders by the minority shareholders.

†††† Companies usually adopt this route to avoid the SEBI guidelines on the pricing of preferential issues.

‡‡‡ See Hawkins (1986) for a detailed discussion on quality of earnings.

	the release of annual reports, when they perform poorly. They manipulate the earnings during that time period. In fact, one auditor has suggested me that if the companies can be forced to release the annual reports within a fortnight, then they will not be able to manipulate the earnings. e) It has reduced the managed expenses like research and development expenditures during hard times to increase its accounting profit. Usually, companies reduce expenditures on research and development when they perform poorly. This increases their current accounting profit. However, it reduces their future profitability.	
Investor Grievances	Investors complaining about: 1. Non-receipt of duplicate shares; 2. Non-registration of transfer of shares; 3. Non-issue of share certificates; 4. Non-receipt of right or bonus shares; 5. Non-receipt of share certificates on conversion; 6. Non-receipt of share certificates after the endorsement, 7. Non-refund of share application money and; 8. Non-receipt of dividend warrant	SEBI website and BSE website
Consistent difference between free cash flow to equity and dividends	Free cash flow to equity is defined as: PAT + depreciation – capital expenditure – increase in working capital + issue of interest bearing liabilities. If FCFE is consistently higher than dividends over the last five years, then we take this as a proxy for corporate misgovernance.	Prowess database
Shareholders (Neutral Form)		
Good quality of earnings	If the company does not have poor quality of earnings, then we classify it as one having good quality of earnings.	IBID database, Vans database, and Notes to accounts from Prowess database
No Investor Grievances	If the SEBI website or the BSE website does not report any investor grievance about the concerned company, then we place it under the neutral form.	SEBI website and BSE website
Bondholders (Positive Form)		
Improvement in credit rating	Improvement in credit rating because of good performance by the company and not because of any external factor like decrease in overall interest rate. Here we consider ratings of CRISIL and ICRA only.	Rating Scan of Crisil, Vans database, Rating Update from ICRA.
Bondholders (Negative Form)		
Downgrade in credit rating	Downgrade in credit rating because of good performance by the company and not because of any external factor like increase in overall	Rating Scan of Crisil, Vans database, Rating

	interest rate. Here we consider ratings of CRISIL and ICRA only.	Update from ICRA.
Transfer of wealth from bondholders to shareholders	Often conflicts of interest can arise between bondholders and shareholders. When the management of a company (apparently at the behest of the shareholders) increases the overall riskiness of the company, the yield on the bonds increases leading to a decrease in the value of the bonds. However the value of equity may rise with the increase in the overall riskiness of the company as equity is a call option on the value of the firm in a levered company. When a company decides not to insure against a pure risk, this leads to a decrease in the value of the bonds and possibly an increase in the value of equity.	Vans database and IBID database
Bondholders' Grievances	Complaint from bondholders about non-receipt of interest warrant, repayment of principal	SEBI website
Default in the payment of interest and repayment of principal	Company sending letters to the investors not to encash the post-dated cheques already issued at the time of issue, company defaulting in the payment of interest and principal	Vans and IBID database
Bondholders (Neutral Form)		
No Grievance	No grievance regarding non-receipt of interest and principal cheques.	SEBI website
No change in credit rating or change in credit rating due to external factors	If the rating does not change during the period, or if the rating changes due to external factors only[§§§§]	Rating Scan of Crisil, Vans database, Rating Update from ICRA.
Employees (Positive Form)		
Low employee turnover	Low employee turnover compared to industry mean	IBID database, Vans database
Issue of ESOPs to Employees	Issue of ESOPs to employees to enable the employees to share in the fruits of their labor	Prowess database (capital history)
Employees (Negative Form)		
Strikes and Lockouts	If a strike (or lockout) has taken place in the last one year	Indian Labor Journal (relevant issues), IBID database, and Vans database
High Employee turnover	High employee turnover compared to industry mean	IBID database, Vans database
Employees (Neutral Form)		
No strike or lockout	No strike or lockout has taken place in the time period	Indian Labor Journal (relevant issues), Vans database and IBID database
Customers (Positive Form)		

[§§§§] We included this criterion before we started collecting data. None of the 113 companies however belong to this category.

Customer Satisfaction	High ranking (top 25%) in customer satisfaction surveys conducted by the market research agencies sponsored partially by the different business newspapers and journals	Brand Equity of Economic Times, A & M
Customers (Negative Form)		
Losing to consumers in court cases	Losing to customers in cases under the Consumer Protection Act, 1986	Indianlawinfo.com, Consumer Protection Digest
Customer dissatisfaction	Low ranking (bottom 25%) in customer satisfaction surveys conducted by the market research agencies sponsored partially by the different business newspapers and journals	Brand Equity of Economic Times, A & M
Customers (Neutral Form)		
Neither in the positive nor in the negative form	Holding the middle 50% rank in the customer satisfaction surveys	Brand Equity of Economic Times, A & M
Suppliers (Negative Form)		
Deferring payments to the supplier	Delay in payments to the supplier reported in the business newspapers.	Vans database, and IBID database
Losing court cases against supplier*****	Losing court cases against the supplier, which has been reported in the business newspapers.	IBID database and Vans database
Suppliers (Neutral Form)		
Non-negative form	If no news item appears about either delay in payment or losing of court cases, then the company has been classified under this category.	IBID database and Vans database
Government (Negative Form)		
Evasion of duties and taxes	As a good corporate citizen a company is supposed to make all the statutory payments to the respective government authorities. Some companies however resort to illegal means to avoid the taxes and the duties they are supposed to pay. It is important to keep in mind that some companies do tax management and hence pay lower taxes. This is perfectly legal. But tax evasion is illegal and is a measure for corporate misgovernance.	Relevant issues of Income Tax Review, Vans database, and IBID database
Violating other legal provisions	Being accused under insider trading, violating provisions of SEBI, violating provisions of the Companies, Act	Corporate Law, SEBI website, IBID database, and Vans database
Government (Neutral Form)		
Neither of the above	If the company has neither evaded the payment of corporate tax/excise duties, nor has it violated any of the legal provisions, then it has been clubbed in the neutral category.	Relevant issues of Income Tax Review, Corporate Law, SEBI website, Vans

***** We included this criterion in our study before collecting data. However, none of the 113 companies has got a negative score on this count.

		database, and IBID database
Society (Positive Form)		
Building social infrastructure	There are some companies who do certain things for the society as a matter of charity. Thus for example, they create hospitals for the local people, they maintain the parks, they adopt villages, etc. This is definitely a sign of excellent corporate governance. It is important to keep in mind that certain chemical companies adopt the villages near the plant to ensure that they do not resist against the pollution. Such cases have been excluded while defining corporate governance here.††††	IBID database, Vans database
Producing socially useful products	Producing anti-pollutant machines	Prowess database
Adopting street children	Adopting street children (as reported in the business newspapers)	IBID database, Vans database
Society (Negative Form)		
Polluting environment	Companies have also certain responsibility towards the society in general and the environment in particular. There are certain statutory requirements that the companies have to follow as far as pollution of the environment is concerned. But a few companies do either adhere to these rules and regulations. Some of the companies promise to develop the villages near the plant but renege on their commitment. In this sense, pollution of the environment has been used as a measure for corporate misgovernance.	IBID database, Vans database
Producing socially harmful products	Producing tobacco, liquor Only when a company generates at least 10% of its revenue from tobacco or liquor, it has been included in this category.	Prowess database
Reneging on commitments made to the society	Some companies make commitments to the society at the time of setting up the factory regarding providing placement opportunities to the members of the society. However, later they renege on that commitment. This is certainly a measure of corporate misgovernance.	IBID database and Vans database
Society (Neutral Form)		
None of the above	If a company does not belong to either the positive form or the negative form, we have included it in the neutral form.	IBID database, Vans database, and Prowess database

Computation of Corporate Governance Index From different sources (web sites of companies, IBID database, Vans database, Prowess database, etc.) we start collecting data on all the 19‡‡‡‡ measures for all the companies. While collecting data, we face two problems. For most of the

†††† This is actually not charity but staff welfare.

‡‡‡‡ There are actually twenty-one cells in the above table. We however ignore the positive-forms for government and suppliers.

companies, we do not get any data on some of the measures that we have identified. This makes it difficult to interpret the corporate governance index. Since our major source of data for some of the measures are news clippings (from Prowess and IBID database and Vans database), it is never possible to be sure that we have an exhaustive list of data.

The second problem arises when we get multiple measures for the different stakeholders. We may come to know that a company has got poor quality of earnings and at the same time the investors have accused it of not sending the dividend cheques in time. Here, both these items fall under the negative form.

We do not have any unequivocal answer to these questions. We therefore decide to solve these two problems in the following manner. In the preliminary analysis, we decide to exclude all the companies from our sample for which we do not get any information on all the 19 measures. This reduces our sample size from 2636 to 113.

As far as the second problem is concerned, we treat multiple measures falling under one form (positive, negative or neutral form) as one measure only.

An alternative method has been suggested by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) where they derive a scoring mechanism of stockholder and creditor rights for a cross-section of countries, where they have given points to each measure, and then simply add them up. It would definitely be interesting to see if our basic conclusions will get affected if we follow this system. We leave it to our future research.

One of the objectives of this paper is to see if the different corporate governance measures are related to the financial performance of the companies. However since we have identified nineteen measures of corporate governance, it becomes difficult to relate each one of them to the financial performance of the companies.

We therefore decide to form one corporate governance index based on these 19 measures of corporate governance. Gompers, Shiil, and Mettrick (2001) have developed a corporate governance index based on 24 provisions of takeover defenses and shareholder rights. In their paper the authors have given equal weight to all the 24 provisions.

In this paper we assign unequal weights to the 19 measures. In particular, we assign higher weightage to the governance measures relating to the shareholders compared to the other stakeholders. Secondly, we assign a higher negative weight (in absolute values) to the negative-form measures as compared to the positive form measures. Table 2 explains the weights we have given to the 19 measures.

Table 2: Weights for different measures of Corporate Governance

Stakeholders ?	Positive-Form	Neutral-Form	Negative-Form
Shareholders	+10	0	-15
Bondholders	+6	0	-8
Employees	+2	0	-3
Customers	+2	0	-3
Suppliers	NA	0	-3
Government	NA	0	-3
Society	+2	0	-3

The Scoring Method: We first collect data on all the measures of corporate governance as explained in Table 1a. Then we assign scores to the companies as given in Table 2 depending on whether we have measures belonging to the positive or negative form. Thus for example, when we find a news clipping (or some other data) to justify that the company belongs to the positive form as far as the shareholders are concerned, then we assign a score of +10. Similarly, we assign scores to the company for all the other stakeholders. Then we add up the scores to get one composite corporate governance index.

Then we compute the corporate governance index for all the 113 companies. This is a mere summation of all the weights for the respective measure. Thus for example, if a company figures in none of the positive-form and neutral-form measures, it will get a corporate governance index score of -38. The maximum score that any company can get is 22.

We do agree that this method of computing the corporate governance index is not completely objective and that one will get a different index (and hence probably different conclusions) if one changes the weights of the 19 measures or if one decides to use different measures for that matter. However the weights given are consistent with our objective of giving more importance to the shareholders (and to some extent the bondholders) compared to other stakeholders in a company.

There is another issue with this scoring system. To understand this, consider one company that is classified in the negative form with respect to the shareholders, but in the positive form for all other stakeholders. The CGI for this company is (–15 + 6 + 2 + 2 + 2) = -3. Consider another company, which is classified, in the positive form with respect to the shareholders, but in the negative form for all other stakeholders. The CGI for this company is (+10 –8 –3 –3 –3 –3 –3) = -13. The question that naturally arises is whether this violates the maintained assumption that the main stakeholders are the shareholders. If one considers this issue carefully, then it will be obvious that the in the long run this scoring system is consistent with our maintained hypothesis. This is so

because a company will find it impossible to maximize shareholders' wealth without taking care of the interests of the other stakeholders. In the short run however, this may cause some anomaly.

Subsequently, we make an attempt to find out the financial performance of these 113 companies. This will be a direct test of our hypothesis that there is no relationship between corporate governance practices and financial performance. We use Tobin's Q and stock returns as the measures of financial performance. We define Tobin's Q as the sum of market value of equity and book value of debt divided by the book value of total assets[§§§§§]. Most studies of corporate governance use Tobin's Q as the measure of corporate performance. In this paper we decide to use industry-adjusted excess stock returns also because Tobin's Q (as defined in this paper) is highly correlated with the price-to-book-value ratio of a firm.

$$Tobin's\ \ Q = \frac{Market\ \ Capitalization + Book\ \ Value\ \ of\ Debt}{Book\ \ Value\ \ Of\ \ Assets}$$

$$= \frac{Market\ \ Capitalization + Book\ \ Value\ \ Of\ \ Debt}{Net\ \ Worth + Book\ \ Value\ \ Of\ \ Debt} + \frac{Market\ \ Capitalization}{Net\ \ Worth}.$$

PBV ratio is usually treated as a proxy for risk. We therefore use stock returns as additional measure of corporate performance to avoid this problem with Tobin's Q.

We also attempt to link the corporate governance index with the stakes of the institutional investors. We have included both the debt and equity investments made by the institutional investors. We define debt investments as the percentage of total borrowings financed through a particular source.

Institutional Investors in India: In India, there are broadly four types of institutional investors. On the first category will fall all the developmental financial institutions, like Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Development Bank of India (IDBI), the State Financial Corporations, etc. The role of these financial institutions (FIs) is to extend funds to the companies for both long term financing and (more recently) working capital financing. The financial institutions extend both debt and equity financing to the companies. The debt covenants sometimes enable the financial institutions to have their nominee directors in the companies. On the second category will fall all the insurance companies like the Life Insurance Corporation (LIC), General Insurance Corporation (GIC), and their subsidiaries. On the third category will fall all the banks. Earlier banks used to finance only the working capital of the companies. But now they are also extending long-term finance to the

[§§§§§] In financial economics, we divide the market value of the company with the replacement costs of the assets and not the book value of the assets to compute Tobin's Q. However Indian companies do not report the replacement costs of the assets and hence we use the book value of the assets as a proxy for the replacement cost of the assets.

companies. Finally, in the last category, will fall all the mutual funds including Unit Trust of India (UTI). The mutual funds collect funds from both individuals and corporate to invest in the financial assets of other companies. In India, the mutual funds participate largely in the equity capital of the companies.

We concentrate our attention on the following institutional investors:

- Industrial Finance Corporation of India
- Industrial Credit and Investment Corporation of India
- Industrial Development Bank of India
- Unit Trust of India
- Other Mutual Funds
- Life Insurance Corporation of India
- General Insurance Corporation of India
- Banks

Table 3 discusses the stakes of the different institutional investors in the different companies. We exclude all companies in which the different institutional investors do not have any stake. Thus for example, one can see from Table 3 that IFCI has stake in only 96 of the 2636 companies. If we do not truncate the data below 0% stake, then the median stakes for all the institutional investors drop to zero.

Shareholding pattern by the institutional investors	No of Companies in which the institutional investors have positive stakes	Mean and Median stake in the truncated sample		Mean and Median stake in the entire sample	
		Mean	Median	Mean	Median
IFCI	98	2.85%	1.97%	0.06%	0%
ICICI	125	3.93%	3.94%	0.11%	0%
IDBI	125	5.67%	2.77%	0.16%	0%
UTI	239	5.42%	2.05%	0.29%	0%
MFs	1891	3.91%	1.41%	1.68%	0%
LIC	131	3.99%	2.24%	0.12%	0%
GIC	132	3.87%	3.83%	0.1%	0%
Banks	444	2.44%	0.435%	0.24%	0%

Certain interesting points emerge from Table 3. The median stake of all the institutional investors is a mere 4.8%. This is very low. However, on a closer examination, it is found that this low number is due to very small investments made by the different institutional investors in a large number of

companies. The minimum stake that any of the institutional investor has in the portfolio of companies that it holds is 0.01%. The maximum stake that all institutional investors have in any single company is 94.44%. The median debt holding****** by the banks is 0.34%. The median debt holding by the development financial institutions is 0.3%. Secondly, out of a total sample size of 2636 companies, as many as 359 companies do not have any institutional stake in them.

To get some meaningful results we must compare the corporate governance practices of the companies in which the institutional investors have invested with companies in which the institutional investors have not invested. It is also quite natural to expect that when the stakes of the institutional investors is high, they will be in a better position to monitor the performance of the companies. We therefore divide our sample of 113 companies into the following groups.

- Companies with no institutional holding (Category 1)
- Companies with institutional holding between 0% to 10% (category 2)
- Companies with institutional holding between 10% to 26% (category 3)
- Companies with institutional holding between 26% to 51% (category 4)
- Companies with institutional holding above 51% (Category 5)

We compute the CGI for each of the above five categories of companies. We do this analysis only at a macro level and not at the institutional investor level because that would have reduced the sample size within each category to a very small number. We report the CGI for these five categories of companies in Table 4.

Table 4: CGI for the five categories of companies

Categories	CG Index
1	-6
2	5
3	-8
4	-6
5	13

If we look at table 4, then we can clearly see two interesting points. First, there is no major difference between the CGI for the first four categories of the companies. If we do a means test to test the null hypothesis that the CGI are the same for the first four groups, then the F Value is 0.85, and we cannot reject the null at any of the standard levels of significance. Second, when we look at the last category where the combined holding is greater than 51%, the CGI is really very high. This implies

****** Defined as the ratio of total bank lending to the total capital.

that the institutional investors do (and can) play a very important role in the corporate governance system of a company if they act together.

Then we make an attempt to observe the financial performance of these 113 companies. We also observe the institutional investment in these 113 companies. Table 4 compares the corporate governance index with the financial performance measures that we have identified here. Here, stock return is actually the excess stock return. This is computed as the difference between the actual return and the median return of the stocks in the same industry. Here return is the annualized return of the monthly stock returns computed using the closing stock price data. We assume that all dividends have been reinvested in the stock itself. The sample period for the computation of the annual return is April 2001 to March 2002.

We divide the 113 companies into five quintiles based on their score in the corporate governance index. Then we observe the financial performance of the companies belonging to these five quintiles. Table 5 reports the main findings.

Table 5: Corporate Governance Index and Performance

Corporate Governance Index (Median for the Quintile)	Tobin's Q		Excess Stock Returns	
	Median	Mean		
			Median	Mean
14	2.14	3.04	2.54%	2.78%
8	1.88	2.9	2.65%	3.05%
2	1.14	1.2	1.51%	1.65%
-5	0.99	1.3	-3.54%	-2.8%
-17	0.74	0.87	-3.52%	-2.85%
F Value	14.08	16.54	9.64	11.21

Certain interesting conclusions can be drawn from Table 5. There is a positive relationship between corporate governance index and financial performance measured in terms of Tobin's Q and excess stock returns. This implies that companies with better corporate governance records have generated higher returns for their investors.

We run a means test to see if the differences between the mean Tobin's Q and mean excess stock returns are statistically significant. The F values are reported in the last row of Table 5. All the F values are statistically significant at 1% significance level.

To obtain additional evidence on the relationship between CGI and financial performance, we regress CGI on both the financial measures in two univariate regressions. The results are reported here. The bracketed figures given below the intercept and slopes are the t-statistics for the respective variables.

CGI = -0.04 + 1.1 * Tobin's Q (R^2 = 0.49)

(-1.65) (10.327)

CGI = 0.1 + 0.6 * Excess return (R^2=0.23)

(1.84) (5.76)

Subsequently we make an attempt to analyze the institutional ownership pattern in the above 113 companies. As before, we make an attempt to understand the mean and median ownership stake of these institutional investors in the five quintiles. Tables 6a and 6b report the mean and median institutional shareholding pattern respectively in the five quintiles.

Table 6a: Median Stakes

	Quintiles based on CGI				
Institutional investors	Q1	Q2	Q3	Q4	Q5
IFCI	0.89%	1.1%	0.64%	1.2%	0.9%
ICICI	1.89%	1.91%	1.89%	3%	2.01%
IDBI	1.16%	0.89%	0.64%	0.94%	1.21%
UTI	0.56%	0.45%	1.1%	1.45%	3.21%
MFs	6.89%	5.45%	3.21%	3.25%	2.14%
LIC	0.74%	0.41%	0.11%	0.75%	0.9%
GIC	1.1%	2.1%	0.32%	0%	0.89%
Banks	0.59%	1.48%	0.74%	1.61%	3.21%
Debt Holding by DFIs	6.41%	6.51%	3.25%	2.85%	4.45%

Table 6b: Mean Stakes

	Quintiles based on CGI				
Institutional investors	Q1	Q2	Q3	Q4	Q5
IFCI	1.24%	1.01%	1.1%	0.79%	1.24%
ICICI	2.01%	2.11%	1.87%	4.02%	2.24%
IDBI	1.32%	0.98%	0.73%	1.17%	1.13%
UTI	0.71%	0.62%	1.07%	1.13%	2.97%
MFs	13%	7.28%	4.41%	4.51%	4.04%
LIC	0.77%	0.34%	0.13%	0.69%	0.74%
GIC	1.3%	1.87%	0.74%	0.09%	1.03%
Banks	0.77%	1.13%	0.77%	1.68%	2.74%
Bank Debt					
Debt Holding by DFIs	11%	8.9%	6.48%	3.74%	5%

From Tables 6a, and 6-b, we can obtain certain interesting results.

- ? There is a positive relationship between the stake of mutual funds and corporate governance index. There is also a positive relationship between the debt holding of the DFIs and corporate governance index.
- ? There is a negative relationship between the stake by the banks and corporate governance index. There is also a negative relationship between the stake of UTI and corporate governance index. This shows that the performance of UTI is totally different from that of the other mutual funds.

To get additional evidence on the relationship between CGI and institutional stake, we decide to regress CGI on the mean institutional stakes and bank and DFI debt.

The regression output is shown in Table 7. In the second column, we report the estimates of the intercept and the regression slope coefficients of the different institutional stakes and DFI debt. In the third column, we report the respective t-statistics.

Table 7: Regression output (CGI on institutional stakes, and Bank and DFI debt)

Here we run the following regression equation: CGI = b0 + b1*IFCI stake + ... + b10 * DFI_debt + error		
Variable	Estimates	t-statistics
Intercept	-0.87	-.21
IFCI stake	0.07	0.64
ICICI stake	0.21	1.24
IDBI stake	-0.12	-0.79
UTI stake	-0.24	-1.98
MF stake	0.31	5.14
LIC stake	-0.03	-0.47
GIC stake	-0.13	-1.08
Bank stake	-0.1	-1.98
Bank Debt	0.08	1.26
DFI debt	0.22	6.54

The R^2 for the above regression is 0.32, and the F value is 5.44. This is significant at 1% significance level.

One interesting point that emerges from the above findings is that although there is no perceptible relationship between the equity holdings of the DFIs and corporate governance index, there is a positive relationship between their debt holdings and corporate governance index. It is tempting to say that companies with higher debt face lower agency costs (like overinvestment)

compared to companies with lower debt. This however cannot be the complete explanation, as this does not explain the almost negative relationship between the debt holding by the banks and the corporate governance. One cannot either say that this happens because the DFIs contribute both equity and debt capital since this argument applies to banks as well.

The second interesting and heartening conclusion is about the corporate governance records of companies in which the mutual funds have invested. This result contrasts the findings of Sarkar and Sarkar (2000).

The fact that there is no clear link between the stakes of most of the institutional investors and corporate governance index shows that the institutional investors do not probably bother about the governance practices of the companies in which they have invested. Or they are ineffective at that. However, the fact that good governance is positively related to financial performance also shows that the institutional investors cannot ignore governance aspect while investing in the companies.

The above results clearly demonstrate that companies with good governance record have in fact recorded better financial performance compared to companies with poor governance records. Here we will briefly discuss the possible rational of these findings. Investors dislike companies with poor corporate governance practices. This happens because for such companies, there is an information asymmetry between the investors on the one hand and the company on the other. The shares and the bond instruments of such companies are looked as lemons by the investors (in the Akerlofian (1970) sense). Zeghal (1984) has observed that the stock returns of companies with poor quality of earnings (a proxy for corporate misgovernance) are much lower compared to the companies with good quality of earnings. Mohanty (1999) has found out that companies with poor quality of earnings also experience a higher cost of capital and hence a lower value.

The value of companies with poor corporate governance comes down probably because of two reasons. Corporate misgovernance causes an information asymmetry and hence the value of the capital assets issued by the companies comes down. Secondly, corporate misgovernance increases the agency costs[†††††] and that also reduces the value of the companies. Therefore, the institutional investors must invest their money in companies with good governance records to ensure that the value of their portfolio does not get reduced. Active monitoring also helps because this prevents the information asymmetry from increasing. This also reduces the agency costs.

[†††††] See Jensen (1986)

Section III

Institutional Investors 'Stakes and Financial Performance

In the previous section, we look at the relationship between corporate governance index on the one hand and financial performance on the other. The corporate governance index depends on a rather wider perspective. We look at the responsibility of the company to all the stakeholders while defining the corporate governance index. In this section we redefine corporate governance using a narrow perspective by looking only at the shareholders. This allows us to increase the sample size considerably as we get all the required data from the Prowess database.

There is also another reason why we feel confident about taking a narrow perspective on the subject. Our analysis in the previous section shows that companies with good governance practices have in fact developed superior stock returns. Their Tobin's Q is also the highest. One can therefore look at Tobin's Q as a proxy for the corporate governance index developed in the previous section.

In this section we attempt to find out if there is a link between corporate governance (Tobin's Q as a proxy) and the stakes of the institutional investors. Following Sarkar and Sarkar (2000), we decide to use spline functions while estimating the relationship between financial performance and the stakes of the institutional investors. Spline functions are used when we suspect the relationship between the explanatory and the explained variables to be non-linear (or piece-wise linear). Thus for example, if we believe that the institutional investors start monitoring the performance of a company only if the stake is above some threshold point, then we cannot estimate the relationship between financial performance and institutional investors' stakes by using a simple regression specification.

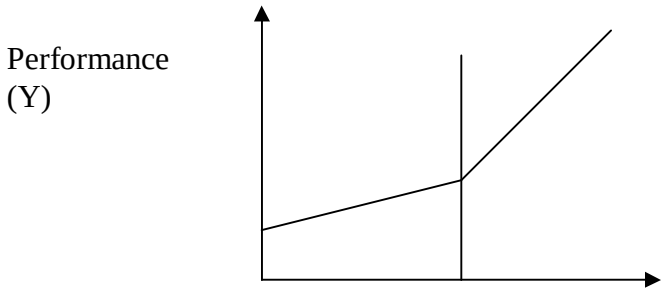
Suppose, we believe that the institutional investors remain passive when their stake is below some percentage 'a'. However there is a positive relationship between stake and performance once stake exceeds 'a'.

There is a theoretical reason to believe that the institutional investors become active only if their stake is above some threshold point. When their stake is less, the institutional investors will always prefer to sell their shares of the company in the market than to actively monitor the performance in case there is some problem in the company. The monitoring costs will be high and it will not make sense to incur these expenses by monitoring the performance of the companies when cheaper options like selling the shares are available. Secondly, even if the institutional investor decides to monitor the performance of the companies, there will always be some free-rider problem. The free-rider problem can of course be addressed if all institutional investors act together.

However if the stake of the institutional investor is above some threshold point, then the benefits from active monitoring will exceed the monitoring costs. Therefore one should observe a

very highly positive relationship once the stake of an institutional investor exceeds this threshold point.

Let us assume that the true relationship between stake (X) and performance (Y) is



$$Y_t = \begin{cases} a_1 + b_1 X_t + e_t & t < a \\ a_2 + b_2 X_t + e_t & t \geq a \end{cases} \quad (1)$$

We can have a linear spline function written as:

$Y_t = a_1 + \beta_1 w_{1t} + \beta_2 w_{2t} + e_t$ (2)

Where

$W_{1t} = t$

$$w_{2t} = \begin{cases} 0 & \text{if } t < a \\ t - a & \text{if } t \geq a \end{cases}$$

We can directly run the OLS regression by using equation (2) above. We will be testing the hypothesis

$\beta_2 = 0$.

If $\beta_2 = 0$, then $\beta_1 = b_1$, and we do not require a spline specification. If $\beta_2 \neq 0$, then this will conform our belief that the relationship between stake and performance is non-linear.

Using a quadratic specification, we first attempt to determine the spline knots for the different institutional investors. However, we do not observe any uniform spline knot for the different investors. It turns out to be non-existent for most of the institutional investors. It varies between 6% to 34% for the other institutional investors. For the insurance companies, it is 34%, whereas it is 6% for the mutual funds. We therefore decide to estimate the relationship between stake and corporate governance using a simple OLS specification.

In any analysis on corporate governance, one must keep in mind the possibility that the effect of stake on corporate performance is a two-way traffic. It is possible that there is a positive relationship between corporate governance and institutional investors' stakes because the institutional investors actively monitor the performance of the companies. It is also possible that the institutional investors have merely invested in the companies with good performance. Therefore, any

attempt to understand the relationship between stake and financial performance will not be complete unless one accounts for both these effects. Following, Bhojraj and Sengupta (2001) we have used simultaneous equation method to understand the relationship between stake and performance.

In the regression, we have included the following control variables.

PBV: Price-to-book value has been included as one control variable for two reasons. First, as some research shows PBV is directly related to good performance. Fama and French (1992), and Mohanty (2000) document the existence of PBV effect in the US and Indian respectively. Another reason why we include PBV as a control variable is that Tobin's Q is highly correlated with PBV. Therefore keeping PBV as a control variable will ensure that we do not capture the PBV effect while finding the relationship between stake and performance. One may raise the apprehension that having PBV as an independent variable will automatically ensure a very high correlation between TQ and PBV. However, as the regression results show, this apprehension is not warranted.

Size: Size is also known to be cross-sectionally related to stock returns and financial performance. Institutional investors are also known to hold the stocks of large companies. (See Mohanty (2000)). We define size as the logarithm of market capitalization here.

Beta: When we observe that stocks of companies with good governance records have done well, it may also mean that in our sample companies with good governance also happen to be stocks with high operating and financing risk. To adjust for the risk, we use beta as another control variable. We compute beta by regressing stock returns for the previous sixty months data after adjusting for illiquidity using Scholes and Williams(1977) method.

Age: We define Tobin's Q as the ratio of the market value of the company and the book value of the assets. Companies with older assets will have lower book value of assets, and hence a larger Tobin's Q. We adjust for this age effect by using age as another proxy variable. We define age following Khana and Palepu (2000).

Industry: We also include an industry dummy to account for the differing growth opportunities and other industry specific factors. Here we adopt the same classification rule that Prowess adopts to classify companies into different industries.

We estimate the parameters using the following system of simultaneous equations. In the regression equation with stake as the dependent variable, we include liquidity as a control variable because institutional investors prefer to invest in companies whose stocks are very liquid. We define liquidity as the logarithm of average number of transactions that took place in the previous one year.

TQ = a_0 + a_1*STAKE-UTI+a2*STAKE-OMF####+a3*STAKE-ICICI+a4*STAKE-IDBI+a5*STAKE-IFCI+a6*STAKE-LIC+a7 * STAKE-GIC + a 8 * STAKE_FI_DEBT + a9 * BANK-EQUITY + a10*BANK-Debt+ a11 * PBV + a12 * SIZE + a13 * BETA+ a14* AGE + a15* industry dummy + error terms

STAKE-IFCI = b_0 + b_1*TQ + b_2*SIZE + b_3*AGE + b_4*LIQUIDITY + error terms

STAKE-IDBI = b_0 + b_1*TQ + b_2*SIZE + b_3*AGE + b_4*LIQUIDITY + error terms

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STAKE-Banks = b_0 + b_1*TQ + b_2*SIZE + b_3*AGE + b_4*LIQUIDITY + error terms

We use two-stage least square method to estimate the parameters in the above system of simultaneous equations. Table 8 reports the results of the simultaneous equation system.

Table 8: Output of the Simultaneous Equation System

Variable	TQ§§§§§§	IFCI	ICICI	IDBI	LIC	GIC	UTI	OMF	Bank	FI-D	Bank-D
Intercept	0.7*	0.028**	0.033*	0.089*	0.07*	0.018*	-0.16*	1.32*	0.13*	5.99*	5.08*
IFCI	-0.01										
ICICI	0.07										
IDBI	-0.05										
LIC	0.05										
GIC	-0.00										
UTI	-0.013										
MF	0.1**										
Bank	0.06										
FI-D	0.1**										
Bank-D	-0.0										
TQ		-0.01	0.016	-0.045	-0.01	-0.06	-0.07	0.017*	0.02	5.12**	-1.24*
Size	-0.023	-0.00	-0.00	0.00	0.00	-0.02	-0.00*	0.02	-0.00	0.01*	0.06
PBV	-0.06										
Industry	0.01										
Beta	0.04*										
Age	0.00	0.04	0.07**	0.1**	0.04	0.03	0.02	0.04	0.07	0.04*	0.00
Liquidity		0.04	0.13*	0.03	0.07	0.00	0.1**	0.1**	0.00	0.02	0.06*
R^2	0.2	0.003	0.29	0.23	0.07	0.09	0.31	0.3	0.08	0.31	0.24
F	7.8	0.008	80.56	49.00	4.32	7.16	93.27	86.77	5.65	93.27	53.62

(*: Significant at 5% significance level, **: significant at 1% significance level)

We derive two interesting conclusions from the above study.

OMF stands for the other mutual funds.

§§§§§§ To understand the extent of simultaneous equation bias, we also run an OLS regression for the TQ equation. We find that the slope coefficients are generally overestimated in the OLS regression equation.

? There is a positive relationship between the stake of mutual funds and financial performance. This relationship is two-way too in the sense that it is financial performance that is determining the stake of the mutual funds in the companies and the investment by these investors is also causing the financial performance to improve. We find in our previous section that there is a high relationship between corporate governance index and the stake of the mutual funds in the companies. The results of the above simultaneous equation system confirm that this relationship is two-way.

? The second interesting result that we find is that there is a positive relationship between the debt extended by the development financial institutions and the financial performance of the companies. We have not reported this result here. This is quite consistent with what we obtain in the previous section. This shows that the development financial institutions have lent money to companies with better corporate governance index. It also implies that the development financial institutions' lending money has improved the performance of the companies.

We find most of the institutional stakes insignificant. However, keeping in mind that institutions might often act together in corporate governance matters, it will be interesting to estimate an alternative system of equation by aggregating the institutional stakes. We run the following system of equations here. Here, we include the equity stakes of all the institutional investors and use that as one independent variable. We similarly club the debt holdings of banks and development financial institutions as another dependent variable.

TQ = a_0 + a_{1*}STAKE-Equity-IIs+ a 2 * STAKE_DEBT-IIs + a3 * PBV + a4 * SIZE + a5 * BETA+ a6* AGE + a7 * Industry-dummy + error terms

STAKE-Equity-IIs = b_0 + b_1*TQ + b_2*SIZE + b_3*AGE + b_4*LIQUIDITY + error terms

STAKE-Debt-IIs-Banks = b_0 + b_1*TQ + b_2*SIZE + b_3*AGE + b_4*LIQUIDITY + error terms

Variables	TQ	Stake-equity-IIs	Stake-Debt-IIs
Intercept	0.71*	3.39*	2.28
Stake-equity-IIs	-0.04		
Stake-Debt-IIs	0.06*		
TQ		0.73*	1.14**
Size	-0.00*	0.00**	0.04*
PBV	-0.03		
Industry	0.01		
Beta	0.05*		
Age	0.06*	0.05*	0.1**
Liquidity		0.06	0.00
R^2	0.3	0.15	0.22
F	43.33	20.19	44.62

The results do not change substantially by consolidating the stakes of all the institutional investors. The only major difference that we find here is that the link between the equity investment and financial performance is a one-way relationship. The above results show that the institutional investors have invested in companies with better financial performance. The investment by these institutional investors does not seem to have any impact on the financial performance of these companies. As far as the debt from the development financial institutions is concerned, the relationship is however two-way. The corporate governance practices of the companies in which the institutional investors have invested are commendable. The development financial institutions have also lent money to the companies with better financial performance.

These results raise a very interesting question about the effectiveness of debt capital in the corporate governance system of a company. We leave it to our future research.

Section IV

Issues in the role of Institutional Investors in Corporate Governance

In this section, we will discuss the question of insider trading by the institutional investors. We will subsequently discuss the feedback we receive on this paper from some of the institutional investors.

Insider Trading

When an institutional investor comes to know of some poor governance practice in the company, it normally has two choices. It should either interfere in the matter and let the management take action to amend the situation. Or it should just sell the shares in the market. The second practice is also known as voting with the feet.

If no body in the market knows of the poor governance issue, then the institutional investor actually faces the prospect of being accused under insider trading. The only way the institutional investor can avoid insider trading is to take the foolish decision of first making the matter public (thereby letting the share price fall), and then selling the shares at a reduced price. In this paper we develop a small model to explain when the institutional investor should actively interfere.

Suppose, the share price before the matter concerning poor corporate governance is known to the market is 'p', and the number of shares is 'n'. Let us assume that the institutional investor's stake is given by 'a'. Then the current value of the investment is given by '$a*p*n$'.

Suppose, the monitoring cost is given by 'MC'. In case the institutional investor interferes thereby improves the performance of the company, the share price increases to 'p_1'. The new value of the investment in that case will be '$a*p_1*n - MC$'

Therefore it will make sense for the investor to interfere only if the following condition gets satisfied.

$$a * p_1 * n ? MC ? a * p * n$$

$$? \quad a * n * (p_1 ? p) ? MC$$

$$? \quad p_1 ? p ? \frac{MC}{a * n}$$

The above equation sets a value-maximizing condition for active monitoring by the institutional investor. This shows that higher the stake of the institutional investor in the company, that is higher is 'a', higher is the possibility that the institutional investor will gain from actively interfering in the activities of the company. This also implies that if the institutional investors act together, then it makes more economic sense for them. It can be proved that it never makes sense to the institutional investor to make the information public before selling the shares to avoid insider-trading rules.

How should the price behave when it comes to know of come corporate misgovernance issues? If the market believes that the company will now improve its performance, then price will rise. If the market did not know of the corporate misgovernance issue earlier and believes that despite the institutional activism, the company will not take any corrective step, then the prices will fall.

To gain additional evidence on the effect of corporate governance on stock returns, an event study approach was used. There are certain instances of direct intervention by the institutional investors in the affairs of the poorly managed companies. During 1997-1999, only twenty cases of direct intervention could be obtained. An attempt was made to see how the stock market has reacted to such interventions. If corporate governance really adds to the shareholders' value, then one should expect a positive response from the market. The major characteristic of these twenty cases is that most of the institutional investors acted together here.

The following methodology was adopted to see how the market reacts to the direct intervention by the market. At first, data on the exact date on which the active intervention news was released to the market was obtained from the IBID database.

Then a 41-day window period was constructed which includes 20 days before the event announcement and 20 days after the event announcement.

Then the stock returns were regressed on the sensex return using the following equation.

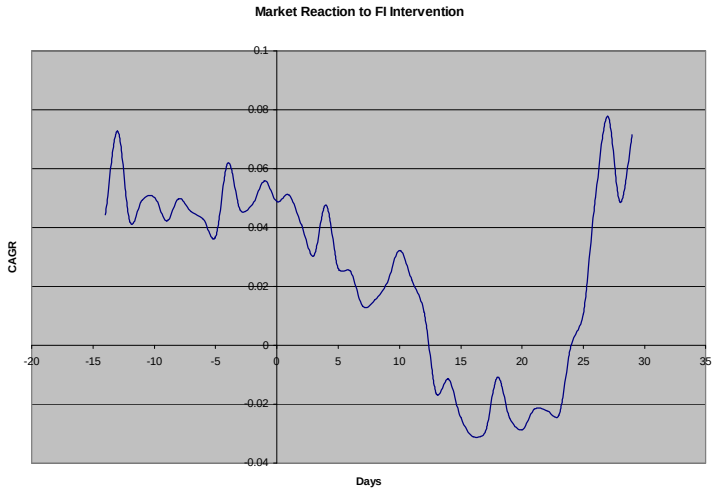
$R_i = ? + ? * R_m +$ error terms.

While running the above regression, the above window period was deleted. Then using estimates of ? and ? (obtained from the above regression) the cumulative abnormal errors were computed.[*******]The cumulative abnormal returns would be zero if the stock market is indifferent to

[*******] For a detailed discussion on event study methodology see Brown and Warner (1980).

the announcement of the event. The cumulative abnormal returns will be positive (negative) if the market likes (dislikes) the intervention. Then the abnormal errors were plotted against the dates to see the market reaction to the announcement of the event. Chart 1 depicts the picture clearly.

Chart 1: Reaction of the Market to Institutional Activism



One can see from this chart that the market reaction was negative immediately upon the announcement of the event. This is obvious because, such direct intervention gives an adverse information to the market. The stock market comes to know that something is wrong with the company. It accordingly revises its expectations. But after a few days, the reaction of the market turns positive††††††. The market believes that the performance of the company will improve now that the institutional investors are actively monitoring the company. This is a very clear indication of the fact that market likes companies with good corporate governance practices. When the market knows that the company under pressure from the institutional investors will perform well in future, the stock prices begin to rise and this adds to the wealth of the shareholders.

These findings have two interesting implications. First, it does not make sense for the institutional investor to sell the shares as this will surely result in a loss for the investor. The institutional investor cannot risk being charged under insider trading either by selling the stocks without informing the market. Secondly, collective action by the institutional investors always helps in the long run. This reduces the incidence of monitoring costs per institutional investor.

†††††† This also means that the market is semi-strong form inefficient.

Feedback from the Institutional Investors

We make an attempt to get the feedback from the institutional investors on the above findings. We send questionnaires to nineteen mutual funds in India. We get response from only six of them.. We also personally interview the four fund managers of the mutual funds. We could get feedback from only one executive from a DFI‡‡‡‡‡. We could not get the feedback from any body in the insurance sector.

We interview some fund managers of some of the leading mutual funds to know if they have any policy on the corporate governance of the companies in which they have invested. In particular, we attempt to find out:

- ✍ Whether the mutual funds study the past corporate governance practices of the companies before making any investments;
- ✍ What actions the mutual funds take when they come to know of some irregularity within the company.

Almost everybody agreed that the development financial institutions usually do not do anything as far as corporate misgovernance is concerned§§§§§§§. They act only in extreme cases, like for example, they became active when Essar Oil was about to default on its foreign borrowings. Fund managers from the mutual funds told that the objective of a mutual fund is to earn enough returns for the unit holders and not to look at the corporate governance records of a company.

As far as the financial institutions are concerned, three reasons are extended as to why they have such pathetic corporate governance records********. Firstly, the financial institutions, due to political pressure, usually support the existing management. They become active only in extreme cases. Secondly, they have stakes in many companies. But they do not have enough senior people who can play the role of active directors in the board of the companies†††††††. Finally, there is no incentive for corporate governance. The nominee directors do not get any reward for active interference. Nor do they get penalized for poor corporate governance practices.

Some of the fund managers from the mutual funds say that they look at corporate governance practices before making any investments. However, it is not a prime consideration. What matters is the return that the stock is generating and not the corporate governance practices followed by the company. One of the fund managers, for example told me "... what matters to me is the money that I can make from the company and not the governance structure in the company... If I

‡‡‡‡‡ Confidentiality has been assured to all the people who responded to our questionnaire and those whom we interviewed.
§§§§§§§ We however find that there is a positive association between DFI debt holding and corporate governance.
******** Almost everybody agreed that the financial institutions, though in a position to influence the corporate governance practices of the companies, do not do anything.
††††††† Sometimes retired bureaucrats are appointed as nominee directors.

am making money I am happy with it." In fact two of the fund managers told me that if we look at corporate governance alone, then the value of our portfolio might fall. The fund managers have a performance evaluation system. It is entirely based on the performance of the funds that they create and manage. Hence, if a company with poor corporate governance record is expected to give a higher return, then the fund manager can very well invest there. One cannot blame the fund manager here because, after all one of the major objectives of the fund manager is to maximize the return of the portfolio.

One executive from a DFI however said that the DFIs have become more active recently. Of late, one can see instances of active interference by the institutional investors in the management of the companies. Thus for example, Core Healthcare has been pressurized by the financial institutions to remove the existing management and bring a more viable management. Similarly, they have stalled the proposed sale of the 36% stake of the Raymond group in Raymond Synthetics to Reliance Industries Limited because the sale price was too low. The DFIs in India have also started the initiative to take part in the active governance of the companies. The DFIs, for example, have developed a code for the nominee directors to follow to ensure good governance in the companies in which they have made investments. Thus, for example, wherever the financial institutions have got nominee directors in the boards of the companies, they must get information on issues like investments in subsidiaries, awards of contracts, mergers and acquisitions, dividend and accounting policies, etc.######

Conclusion

It is important to understand that corporate mis-governance is not a fault of the institutional investors. However, being dominant shareholders, they are expected to perform the role of an active monitor in the affairs of the company.

In this paper we take the stance that the basic objective of an institutional investor is to maximize its own shareholders' wealth and not to monitor the activities of the companies in which it has invested. However, we find that companies with good financial performance have actually performed better compared to companies with poor governance records. We also find that development financial institutions have extended loans to companies with good governance records. We also find that the mutual funds (other than UTI) have invested companies with good governance records. However we find that there is no effect of equity the investment of the institutional investors on the corporate governance records of the companies. Rather the institutional investors as a group have invested in companies with good financial performance.

See the Economic Times, November 25, 1996.

This paper raises interesting issues on the role that debt capital can play in the corporate governance system of a company. It is interesting to know why debt extended by the development financial institutions has a better effect on firm performance compared to debt extended by the banks. Traditionally banks used to provide debt for working capital only while development financial institutions used to provide term loans. Mo research is needed in this area to throw more light on this issue.

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