The Ownership Structure and Corporate Governance: A Case af Pakistan Stock Exchange

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Abstract

The current study investigates the impact of various proxies of ownership structure (such as ownership concentration, managerial ownership, institutional ownership and foreign ownership) on the internal corporate governance mechanism of the listed non-financial firms in Pakistan Stock Exchange (PSX). The study developed a corporate governance index by using 7 distinct proxies of corporate governance mechanism. The research analyzed an unbalanced panel of 287 firms from 2010 to 2016 listed on the Pakistan Stock Exchange (PSX). The study demonstrates that the ownership structure is an important determinant of corporate governance practice in Pakistani firms. Different proxies of ownership structure have a distinct impact on internal governance mechanism, for example, ownership concentration and managerial ownership is negatively associated with governance index. However, institutional ownership is positively associated with governance index while foreign ownership is found ineffective in promoting good corporate governance practices in firms. This study contributes empirically that different characteristics of ownership structure are reliable sources to explain the corporate governance mechanism. The diverse findings in the current study provide a deeper insight to the policy makers and regulatory bodies to fortify internal governance mechanism in order to enhance the trust of the investors.

Keywords: Corporate governance index, ownership concentration, managerial ownership

Introduction

The nationalization process in Pakistan started in 1970. In this program the elected government nationalized the private sector in three phases under the "Nationalization and Economic Reforms Order (NERO). In the first stage, the government nationalized majority of the corporations working in Oil and gas sector, electricity generation and distributions, iron and steel, heavy engineering and electric industry, and assembling and manufacturing automobiles units. In the second phase, the government nationalized financial sector in Pakistan under the framework of the Banks Nationalization Act 1974. In the third stage, which started in 1976 all textile firms and remaining manufacturing units were nationalized. The objective behind this policy was to stimulate the economic growth and reduction of poverty. However, this nationalization strategy could not yield desired results, and latter on, from 1990s and onwards the government of Pakistan gradually privatized the nationalized units in both financial and non financial sector. After the privatization, the local and foreign investors stimulated the economic activities in Pakistan, which also resulted in growth of Pakistan stock exchange (PSX). Currently, majority of the registered firms in Pakistan have concentrated ownership structure either by government, controlling family, associated firms or institutional investors (Khan & Nouman, 2017).

The phenomena of corporate governance emerged with the birth of the corporations but the researchers in the developed countries realized its importance in the latter half of the 20th century (Vinten, 1998). Many researchers (Cabalu, 2005; Husnan, 2001; Johnson, Boone, Breach, & Friedman, 2000)identified poor corporate governance practices in the countries of ASEAN region which aggravated the Asian financial crises (1997-98). Efficient corporate governance practices improve the firms' performance and, especially, in the developing countries effective corporate governance system not only reduces the probability of financial crises but also leads towards capital market development and long term economic growth of the country (Javid & Iqbal, 2010). Thus, assessing the importance of corporate governance mechanism, Security Exchange of Pakistan (SECP), issued the corporate governance codes 2002, for all the publically listed firms in Pakistan.

Corporate ownership structure has strong influence on the corporate governance mechanism (Xu & Wang, 1999). Theoretically, agency theory also describes various conflicts between principal (owners) and agents (managers) which arise due to diverse ownerships structure in the corporations and these conflicts result in a discontinuity in the corporate governance policies in the firms. Several studies (Bertoni, Meoli, & Vismara, 2014; Cull & Peria, 2013; Lin, Ma, Malatesta, & Xuan, 2011) explore the relationship between ownership structure and corporate governance but most of the empirical research is conducted in the developed countries. The geographic and economic conditions in the developing countries are different from those in the developed countries in term of political stability, law and order situations, infrastructure development,income level and financial structure. Moreover, the current literature does not consider the philosophy underwhich a business is conducted, especially, in the Muslim countries.

There are a number of studies which explain the corporate governance phenomena in Pakistan. Nishat and Shaheen (2004) and Javid and Iqbal (2010) concluded a positive association between corporate governance index and performance of non-financial firms in Pakistan. Ashfaq, Mujtaba and Saeed (2017) explored the relationship between corporate governance and earning management practices in financial sector of Pakistan. The association of corporate governance is also explained with dividend policy (Mehar, 2005) cost of equity and ownership concentration (Javid & Iqbal, 2010) in Pakistan. But none of these studies focused on the relationship between ownership structure and corporate governance in Pakistan. Thus, the current study explores the relationship between ownership structure and corporate governance practices in Pakistani context. It further explores whether variation across ownership structure results in a systematic variation in the firm's corporate governance quality. The ownership structure and corporate governance relationship has not been explored or assessed previously, so to the best of our knowledge this study is the first endeavor to examine the ownership structure and corporate governance relationship in Pakistani listed firms.

The findings of the study suggested that different aspects of ownership structure (such as ownership concentration, managerial ownership and institutional ownership) have very strong influence on the internal corporate governance mechanism. The study empirically contributed to the body of literature that the quality of the internal corporate governance varies with the variation of the ownership structure of the firms. The current study provides a unique opportunity to explore the way different components of ownership structure, such as, concentrated ownership, managerial ownership, institutional ownership, and foreign ownership interact with the corporate governance mechanism. Unlike the previous studies (Butt & Hasan, 2009; Kamran & Shah, 2014; Sheikh, Wang, & Khan, 2013), which analyzed different characteristics of corporate governance, the current research uses a comprehensive corporate governance index developed by (Gompers, Ishii, & Metrick, 2003). Thus, the primary objective of the current study is to find out whether corporate governance mechanism helps in shaping a particular type of ownership structure in Pakistan.

Literature Review

Ownership structure is an imperative feature of corporate governance which also helps in identifying the nature of the agency problems between owners and the agents (Cabalu, 2005; Prowse, 1998). In the Anglo-Saxon countries where majority of the firms rely on equity finance and the dispersed ownership structure decreases the influence of the controlling shareholders; there the management is not under any influence and follows good governance practices (Gilson, 2005). Whereas, in the continental Europe dispersed ownership structure creates conflicts of opinion between the owners and the management which results in discontinuity in the corporate governance policies (Gilson, 2005). The researchers developed different proxies to gauge the ownership structure, such as, ownership concentration, institutional ownership, managerial ownership and foreign ownership (García-Meca & Sanchez-Ballesta, 2010). In Pakistan majority of the firms have concentrated ownership by the controlling family, financial institutions or by the government (Javid & Iqbal, 2010). The current study has used ownership concentration, institutional ownership, managerial ownership and foreign ownership as proxies of ownership structure and in order to judge the level of corporate governance practices the current study has developed a corporate governance index by using the methodology of Gompers et al., (2003).

Ownership Concentration and Corporate Governance

The review of the related literature suggests that the majority of the firms in the developing market have concentrated on ownership (Javid & Iqbal, 2010; Madhani, 2016; Shleifer & Vishny, 1997). The limited access to the external financing sources, weak legal environment and non developed financial markets in the developing countries encourages the original owners and founding families to maintain a large stake in the firms ((La Porta, Lopez de Silanes, Shleifer, & Vishny, 2000; Pistor, Raiser, & Gelfer, 2000). In the case of concentrated ownership, although, the agency conflict between the management and the owners is controlled but there is a greater probability that managers will make decisions under the majority shareholders on the expense of minority share holders (Cheema, Bari, & Saddique, 2003; Javid & Iqbal, 2010). But concentrated ownership directly influences corporate governance mechanism by both alleviating and aggravating the agency problems (Setia Atmaja, 2009).

Empirical results suggest that concentrated owners have power and incentive to influence the management (Jensen & Meckling, 1976; Burkart, Gromb, & Panunzi, 1997). Thus, these large shareholders in any firm compel the management to deviate from corporate governance practices in order to protect their interests. Furthermore, concentrated owners directly influence the corporate governance decisions for their wealth maximizations and deprive the individual investors from their part of residual income (Desender, Aguilera, Crespi, & GarcÍa cestona, 2013). So, more power in the hands of few shareholders discourages the good corporate governance practices in any organization. Therefore, consistent with the literature the current study anticipates an inverse relation between corporate governance and ownership concentration.

H1: There exists a negative relationship between ownership concentration and corporate governance index in Pakistan.

Managerial Ownership and Corporate Governance

Managerial ownership resolves several conflicts between other owners and the management (Brailsford, Oliver, & Pua, 2002). However, when managerial ownership increases to a certain limit it creates entrenchment effect in the corporation (McConnell & Servaes, 1990). A powerful management team uses the resources of the firm for its personal benefits and spends the firm's wealth in the form of higher remunerations and bonuses (Beasley, 1996). Theoretically, managers' responsibility is efficient utilization of firm's resources so that the wealth of the shareholders is raised. Managerial ownership not only reduces incentive problems but also motivates the management to make efficient corporate governance policies (Denis, Denis, & Sarin, 1997). The higher level of managerial ownership in firm ownership structure aligns the inters of mangers with other form of owners which decreases the opportunistic behavior of the management as a result agency conflicts decrease and a firm has continuity in its governance practices(Kamran & Shah, 2014). On the contrary, the entrenchment hypothesis describes that if the managerial ownership rises beyond a certain level then it becomes authoritative and use its dominance to exploit the wealth of the minority shareholders (Shleifer & Vishny, 1997). However, in both of the above discussed cases, the managers are satisfactory monitors and they want to decrease the influence of other monitors (Rashid, 2016). Managerial ownership has higher degree of concentration in Pakistani listed firms (Cheema, et al., 2003), wherein the dominant managers act under one-tire corporate management board. The absence of supervisor board provides them the luxury to over look the corporate governance mechanism. So on the bases of the above discussion the study hypothesizes that:

H2: There exists a negative relationship between managerial ownership and corporate governance index in Pakistan.

Institutional ownership and Corporate Governance

The review of the literature confirmed that the growing magnitude of institutional investors in the firm's ownership structure has influence on the firm's corporate governance mechanism (Chung & Zhang, 2011; Cremers & Nair, 2005; Hartzell & Starks, 2003; Shleifer & Vishny, 1997). The presence of institutional ownership puts various financial constraints on the managers (Shleifer & Vishny, 1997) which not only improve governance quality but also reduce agency conflicts. Institutional investment acts as an agent who propagates good governance and convergence practices in the firm either directly by forcing the management with their voting rights or indirectly threatens the management to vend their shareholdings (Aggarwal, Erel, Ferreira, & Matos, 2011).The monitoring of the governing body is a difficult task, as monitoring requires financial and managerial expertise along with associated cost. Empirical results revealed that the financial institutional are excellent monitors of the management (Chung & Zhang, 2011; Hartzell & Starks, 2003). Large institutional investors discipline the management and they also enforce the management to adopt better disclosure practices (Bushee & Noe, 2000). Some institutional investors, such as, commercial banks and insurance companies have very strong fiduciary responsibilities (Del Guercio, 1996). Such prudent institutional investors have a very close eye on the cash flows related policies of the governing body (Cornett, Marcus, Saunders, & Tehranian, 2007), so in corporate governance mechanism financial institutions do not let the management to take up the riskier financial strategies (Grinstein & Michaely, 2005). However, some researchers revealed that the institutional investors are economic agents, who want to earn maximum profit in a limited period of time (Bhide, 1993; Coffee, 1991). Their investment behavior determines their level of involvement in the corporate governance practices of the firm (Hutchinson, Seamer, & Chapple, 2015). So, based on the above arguments the study hypothesized that:

H3: There exists a positive relationship between institutional ownership and corporate governance index in Pakistan.

Foreign Ownership and Corporate governance

The presence of foreign ownership in the firm's ownership structure is a signal that foreign owners have trust and confidence on the domestic firms and their operational mechanism (Bohl, Schuppli, & Siklos, 2010; Anum Mohd Ghazali, 2010). The foreign ownership introduces new corporate governance strategies to their target firms which increases the competitive advantage of the firms (McGuiness & Ferguson, 2002). Ting, Yen and Chiu (2008) found that foreign investors have a long term investment objectives and the empirical research in the developed countries revealed that long term investors not only monitor the corporate governance mechanism but also actively participate in it (Cox & Wicks, 2011). In the case of emerging Chinese economy, foreign investors play a very vital role in the growth of the local listed firms by ameliorating corporate governance mechanisms (Kang, Shi, & Brown, 2008). Arggawal et al. (2011) conducted a multi-country research study to explore the role of foreign investors in those countries which have weaker investor protection mechanism and confirmed their active involvement in firm's governance affairs. On the other hand, Balasubramanian, Khanna and Black (2008) concluded that the foreign owners in Indian firms are not aware of the local dynamics in which firms operate so their role is insignificant in the corporate governance mechanism whereas, in Russia foreign investors augmented the governance practices (Yudaeva, Kozlov, Melentieva, & Ponomareva, 2003). Ferreira & Matos (2008) concluded that although foreign institutional ownership increases firm's valuation but there is no direct evidence which confirms their involvement in the corporate governance practices. Thus, based on the above conflicting arguments the current study hypothesized that:

H4: There exists a positive relationship between foreign institutional ownership and corporate governance index in Pakistan.

Methodology/materials

Sample

The sample of the study includes non-financial listed firms on Pakistan Stock exchange with complete data. The data used for analysis is obtained from a number of sources. The related to corporate governance variables and ownership structure is obtained from the firms annuals reports. The data related to control variables such as ROA, firm size, leverage, dividend yield and sales growth is calculated with the help of balance sheet analysis published by the state bank of Pakistan. The final selected sample consists of an unbalance panel of 287 firm over a period of 7 years from 2010 to 2016 from distinct sectors such as cement, chemical, engineering, fuel and energy, paper and board, sugar and allied, textile, and miscellaneous.

Variables

Dependent Variable

Corporate Governance Index (CGI) is the dependent variable of the study. The study used a comprehensive measure of corporate governance index, developed by Gompers et al., (2003). This addition the bases of seven internal corporate governance proxies such as board size, number of executive directors, number of non-executive directors, number of independent directors, CEO- duality, number of board meetings and big four.

Independent Variables and Control Variables

Ownership structure is the independent variable in the current study. For the purpose of analysis, this variable is further divided into ownership concentration, managerial ownership, institutional ownership and foreign ownership. The following table gives the detail of the proxies of ownership structure along with the control variables.

Ownership Structure Proxies		
Variable	**Symbol**	**Definition**
Ownership Concentration	OC	It is the fraction of shares held by top 5 shareholders to the total common shares.
Managerial Ownership	MO	It is the fraction of shares held by the management to the total common shares.
Institutional Ownership	IO	It is the fraction of shares held by the financial institutions to the total common shares.
Foreign Ownershi	FO	It is the fraction of shares held by the foreign investors to the total common shares.
Control Variables		
Firm Size	FZ	It is the natural logarithm of total assets of the firm.
Leverage	LEV	It is the fraction of total debt to total equity of the firm.
Dividend Yield	DY	It is the fraction of annual dividend paid to the total all common shares holders.
Firm age	FA	It is the natural logarithm of the number of the years of the firm when it was established.

The Model

The objective of the current study is to explore the impact of ownership structure on corporate governance in non-financial Pakistani listed firms from 2010 to 2016. As the data has both cross section and time series characteristics, so a panel data methodology is used to control the undetectable heterogeneity. Under this methodology common effect, fixed effect and random effect models are regressed to explore the corporate governance and ownership structure relationship. Moreover, the results of the Hausman test are also reported which suggest that fixed/random model is best fitted to explain the models (Chen, 2001; Mollah, Al Farooque, & Karim, 2012; Xu & Wang, 1999; Zheka, 2005).The above mentioned models are run with the help of the following econometric equation.

$$CGIi,t = \beta 0 + \beta 1OCi,t + \beta 2MOi,t + \beta 3IOi,t + \beta 4FOi,t + \beta 5LEVi,t + \beta 6DYi,t + \beta 7FZi,t + \beta 8FAi,t + \square i,t$$

Results and Findings

Descriptive Statistics

Table 1 provides the descriptive statistics of the variables used in the current study. The mean value of the ownership concentration is 63.6 percent with minimum value of 8.9 percent and maximum value of 98.2 percent. This shows that the selected sample is evenly distributed around its mean value. Managerial ownership has a maximum value of 92.9 percent with standard deviation of 20.1 percent which indicates that Pakistani shariah complaints firms are dominated by their management. The descriptive statistics revealed that there are firms in the selected sample with no institutional ownership; the mean value of the institutional ownership is 11.5 percent with lowest standard deviation of 11.8 percent as compared to the other variables under study. This low value of the standard deviation depicts that majority of the selected firms in the sample has lower concentrated institutional ownership as compared to the managerial ownership. The mean value of the foreign ownership is 7.9 percent with standard deviation of 19.4 percent.

Table 1: Descriptive Statistics

Variables	Min	Maximum	Mean	Standard Deviation
Corporate Governance Index	0.000	1.000	0.472	0.199
Ownership Concentration	0.089	0.982	0.636	0.201
Managerial Ownership	0.000	0.929	0.205	0.247
Institutional Ownership	0.000	0.795	0.115	0.118
Foreign Ownership	0.000	0.890	0.079	0.194
Dividend Yield	0.000	3.378	0.051	0.157
Leverage	0.031	1.997	0.483	0.195
Firms Size	4.939	8.465	6.760	0.660
Firms Age	1.386	4.290	3.500	0.494

Correlation Matrix

The table 2 provides the correlation matrix among dependent variable which is corporate governance index and independent variables such as ownership concentration, managerial ownership, institutional ownership and foreign ownership. The correlation matrix also includes dividend yield, leverage, firm's size and firm's age as control variables. The matrix shows that ownership concentration, managerial ownership and foreign ownership is negatively correlated with the corporate governance index whereas the institutional ownership is positively related with the regressand. Furthermore, all the values in the sample are lower than .7 which indicates that there is no issue of multicollinearity among the explanatory variables.

Table 2: Correlation Matrix

Variables	1	2	3	4	5	6	7	8	9
Corporate Governance Index (1)	1.000								
Ownership Concentration (2)	-0.224	1.000							
Managerial Ownership (3)	-0.276	-0.141	1.000						
Institutional Ownership (4)	0.395	-0.149	-0.178	1.000					
Foreign Ownership (5)	-0.040	0.151	-0.257	-0.115	1.000				
Dividend Yield (6)	0.012	-0.071	0.023	0.056	0.016	1.000			
Leverage (7)	-0.097	0.069	0.154	0.022	-0.097	-0.054	1.000		
Firms Size (8)	0.062	0.020	-0.286	0.092	0.082	-0.038	-0.010	1.000	
Firms Age (9)	0.004	0.070	-0.145	-0.049	0.123	0.009	-0.196	-0.043	1.000

The Table 2 provides the correlation matrix among corporate governance index, ownership concentration, managerial ownership, institutional ownership, foreign ownership, dividend yield, leverage, firm's size and firm's age.

Regression Analysis

The following table 3 provides the results of the pooled OLS regression, fixed effect and random effect models for the corporate governance index as regress and along with proxies of ownership and control variables. Pooled regression model neglects the cross section and time series nature of data and assumes that all the companies are same in all included time periods. Whereas fixed effect and random effect models treat the heterogeneity of the firms over a period of time. In the fixed effect models individual companies are assigned a unique value of intercept which remains invariant over the selected time period. On the other hand, random effect models analyze the data on the bases of a common mean intercept value of the selected firms. The study also applied Hausman test which suggests the most appropriate model for explaining variables in the study. The following table shows that ownership concentration is negatively and significantly associated with the corporate governance index in all of the three models under study. This result confirms the first hypothesis H1 of the study and it is also consistent with the findings of (Burkart, Gromb, & Panunzi, 1997; Cheema, Bari, & Saddique, 2003; Kuznetsov & Muravyev, 2001). The second hypothesis H2 of the study describes that there exists a negative relationship between managerial ownership and corporate governance index in Pakistan. The coefficient of managerial ownership is negative in all of the models under study and it is also significant at 99% in fixed effect and random effect models. These findings are consistent with the findings of (Baek, Johnson, & Kim, 2009; Dixon, Guariglia, & Vijayakumaran, 2017; Rashid, 2016). The coefficient of institutional ownership is significantly positive with corporate governance index in all of the three models, which confirms the third hypothesis H3 of the study. The coefficient of the foreign ownership is insignificant in all the three models which reject the fourth hypothesis H4 of the study. Moreover, the value of the F-statistics for all the three models suggests that the ownership structure has a significant association with the corporate governance index. The control variables also show some significance with the dependent variable but they are not comparable.

Table 3: Results for corporate governance index regressed on ownership structure proxies and other control variables

Variables	Polled	Fixed Effect	Random Effect
Ownership Concentration	-0.210***	-0.341***	-0.283***
	(0.033)	(0.058)	(0.044)
Managerial Ownership	-0.210**	-0.312***	-0.289***
	(0.029)	(0.057)	(0.040)
Institutional Ownership	0.538***	0.499***	0.521***
	(0.057)	(0.065)	(0.058)
Foreign Ownership	-0.041	-0.019	-0.021
	(0.035)	(0.037)	(0.034)
Dividend Yield	-0.023*	-0.039	-0.026
	(0.041)	(0.044)	(0.039)
Leverage	-0.057*	-0.092**	-0.068**
	(0.034)	(0.047)	(0.039)
Firms Size	-0.011	-0.079**	-0.039***
	(0.010)	(0.038)	(0.016)
Firms Age	-0.005	-0.063	-0.029
	(0.013)	(0.059)	(0.023)
R-Square	0.249	0.571	0.214
F-Statistics	29.997	9.274	24.676
Prob (F-Statistics)	0.000	0.000	0.000

*Note: Statistical significance is denoted by ***, **, and * at 1, 5, and 10 percent respectively.*

The following Table 4 shows that the probability value of chi-square statistics is more than 5% (21.70%) at 8 degree of freedom so the results of the random effect model are more reliable to explain the relationship between corporate governance and ownership structure variables.

Table 4: Results of Hausman Specification Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	10.73752	8	0.217

Conclusion

This study analyses the various proxies of the ownership structure (such as ownership concentration, managerial ownership, institutional ownership and foreign ownership) influencing the corporate governance mechanism in listed 287 firm over a period of 7 years (2010-2016) from non-financial sector in Pakistan. The sample set revealed that the majority of the firms hold concentrated ownership either in the hands of managers or financial institutions, which reflects weak legal environment in Pakistan. The overall impact of the concentrated ownership is negatively correlated with the corporate governance index. It shows that the majority of the sampled firms do not take steps to strengthen the internal corporate governance practices. The corporate governance index is also negatively associated with the managerial ownership. This empirical result is according to the entrenchment theory which describes that an authoritative management not only violates best practices to increase its influence but also exploits the wealth of the minority shareholders. The study also concludes that the financial institutions play an effective role in propagating good corporate governance practices in Pakistan and their effective monitoring reduces the managerial influence.

Lastly, the study implies that foreign investors are not interested to invest in listed firms, as their shares holdings in the ownership structure is very low which is also statistically insignificant with the corporate governance index. The present study is useful for policymakers, regulators and investors who could determine the power of the share holders and their effect on the internal governance mechanism. Moreover, the current research opens up the avenues for further investigation in this area. The future research could include financial sector companies and other potential features of ownership (e.g. governmental ownership, individual ownership and family ownership).

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