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The Role of Corporate Governance in Attracting Foreign Institutional Investors: A study of Pakistani Listed Companies

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ABSTRACT

This study examines the relationship between Corporate Governance and Foreign Institutional Investment. For this purpose, nine years' data from 2006-2014 is taken of forty five Pakistani companies listed on Karachi Stock Exchange (Now Pakistan Stock Exchange-PSX) having foreign investment, is studied. The effect of different Corporate Governance variables like non-executive directors, independent audit committee, board size, inside ownership, and CEO duality on the foreign institutional investment is studied. Firm size, market to book ratio, return on equity, liquidity, dividend yield, leverage and firm age were taken as control variables. To analyze the data, the study uses Panel data regression techniques. The findings showed that there is a negative impact of CEO duality, concentrated ownership, and dividend yield on foreign institutional investment, whereas, firm size, board size, age, and liquidity have a positive effect on foreign institutional investment. But all other variables, such as non-executive directors, independent audit committee, return on equity, market to book value, and leverage are found to have an insignificant effect.

Keywords: Corporate Governance, Foreign Institutional Investment, Karachi Stock Exchange, Panel Regression

INTRODUCTION

Institutional investors influence financial markets worldwide through their predominance as buyers, holders, and sellers of corporate securities. On one side due to the size of investments they hold and on the other side having a high level of professional competence, experience, exposure, and broader long-term vision, which the other investors may lack, they affect the way the companies do business as well as corporate structure. In the latter half of 20th century institutional investors have become significant in the equity market. As given example of United States, in 1950 the institutional investors were only 6.1% and this percentage raised to more than 50% by 2002 (Ahmed, Gust, Kamin, & Huntley, 2002).

Research works conducted in the past state that with good corporate governance mechanism, companies can adjust their risk as compared to the returns for the owners and that is the reason institutional investors prefer to invest in the companies that have good governance system (Asad & Farooq, 2009). The significance of corporate governance has been enhanced due to the agency problem being highlighted in the events namely failures in the corporate world, for example, Italy's Parmalat, United Kingdom's Maxwell and United States' Enron and WorldCom (García-Meca, García-Sánchez, & Martínez-Ferrero, 2015; Ducassy & Guyot, 2017).

Saleh, Zahirdin, and Octaviani (2017) emphasized that the need of corporate governance is to solve the problems of shareholders who are true owners of the company and the managers of the company who runs the company on behalf of true owners and in their best interest. In Asia financial crisis of the late nineties proved that there is a need for an effective mechanism of corporate governance structure in Asia (Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000). The code of corporate governance suggests that developing as well as developed countries of the world should focus on the importance of mechanism of corporate governance. (Hambrick, Misangyi, & Park, 2015; Desender, Aguilera, Lópezpuertas-Lamy, & Crespi, 2016). This governance on top managers results in protection of the interest of minority shareholders. (Shleifer & Vishny, 1997).

The importance of Corporate Governance with reference to Pakistan is pertinent because the corporate structure of the country basically dictated by the family-owned businesses (Hassan & Marimuthu, 2015). Corporations face narrow access to capital gains as investors do not invest in the companies owned by families. Agency problem is more in the family-owned corporations as in these corporations the managing heads consider the benefits of their own (Bosse & Phillips, 2016). The protection of shareholders, creditors, and other stakeholders by a good system are basic to accept models of corporate finance in different countries (Ntim, 2018). After the financial globalization, the issues regarding ownership structure and good governance gets more importance due to increased access to financial markets around the world the investors on one side has the opportunity to diversify their portfolios and on the other side the corporations have the chance to raise funds globally (Almansour, Asad, & Shahzad, 2016). Additionally, increasing controlling inflation and corruption etc. so, for a country like Pakistan, this issue gets more important to prove its governance structure not only at country level but also at the corporate level and develop a satisfactory environment for foreign investment (Dunne, 2015). This issue is also increased due to distance so the monitoring costs will be higher for foreign investors. These policies would increase the confidence of foreign investors in the local market

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(Bashir, & Asad, 2018). Hence, there is a reason to believe the positive association between the structures of corporate governance and foreign investor share ownership. The results of this study would benefit the scholars, industry and corporate sector in Pakistan because it would offer them an insight into the effectiveness and efficiency of corporate governance in attracting foreign investment and benefit the investors as well to make efficient investment decisions. This study will also be very beneficial for the researchers and helps out the corporate policy makers and others decision making bodies.

LITERATURE REVIEW

Foreign investment in various parts of the world is significantly grown with the support of phenomenon of independent corporate boards. This can decrease the monitoring cost to the external stockholders (Lien & Filatotchev, 2015). Relationship of corporate governance with the foreign portfolio was studied many times with different variables by many researchers in different time periods. The literature on this topic includes a wide variety of studies that explore these relationships in different countries, time periods by using different econometrics methodologies and multivariate frameworks (Joyeux, Ripple, & Li, 2017). Most studies have been conducted in the developed countries and a very less work has been done in this field in developing countries in general (Kourula, Pisani, & Kolk, 2017). So a gap still exists till now as a very few references are from developing countries, predominantly from China, which has become a leading emerging economy of the globe. According to Doidge, Karolyi, and Stulz (2007), the importance of independent directors is more important in poor investor protection countries as compared to high investor protection countries (García-Meca, García-Sánchez, & Martínez-Ferrero, 2015). The BOD have to certify the financial statements' quality. Therefore, on balance, there is a reason to expect a positive relationship between Non-executive directors and foreign institutional investment (Pucheta-Martínez & García-Meca, 2014). Hence:

H-1b: There is a positive relationship between a number of non-executive directors on the board and foreign institutional investors

Armstrong, Guay, Mehran, and Weber (2015) showed that transparency is increased by an independence of an audit committee. The audit committee has been an important area of research in relation to corporate governance mechanism. Previously, many studies have been focused on the independence of an audit committee's member. The financial expertise and actions of members of an audit committee have also get importance (G.Badolatoa, Donelson, & Ege, 2014). Freshly, the research about the independence of an auditor has been focused on the amount of "non-audit" services that have been provided by an external auditor. Nonaudit service has been perceived as difficult to the independence of auditor (Tepalagul & Lin, 2015). There have been found a positive relationship among foreign share ownership & independent audit (Waweru, 2014).

H-2b: There is a positive relationship between a number of non-executive directors in the audit committee and foreign institutional investors

The value of corporate governance is also affected by the size of the board of directors. The board size shows a material effect on the mechanism of corporate governance (Abdullah, Ismail, & Nachum, 2015). Thus, many researchers have conducted studies that support this idea that the large size of the board cannot be properly functional. However, there are ultimately shortcomings of the large boards in the shape of management costs issues (Jensen & Meckling, 1976). When the size of the board is larger it leads to larger information as collective possessed by all the directors, hence it leads to improvement in performance. Hence:

H-3b: There is a positive relationship between board size and foreign institutional investors

CEO duality refers to the situation when the CEO also holds the position of the chairman of the board (Usman, Akhter, & Akhtar, 2015). The main issue that arises when corporations are run-through CEO duality is that who is monitoring the management. Guidone and Mantovani, (2017) have argued that firm's managers can have an impact on the performance of a sitting board. They have the ability to control the information and thus create a problem in the efficiency of working on the board. Heyden, Kavadis, and Neuman, (2017) proposed that CEO duality is one of the important issues in the perspective of the corporate governance structure. On the basis of above discussion, it can be expected a strong relationship between CEO duality and Foreign Institutional Investment.

H-4b: There is a negative relationship between the CEO duality and Foreign Institutional Investors.

Concentrated ownership refers to the amount of stock owned by individual investors (Acero, Serrano, & Dimitropoulos, 2017). In presence of ownership concentration, the majority shareholders got involved them forcefully in the management. This is because of the absence of outsider managerial discipline (Zhang, 2014). According to Agency theory, the majority shareholders or corporate managers worked for their benefit instead of protecting the interest of minority shareholders (Sun, Hu, & Hillman, 2016). Thus, they feared to face the risk of expropriation being attempted by majority shareholders or corporate managers. So, there is a reason to expect a significant relationship between concentrated ownership and foreign portfolio, individual as well as institutional investors. Hence:

H-5b: There is a negative relationship between the concentrated ownership and foreign institutional investors

Desender, Aguilera, Lópezpuertas-Lamy, & Crespi, (2016) proposed that some of the institutional investors have more ability or power to monitor the others or they actively monitor the activities in relation to the corporate governance system of a company. On contrary institutional investors do not take interest in the corporate governance system of a company because they have their own main responsibility for their own investments and benefits which may result in a conflict of interest with the owners (Samra, 2016). The main problem arises from the difference in the interest of the manager and the shareholders. In the past CEO and CFO didn't know the majority shareholders so they don't care about them. Some studies also suggested that the institutional investors have not an important role in corporate governance (Pevzner, Xie, & Xin, 2015). There are a number of other variables which in this study are being categorized as control variables. For example, the association among company size and foreign share ownership have been found. Along with this there have been found a negative association between foreign share ownership and gearing ratio (Dixon, Guariglia, & Vijayakumaran, 2015). It was found that there exists a positive association between foreign share ownership and liquidity ratios (Mathuva, 2010). This study adds a new thing to the literature especially in Pakistan by examining the relationship between board structure and shareholders base. Up to some extent this issue had already been proved empirically.

THEORETICAL FRAMEWORK

From literature discussed in the previous chapter, it is revealed that effective Corporate Governance Structure has a great impact on Foreign Portfolio Investment. The major determinants of Corporate Governance are the No. of Non-executive directors, Independent Audit Committee, Board size, CEO Duality and Ownership Concentration.

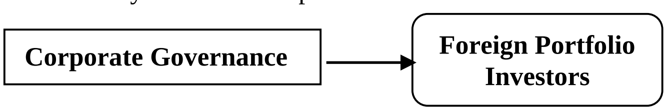

Figure 1: Conceptual Framework

METHODOLOGY

In the current study, the unit of analysis is an organization, i.e. all publically traded firms listed on Karachi stock exchange. Population for this study is all those companies listed on the Karachi stock exchange and having foreign investment. The period of study will be nine years i.e. from 2006 to 2014. The sample size is only those listed companies in which the foreign investors have investment since at least the last two years. For the purpose of the study the secondary data was collected, from the annual reports of listed companies on Karachi Stock Exchange (KSE) having foreign investment, from the official website of State Bank of Pakistan (SBP) and World Development Indicators.This effort resulted in the gathering of 310 Observations from 45 different companies belongs to the financial and non-financial sectors. The industry-wise breakup was given in the following

Table 1: *Industry Descriptive*

Industry	Companiesselected
Textile	3
Food Products	3
Cement	5
Chemicals	3
Pharmaceutical	2
Oil & Gas	3
Fertilizer	3
Automobile	2
Energy	2
Engineering	2
Others (Communication + Glass + Shoes)	3
The financial sector (Banks + Insurance companies)	14
Total	45

Table 2: *Measurement of Variables*

Abr.	Variables	Measures
	Foreign Individual Ownership	$\frac{\text{Foreign Individual}}{\text{No. of shares}}$ x 100
NEX	Foreign Institutional Ownership	$\frac{\text{Foreign Institutions}}{\text{No. of shares}}$ x 100
INS	Total Foreign Portfolio Ownership	Foreign individual investors + Foreign institutional investors
MBR	Non-Executive Directors	$\frac{\text{Nonexecutive}}{\text{Total directors}}$
BS	Board Size	No. of Directors
CEOD	CEO Duality	If CEO is chairman it takes value 1 else 0
IND	Inside Ownership	$\frac{\text{Top 10 shareholders}}{\text{No. of shares}}$
FS	Firm Size	Total market capitalization
ROE	Return on Equity	$\frac{\text{Profit after tax}}{\text{Owner's equity}}$
AGE	Firm Age	No. of Years since incorporation
CACL	Liquidity	$\frac{\text{Current assets}}{\text{Current liabilities}}$
	Market to Book Ratio	$\frac{\text{The market value of equity}}{\text{The book value of equity}}$
DY	Dividend Yield	$\frac{\text{Dividend per share}}{\text{Market value per share}}$
LEV	Leverage	$\frac{\text{Long-term debt}}{\text{Owner's equity+Long term loans}}$

Model of the study

$$Foreign\ Institutional\ investment = a_1 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \beta_9 X_9 + \beta_{10} X_{10} + \beta_{11} X_{11} + \beta_{12} X_{12} + e$$

The data of the study was run under various tests in E-views and SPSS and, firstly the assumptions were tested. Log of Non-executive directors, Market Size, Market to Book ratio, Current assets to current liabilities, Foreign institutional investment was taken whereas Square root of Return on equity and Dividend yield was taken. The results are as follow

Table 3: *Descriptive Statistics*

Variable	Mean	Med.	Max	Min.	St. dev.
AGE	0.5	0.5	1	0	0.50
BS	9	9	11	7	1.11
CACL	0.11	0.10	0.97	-0.65	0.25
CEOD	0.04	0	1	0	0.21
DY	1.69	1.65	2.49	1	0.35
FS	9.88	9.94	11.70	8.0	0.73
IND	0.93	1	1	0	0.25
INS	64.02	64	94.33	31.75	15.07
LEV	41.48	42	73	9	13.89
MBR	1.96	1.07	41.40	1.26	3.63
NEX	0.77	0.80	0.94	0.37	0.13
ROE	3.79	3.71	7.61	0.52	1.48

Descriptive statistics clarify different things like averages, deviations, maximum, and minimum values of different variables. For example, as shown in table 3 average board size is 9 directors along with deviation from the average upward or downward of 11.2% whereas, maximum and minimum directors are 11 and .7 respectively.

In the same way inside ownership average is 64 %, the standard deviation is 150%, and the maximum is 94.33% and minimum 31.75%. Independent audit committee and CEO Duality were treated as dummy variables

Hausman Test

To choose the best appropriate model there are a few ways. To choose from Fixed Effects Model and Random Effects Models Hausman Test was applied and the results are as follows

Table 4: *Correlated Random Effects - Hausman Test*

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	P.
Cross-section random	9.073971	12	0.67

The Probability value of the test is 0.6966 which is higher than 0.05 so the results show that the Random Effects Model is more appropriate for the data set of the study than the Fixed Effects Model.

Table 5: *Random Effect Model*

Variable	Coefficient	Std. Error	T-stat	Prob.
C	-4.02	1.32	-3.04	0.00
NEX	0.37	0.66	0.56	0.58
IND	0.13	0.33	0.39	0.70
BS	0.12	0.04	2.84	0.00
CEOD	-1.72	0.60	-2.85	0.00
INS	-3.87	1.28	-3.01	0.00
FS	0.30	0.12	2.47	0.01
MBR	-0.38	0.24	-1.57	0.12
ROE	0.02	0.05	0.58	0.57
CACL	0.78	0.25	3.11	0.00
DY	-0.14	0.15	-0.94	0.35
AGE	0.58	0.16	3.51	0.00
LEV	0.00	0.00	0.71	0.48
R^2	0.19			
R^2 Adjusted	0.14			
F-Statistic	4.31			
Probability	0.00			

DISCUSSION

Application of panel data analysis showed that non-executive directors and the independent audit committee have an insignificant impact on foreign institutional investors with their coefficients were 0.369 and 0.128 respectively. The board size, however, carries a positive impact on the dependent variable with every one-unit increase in board size, foreign institutional investment increases by 0.12. So as board size increases foreign institutional investment also increases. CEO duality showed a negative relationship with foreign institutional investors with a coefficient of 1.716, which means that with one-unit variation in CEO duality causes 1.716 negative variations in foreign institutional investment. Ownership, statistics showed a negative relationship with foreign institutional investors with coefficient 3.87, which means that with a one-unit increase in inside ownership foreign institutional investment decreases by 3.87. The results show that CEO duality, foreign institutional investment, inside ownership, foreign institutional investment have a significant relationship.

Among control variables firm size, current assets to current liabilities, and firm age have a significant relationship with foreign institutional investment, whereas market to book ratio, leverage, return on equity, and dividend yield shows an insignificant relationship with Foreign Institutional Investment.

CONCLUSIONS

The current study provides evidence for literature from developing economies particularly from Pakistan regarding Corporate Governance and its impact on foreign portfolio investment and further strengthens the concept and theory. This study identifies and empirically proves that Corporate Governance enhances firm performance and plays an important role in attracting the foreign investment in emerging economies as well.

The results empirically support the theoretical concepts on the relationships between Corporate Governance and foreign portfolio investment and show how different variables of Corporate Governance affect the performance of the firms. It is recommended that the benefits of a larger board of directors' are larger collective information that the board of directors possesses and therefore larger but effective and efficient boards of directors will lead to the higher performance of the firm. The current study focused on twelve largest sectors i.e. textile, food, cement, chemical, pharmaceutical, oil & gas, fertilizer, automobile, energy, engineering, financial and others (Communication + Glass + Shoes) but the representation from these sectors is very small i.e. only three companies from each sector are taken.

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