

# Corporate Governance Implications of Share Pledging by Promoters in India

P. Srikant

Finance and Control

IIM Calcutta

## **Extended Synopsis**

My thesis examines the phenomenon of share pledging by promoters in India. Promoters (owner-managers) of firms approach providers of capital for loans, against which they offer shares as collateral. In the event that the share price falls, promoters either need to provide additional collateral; or the lender can liquidate the collateral. Over 2% of India's market capitalization is pledged, and pledging therefore constitutes an important source of alternative finance. Pledging has also been a regulatory focus since the Satyam accounting fraud case.

In the first part of my thesis, I provide an overview of the institutional structure and mechanisms of the share pledging by combining two complementary approaches. First, I look at share pledging in the context of the relevant legal frameworks such as the Contracts Act and the Depositories

Act. Second, I interviewed market participants who shared details of transactions, termsheets and case histories to help me understand the structure and operational aspects of pledging in India and abroad. I combine these strands to build a understanding of share pledging, and its similarities and differences with other mechanisms like mortgages and securities borrowing and lending. In contrast to securities borrowing and lending, share pledging allows a promoter to continue to exercise voting rights. I argue that share pledging therefore represents a less-studied wedge between ownership and control. Such wedges also arise in contexts such as pyramids and dual class shares, and have been linked with corporate governance issues. I next provide several summary caselets on pledging, where pledging has led to various governance problems. For example, a promoter can use pledging to fraudulently reduce his exposure to an overvalued asset; leverage investments and transfer risks to borrowers; or provide finance to other group companies. When a lender liquidates pledged shares, it can result in volatility, persistent undervaluation, fragmentation of ownership and the threat of takeovers.

Anecdotally, promoters most commonly pledge shares to provide working capital loans to their own firms. To explain the promoters choice of pledging, I develop a pecking-order style model where a firm with risky assets in a place makes financing choices. The model is a variant of the classic Myers and Majluf model. The value of assets in place are common knowledge but follows a known risky process; while the investment return is private information. Pledging emerges as an optimal response when the underlying return is high, and the volatility is low. The model highlights the use of pledging as a tool for expropriation of minority investors in two ways. One, a promoter may

charge a spread on loans to the company. Two, in the event of a pledge liquidation, minority holders pay a larger proportion of the debt repayment. I present a simple decision experiment on pledging in order to illustrate the model, and as a teaching aid. For practitioners, I explain how a pledge can be valued as a portfolio of barrier options. A pledge can be considered a combination of a down-and-out call, and fewer down-and-in calls. I argue that like debt overhang, pledging overhang can create perverse incentives for promoters to misuse their control rights to the detriment of minority holders.

Finally, I explore the data on pledging to identify stylized patterns associated with pledging activity. I find that pledging is concentrated in private sector firms, and that firms that pledge have lower liquidity ratios. I examine quarterly data on shareholding to show that changes in pledging are positively correlated with changes in ownership. Finally, I use annual financials to test a ShyamSunder & Myers style empirical specification of the pecking order model to argue that pledging is correlated with financing deficits.