

# Can Corporate Governance Reforms Increase Firms' Market Values?: Evidence from India



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# Overview



- Event Study of adoption of major package of governance reforms (Clause 49) in India. Reforms phased-in (larger firms comply earlier) providing a natural experiment with smaller firms as control group.
- Basic Results: Over 3-day event window, larger firms gain 4%-5% relative to smaller firms. Results hold up under series of robustness checks. Discuss: critical assumptions, limitations, and further work.
- Other Results & What might they tell us about corporate governance:
  - Faster Growing Firms (esp. mid sized ones) benefit more than others.
  - Cross-listed firms benefit more than others.
    - Suggests complementarity of Clause 49 governance reforms and disclosure standards for cross-listed firms. Why would this be?
  - Clause 49 is similar to SOX, but average response to Clause 49 is positive, in contrast to mixed (often negative) evidence on SOX.
    - Suggests similar reforms can have different effects in different institutional environments.

# Related Literature - Corp. Gov. in Emerging Markets

- Does corporate governance affect firm value?
- Core empirical problem: governance is endogenous to many of the factors that affect share price
- Cross-country studies
  - overall governance: LLSV; Durnev Kim (2005), others
  - boards of directors: Dahya Dimitriev McConnell (2007)
- Time series, firm fixed effects
  - Black, Love Rachinsky (2006) (Russia)
  - Black Kim Jang Park (2007) (Korea)
- A few natural experiments in emerging markets:
  - Brazil (Nenova, 2005)
  - Bulgaria (Atanasov Black Ciccotello Gyoshev, 2007)
  - Korea (Black Jang Kim 2006), Black Kim (2007)
  - SOX for cross-listed firms (Litvak, 2007).
- Why study India – decent control group and narrow event window.

# India Corp. Gov. Background (Khanna, 2007)

- Pre-1947: Reasonable CG , borrowed from UK
- 1947 – 91: Deterioration in CG –
  - Government became primary capital provider (debt and equity).
  - Secondary capital providers face serious obstacles (delays).
  - Market was not competitive.
- 1991 – 98: Economy opens up, smaller state role (liberalize).
  - Demand for external capital as competitive spaces open up, tech sector booms and outsourcing grows.
- 1998 – current: Reform Era
  - Confederation of Indian Industry (CII) devises Voluntary CG Code for larger firms
  - 1999 – CII lobbies for reform, SEBI forms Kumarmangalam Birla Committee (KMBC) to propose reforms
  - 2000 – SEBI enacts KMBC recommendations (Clause 49) with phased implementation

# Potential Event Dates

- Search newspapers & SEBI announcements:
  - May 7, 1999 – formation of KMBC, not confounded.
  - June 11, 1999 – news reports on possible KMBC proposals, but not surprising, confounded (Kargil conflict).
  - Sept. 30, 1999 – first draft of KMBC report released, but not surprising, confounded (Indian National Elections).
  - Oct. 14, 1999 – SEBI announce will adopt CG reforms soon, but confounded (Pakistan Coup – Musharraf).
  - Jan. 26, 2000 – KMBC final draft (basically same as first draft). Not much new.
  - Feb. 21, 2000 – SEBI officially adopts Clause 49. Not much new.
- May 7, 1999 – new information, not confounded
  - difference between small and large firms likely expected (market knowledge of CII's role).
- Unreported regressions on other dates – no consistent pattern, results mostly in line with confounding events.

# Sample Selection



- Given phased implementation of Clause 49 we need something to track the phased-in schedule.
  - BSE has groupings of firms that are similar to Clause 49's schedule – A, B1, and B2 firms.
  - Key assumption: At May 7, 1999, investors expected differential application to large vs. small firms
- Firms in our sample:
  - For all regressions – firms trading on at least May 6 & May 7.
  - For Market-Adjusted Returns and CARs – B2EW Index ( $\geq 30$  returns during year before May 7, 1999).
- Control variables
  - Ln(assets), business group, sales growth, foreign ownership, inside ownership, industry, govt control.
  - Data from Prowess supplemented by public sources.

# Methodology



- **Hypothesis** – Large (Group A) firms exhibit positive returns, compared to smaller firms, during event period around May 7, 1999.
  - Mid-sized (Group B1) firms have intermediate reactions.
- **Methodology**
  - Market adjusted returns (MARs) over different windows, regression approach.
  - Cross-sectional study of factors that predict MARs
  - Cumulative abnormal returns (CARs), classic event study approach

# Methodology II - Cross-Sectional Dependence

- Empirical problem: Event date is common to all firms → returns may be correlated for reasons other than the regulatory event we study.
  - Firms in similar industries may move together
  - Firms in A, B1 and B2 groups may move together.
- Our response
  - In regressions, we cluster on industry and group.
  - In event study setup, we form:
    - industry portfolios (within each group)
    - group portfolios (treat all A firms as one portfolio, B1 firms as another portfolio)
    - How much confidence do you have in industry portfolio results, versus group portfolio results

# Basic Results

- Which event window to use?
  - Unreported regressions – no evidence of leakage before May 7.
  - Look at different windows, from 1 to 5 trading days:  $(0)$ ;  $(0, +1)$ ;  $(0, +2)$ ;  $(0, +3)$ ;  $(0, +4)$
  - Focus on  $(0, +2)$  as window that gives investors time to respond to complex news (event date is Friday so there is a weekend during the window).
- Basic results: 4-5% rise of larger firms (Group "A" firms) relative to smaller firms.
  - mid-sized firms have intermediate reaction
  - small firms don't decline

# Basic Results II

	1	2	3	4	5
Dep. variable	Raw Returns over indicated window				
Window	day 0	(0, +1)	(0, +2)	(0, +3)	(0, +4)
groupA	0.005	<b>0.040***</b>	<b>0.046***</b>	<b>0.048***</b>	<b>0.072***</b>
	[0.54]	[4.50]	[4.69]	[4.47]	[5.34]
groupB1	-0.003	<b>0.022***</b>	<b>0.020***</b>	<b>0.022**</b>	<b>0.031***</b>
	[-0.35]	[2.88]	[2.16]	[2.39]	[2.87]
Constant (return to B2 firms)	0.010	0.009	<b>0.028***</b>	0.000	0.002
	[1.21]	[1.26]	[3.65]	[0.04]	[0.18]
Observations	952	837	791	765	747
R <sup>2</sup>	0.001	0.020	0.025	0.026	0.045

Same results for MARs, only constant term changes.

# Basic Results III – Effect of Outliers

	1	2	3	4	5	6
Dep. var: raw returns	all returns	winsorize 2/98%	winsorize 5/ 95%	Trim 2/98%	trim 6%/day	robust reg.
groupA	0.046***	0.046***	0.045***	0.045***	0.051***	0.054***
	[4.69]	[6.06]	[6.30]	[6.29]	[7.25]	[6.70]
groupB1	0.020***	0.018***	0.017***	0.017***	0.019***	0.021***
	[2.16]	[2.95]	[3.14]	[2.94]	[4.36]	[3.34]
Constant	0.028***	0.028***	0.027***	0.027***	0.017***	0.018***
	[3.65]	[6.56]	[7.63]	[7.77]	[5.66]	[3.63]
Observations	791	791	791	761	745	791
R <sup>2</sup>	0.025	0.038	0.044	0.045	0.064	0.049

# Other Results I – Cross-Section

Dep. variable	MAR (0,+2, winsorize at 5/95%)							
	1	2	3	4	5	6	7	
groupA	<b>0.045***</b>	<b>0.035***</b>	<b>0.040***</b>	<b>0.044***</b>	<b>0.044***</b>	<b>0.041***</b>	<b>0.045***</b>	
	[6.30]	[3.17]	[4.78]	[6.39]	[5.37]	[5.87]	[5.66]	
ln(assets)		0.002						
		[0.83]						
sales growth			<b>0.017**</b>					
			[1.96]					
business group				0.001				
				[0.11]				
inside ownership					0.002			
					[0.17]			
foreign ownership						0.020		
						[0.44]		
govt control dummy							-0.005	
							[0.40]	
group B1 dummy, constant							yes	12

# Other Results II – Interactions

- We ran interactions (Table 6 Panel B) for most of the independent variables and the primary results were:
  - Faster growing firms benefited more. Further, most of this benefit seems concentrated on the mid-size faster growing firms. Why?
  - Mid-size government controlled firms seem to react negatively. However, perhaps too small a sample to derive strong conclusions.
  - Cross-listed firms benefited more (see Table 7) – why?

# Other Results III – Cross-Listing

Dependent variable	MAR (0,+2, winsorize at 5/95%)		
	1	2	3
groupA	0.045***	0.045***	0.039***
	[6.30]	[6.85]	[4.97]
early adopter dummy (n = 8)		-0.014	
		[0.75]	
cross-list dummy (n = 34, 29 Europe, 5 US)			0.035**
			[2.57]
Constant, group B1 dummy	yes		

# Other Results IV - Event Study Approach

Dep. var.	CARs (0,+2)	Mean (z-stat)		
	No. of firms	firm	industry	group
Portfolios				
Group A	155	0.058 (16.32)***	0.055 (5.42)***	0.054 (2.04)**
Group B1	251	0.037 (9.34)***	0.026 (3.08)***	0.034 (1.66)

# Comparison of Clause 49 to SOX

## Clause 49 (listed companies)

- Board:
  - Independence (gen.majority)
  - Internal Control system
  - Disclosure & Code of Conduct
- Audit Committee:
  - Independence (2/3) & Financially Literate
  - Review audit & internal audit
- Disclosures:
  - Compensation
  - RPTs
  - Risk Management & Accounting Standards
  - Use of Proceeds
- Certifications:
  - CEO & CFO – Financials, Internal Control, Comply with Laws, Changes in Policy

## US – SOX & Other Laws

- Board:
  - Independence
  - Internal Control System
  - Disclosure & Code of Conduct
- Audit Committee:
  - Independence & Financially Literate
  - Review audit & Internal audit
- Disclosures:
  - Compensation
  - RPTs
  - Risk Management, etc... not required, but generally provided.
  - Use of Proceeds
- Certifications:
  - CEO & CFO – Financials, internal controls, etc...

# Comparison of Clause 49 to SOX (cont'd)

## Clause 49 (listed companies)

- Compliance:
  - Certificate on this.
  - Disclosure compliance or not with mandatory and non-mandatory req'ts.
- CG reports:
  - Quarterly
- Subsidiary:
  - Significant issues report to parent board.
  - Independent directors.
- Non-Mandatory:
  - Training
  - Whistleblower policy
  - Evaluate non-executive board
  - Limits on independence
- Penalties & Enforcement:
  - De-Listing

## US – SOX and Other Laws

- Compliance:
  - Similar, but no requirement to disclose if meet non-mandatory req'ts.
- CG Reports:
  - Not required though often provided.
- Subsidiary:
  - Generally required to report important issues as per state corporate law.
- Others:
  - Whistleblowers much more prevalent
  - Training not required, but often provide.
  - Performance evaluation
  - Greater discussion on compen. levels.
- Penalties & Enforcement:
  - Large criminal penalties (individuals & companies)
  - Large civil penalties (public & private).

# Clause 49 vs. SOX?

- SOX receiving mixed (and increasingly negative) responses in USA. “Going Dark” and listing in London? Large costs?
- However, Clause 49 and SOX share similarities, but different responses by market – what might explain this? Perhaps only some CG changes valuable (which ones?) and some CG changes positive in one environment and not in others (which ones again?). Also, genesis of changes different: Clause 49 (Industry), but SOX was scandal (Enron, etc...).

# Future (data permitting)

Wish we had, but don't:

- Better cross-sectional measures of governance
  - compare SOX studies, Karpoff Malatesta (1995)
- Unresolved question: *channels*
  - Signaling – why is the signal credible?
  - Restricting opportunistic behavior – how?