Cor orate Governance Im lications of Share Pled in by Promoters in India

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Extended Synopi

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 complnifgk(co(t)-hrcie1ing)-

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