Corporate Governance and Firm Value – An Empirical Study of Financial Services Firms in India

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Abstract

Empirical evidence on the association between firm value and corporate governance has mixed results depending on the chosen attributes for governance and firm value. The study investigated this relationship for financial services firms in India. Based on the literature review, four attributes of corporate governance were chosen: ownership concentration, institutional ownership, board independence, and CEO duality. Tobin's *Q* value was taken as a proxy for firm value. The dataset consisted of 20 companies forming part of the National Stock Exchange financial services index. An additional two control variables are included in the model: the firm's size and leverage ratio. All data were sourced from the annual reports of the companies, and the period of study is from 2016 – 2020. The panel data were analyzed using the generalized method of moments. The empirical findings revealed a positive and significant impact of ownership concentration, institutional ownership, and board independence on firm value, while the CEO duality role had no impact on firm value. The study contributed to the corporate governance literature of financial services firms in India.

Keywords : **Corporate governance, corporate valuation, financial services, generalized method of moments**

JEL Classification Codes : G20, G30, G32

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In the global context, Enron's collapse first galvanized support among regulators for an effective corporate governance mechanism. The enactment of the Sarbanes Oxley Act of 2002 in the USA was one of the first legislations worldwide aimed at curbing some of the most blatant abuses resulting from corporate misgovernance (Gupta et al., 2009). This was followed by Canada, the UK, and other countries bringing out their legislation. In India, the reforms of 1991 – 92 set the pace for greater participation of private firms in the growth process, and a need was felt for defined corporate governance standards. However, the issue of corporate governance was first addressed by the Confederation of Indian Industries in 1998 with its concept of a "Desirable corporate governance code." It mooted the role of independent directors in limited companies and their compensation fixation. This was followed by the setting up of various committees over the years by the Securities and Exchange Board of India (SEBI) and the Ministry of Finance, prominent ones including the KM Birla Committee in 2000, the Naresh Chandra Committee in 2002, and the Narayan Murthy Committee in 2003. All these deliberated on various aspects of corporate governance, including board composition, the role of independent directors, auditor–company relationship, audit company responsibilities, audit reports, risk

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management, codes of conduct, and financial disclosures. Most of their recommendations were included in "Clause 49" of the stock exchange listing requirements issued by SEBI. However, with the Companies Act 2013, "Clause 49" was further amended to include additional aspects like performance evaluation of the board, the appointment of women directors on the board, and functions of the auditor company. Thus, in the Indian context, the Ministry of Finance and SEBI have played a pivotal role in all initiatives for better corporate governance. Currently, SEBI's listing obligations and disclosure requirements (LODR) are the rulebooks for the corporate governance of listed companies in India.

In India, the corporate governance mechanism differs from that of the US and the other developed countries in the west. This could be on account of the structural differences in the economies and the stage of maturity of firms. While for developed countries, disciplining the management is the critical issue in corporate governance, in India, it is more to do with protecting minority shareholders' interests (Suresh Kumar & Lakshmana Rao, 2021).

What attributes constitute the corporate governance mechanism, how can these attributes be quantified to give a composite corporate governance score/index, and do firms with better corporate governance scores perform better as compared to firms with low scores have been some of the areas of research in corporate governance. Most common are studies examining the linkages between corporate governance and firm value or firm performance. The consensus is that better corporate governance is associated with better firm performance (Gillies & Dickinson, 1999; Venkatraman & Selvam, 2014). Besides impacting firm performance and value, good corporate governance can also have other benefits, including access to capital and reducing a firm's vulnerability to the financial crisis (Javed et al., 2006; Zhu, 2014).

Literature Review

Existing literature on the relationship between corporate governance and firm performance/value can be categorized into four groups. These studies have examined the association between corporate governance scores/attributes vis a vis (a) excess return generated by the firms; or/and (b) firm performance measured by attributes like return on assets (ROA), return on equity (ROE), earnings per share (EPS), or market value (MV) to book value (BV) of shares; or/and (c) market capitalization of firms; or/and (d) firm value.

In the existing literature, the measure of corporate governance is either through corporate governance scores published by information intermediaries or through the selection of one or multiple attributes representing corporate governance. The scores serve as indicators to distinguish good governance firms from ones with bad governance (Mishra & Mohanty, 2014). A few of the prominent studies which have used corporate governance scores include Aggarwal et al. (2007); Brown and Caylor (2006) ; and Gompers et al. (2003). The majority of the studies in the area have taken one or multiple attributes to represent corporate governance. In the Indian context, Saibaba and Ansari (2012) used two attributes, namely board independence and CEO duality; Arora and Sharma (2016) used board size and CEO duality; Jackling and Johl (2009) used board size and CEO duality ; and Mohapatra (2016) used board size. For firm performance, ROA and ROE have been the most widely used variables, but a few studies have examined the relationship between corporate governance and selected efficiency and value-creating indicators. Goel et al. (2015) used efficiency of working capital management, Noronha and Mehta (2012) used investment decisions, Kumari and Pattanayak (2015) used earnings management, while Rajpurohit and Rijwani (2020) used financial reporting practices. All these studies concluded with the positive impact of corporate governance practices. The majority of the studies before the year 2010 examined the relationship between corporate governance and firm performance (Adjaoud et al., 2007; Becht et al., 2002; Denis & McConnell, 2003; Hermalin & Weisbach, 1991; Holderness & Sheehan, 1988; Mitton, 2000; Shleifer & Vishny, 1997).

With value maximization becoming an important performance metric for all stakeholders of a firm, studies lately have been increasingly focusing on the relationship between corporate governance and firm value (Ammann et al., 2010; De Oliveira et al., 2012; John et al., 2016; Kumar & Zattoni, 2015; Souther, 2021). The use of Tobin's *Q* as a measure of firm value has been common among researchers (Abdelzaher & Abdelzaher, 2019; Bhagat & Black, 1998; Gompers et al., 2003; Koerniadi et al., 2014). Both cross-country as well as country-specific studies examining the relationship between corporate governance and firm value can be found in the literature. However, at best, sector-specific studies are limited, especially in the Indian context. Kumar and Prusty (2017) investigated this relationship for firms in the IT sector in India, while a recent study by Sandhya and Parashar (2020) focused on selected banks in India. To the best of our knowledge, no studies examine the relationship between corporate governance and firm value for firms in financial services, including both banks and non-banking financial institutions. The study attempts to fill this gap.

Data and Methodology

The objective of the study is to analyze the impact of corporate governance on firm value for Indian firms in the financial services sector. The period of study is from 2016 up to 2020.

The composition of the financial services sector has undergone a significant change over the last couple of decades. In a sector where historically, banks were the predominant players, the financial services space now has important contributions from non-banking finance companies and other specialized companies engaged in insurance, asset management, and housing. The "Nifty Financial Services Index" is the most prominent index tracking the movement of this sector. The Nifty Financial Services Index is designed to reflect the behavior and performance of the Indian financial market, which includes banks, financial institutions, housing, finance, insurance companies, and other financial services companies (www.1.nseindia.com/content/indices/ind_Nifty _Financial_ Services.pdf). This index comprises of 20 stocks that are listed on NSE. These stocks have been taken as the sample for the study.

The study uses Tobin's *Q* as a proxy for firm value. This value is estimated as :

$$Tobin's\ Q_{it} = \frac{(MVE_{it} + BVL_{it})}{TVA_{it}}$$

Where, "*i*" and "*t*" denote the sample firm and year, respectively. MVE_{it} represents the market value of equity for each of the firms and is estimated as a multiple of the closing price of the firm's stock price as of 31st March and the number of outstanding shares on that date. BVL_{it} and TA_{it} represent the book value of liabilities and the book value of the total assets of the firm. These values are estimated for each firm for each of the years from 2016 – 2020.

Researchers have lately shifted from examining the association between corporate governance and firm performance to firm value. Common metrics used for the measurement of firm performance have been ROA, ROE, and EPS. Since these are estimated based on historical data, they are backward-looking. Another weakness of using firm performance was it being prone to accounting variations and under or misreporting. As compared to firm performance, Tobin's *Q* measures firm value based on the perception of equity investors. Thus, it is forward-looking since its value is a function of the future expected cash flows by equity investors.

Based on the literature review, four variables are taken to represent corporate governance. These include ownership concentration *(OWNCON)*, institutional ownership *(INOWN)*, CEO duality *(CEOD)*, and board independence *(BOIN)*. Ownership structure decides who makes decisions in the firm and hence is a key variable in corporate governance (Kumar & Zattoni, 2015). The study uses the Herfindahl – Hirschman Index to measure the

extent of ownership concentration. This is a widely used and accepted measure of concentration worldwide. From 2021 onwards, this index is now being used by the "Competition Commission of India" as an index to track market concentration. Typically measured as $\Sigma^{i=n}_{i=1} S^2_i$, where n is the number of shareholders with over 5% of the total holding and S_i is the percentage of shares held by the i^{th} shareholder. This approach is akin to one adopted by Navissi and Naiker (2006). The value of this index can range from 0%, signifying perfect competition to 100%, signifying total concentration or monopoly.

The second variable is institutional ownership (INOWN). It was Means (1991), followed by Jensen and Meckling (1976), who were among the first to advocate a positive relationship between firm value and institutional ownership. Over the years, their finding has been supported by studies by McConnell and Servaes (1990) and Shleifer and Vishny (1986). For a firm, institutional ownership is measured as the percentage of the total number of shares held by institutional investors. The third variable is CEO duality (CEOD). The agency theory advocates for a separation of the role of the CEO from the Chairman of the board to reduce potential conflicts of interest. This has been supported by studies by Donaldson and Davis (1994) and Strier (2005). A dummy variable of 1 is taken where there is a commonality in the role of CEO and Chairman of one individual, else 0 is taken. The last variable taken to represent corporate governance is board independence (BOIN). The role of board composition in value creation has been a subject of research for many scholars (Minton et al., 2012; Stiles & Taylor, 1996). For each of the firms in the sample, it is taken as the ratio of independent directors to the total number of directors on the board.

Two control variables have additionally been taken, namely leverage ratio and size of the firm. The impact of size on firm value has been proven in many prior studies ; hence, the natural log of the book value of assets is included in the model to control for size (Craswell et al., 1997). A significantly large leverage ratio can have an impact on investors' perception and firm value. Hence this ratio is also taken (Table 1).

It is possible to employ the ordinary least squares (OLS) and the fixed effects (FE) model on the panel data available. But two problems can be seen here. One is the problem of endogeneity in estimating the panel regression equation due to the possible existence of a simultaneous relationship between the value of the firm and the variables of corporate governance. Secondly, the finite sample size is a limitation, and OLS and fixed effects regression may provide unreliable estimates (Baltagi, 2007). Thus, the study uses the one-step generalized method of moment (GMM) as proposed by Arellano and Bond (1991). The model is also suitable for estimating dynamic panel data models where the sample size exceeds the time of the study.

The following equation is estimated :

$$VALUE = \beta_0 + \beta_1\ OWNCON + \beta_2 INOWN + \beta_3 CEOD + \beta_4 BOIN + \beta_5\ SIZE + \beta_6 LEV + e_t \qquad (1)$$

where, e_t = error term.

Table 1. ***Variables in the Study***

Variables	Description
Tobin's Q	Proxy for firm value
OWNCON	Ownership concentration
INOWN	Institutional ownership
CEOD	Chief executive officer duality
BOIN	Board independence
SIZE	Size of the firm
LEV	Leverage ratio of the firm

Eq. (1) is estimated considering two or more lags of the independent variables as instruments for the regression in the first differences. This is done to get rid of firm-specific effects, which may affect the estimated values. Additionally, two specification tests are done as proposed by Arellano and Bond (1991). Sargan test checks for the overall validity of the instruments, and the error terms are tested for no serial correlation. All data is sourced from the audited balance sheet of individual firms. The above discussion leads to the formulation of the following four hypotheses of the study. For Indian firms in the financial services sector :

- **H01 :** There is no relationship between firm value and ownership concentration.
- **Ha1 :** There exists a relationship between firm value and ownership concentration.
- **H02 :** There is no relationship between firm value and institutional ownership.
- **Ha2 :** There exists a relationship between firm value and institutional ownership.
- **H03 :** There is no relationship between firm value and CEO duality.
- **Ha3 :** There exists a relationship between firm value and CEO duality.
- **H04 :** There is no relationship between firm value and board independence.
- **Ha4 :** There exists a relationship between firm value and board independence.

Empirical Analysis, Results, and Discussion

Table 2 captures the descriptive statistics of the selected variables for the period from 2016 – 2020. A Tobin *Q*'s value greater than 1 implies that the market value of assets is more than the book value of its assets. However, with the mean value close to 1, it indicates that the overall equity of the financial services firms is priced fairly by the market.

The results indicate a relatively high level of ownership concentration for financial services firms in India, where concentrated ownership has been the practice. The equity participation of the government and large financial institutions is significantly higher in these firms due to the requirement of a large capital base. This result is further supported by a high average institutional ownership of 41.06%. The minimum and maximum percentage of institutional ownership are 12.19% and 89.11% for Bajaj Finserv and Housing and Development Finance Ltd, respectively.

Table 2. ***Descriptive Statistics***

Variable	Mean	Median	Minimum	Maximum	Standard Deviation
Tobin's Q	1.14	1.13	0.75	2.25	0.34
OWNCON	57.15	57.49	40.25	77.98	9.67
INOWN	41.06	36.01	12.19	89.11	19.84
CEOD	0.28	0	0	1	0.39
BOIN	48.19	54.55	0	66.67	17.36
SIZE	12.01	11.78	9.65	15.25	1.39
LEV	0.82	0.86	.002	0.99	0.21

A mean of 0.28 for CEO duality indicates that approximately one-third of the sample firms have one individual occupying both the positions of the CEO and the Chairman of the board. This is against 53% of the top 500 companies based on the market cap, where the roles are separated as of the end of Dec 2020 (SEBI Chairman, April 06, 2021, 14th CII Corporate Governance Summit). The objective of role separation is to improve corporate governance. This role separation has also been advocated by the OECD, and most countries, including the U.K, Australia, Germany, and the Netherlands, have been in favor of this. In India, with effect from April 1, 2022, the top 500 listed companies based on market capitalization are required by regulation to separate the roles of Chairman and MD/CEO.

A mean board independence of 48.19 indicates that, on average, half the board members represent independent directors. Although the ratio is satisfactory, the "independence of independent directors" has always been a matter of debate in corporate governance. However, with the recent guidelines by SEBI in the context of the appointment and role of independent directors, this issue may be addressed to some extent. There is a wide variation in the size of firms as captured by the natural log of the book value of assets. Financial firms are highly leveraged, and this is reflected in the average leverage ratio of 0.82. The result of Eq. (1) GMM is reported in Table 3.

Amongst the variables, both institutional ownership and ownership concentration have a significant impact on firm value. It implies that financial firms with a large concentration of shareholdings and institutional ownership tend to have a higher value. This aspect has been a subject of research in many studies. Most of these studies have similar results as compared to the present study (Holderness & Sheehan, 1988; Navissi & Naiker, 2006; Shleifer & Vishny, 1986). The most probable explanation of this positive relationship is based on the hypothesis of "convergence of interest." Large shareholders and financial institutions are generally well informed with active involvement in the firm's operations. With their large shareholding, they often occupy key positions on the board. This makes insider monitoring more effective and facilitates optimal decision-making by the firm.

On the other hand, CEO duality has a negative and insignificant impact on firm value. The study on the relationship between CEO duality and firm value has mixed results across different countries/regions. The

Table 3. ***Results of Dynamic Panel - Data Estimation, One-Step System GMM***

Variable	Value	Status of Hypotheses
Intercept	1.132*** (0.00271)	
$Q_{(t-1)}$	0.377*** (0.0294)	
OWNCON	0.761***(0.00152)	H01 rejected/ Ha1 accepted
INOWN	0.376*** (0.01014)	H02 rejected/ Ha2 accepted
CEOD	–0.043 (0.1505)	H03 accepted
BOIN	0.175** (0.0213)	H04 rejected/ Ha4 accepted
SIZE	0.424*** (0.0012)	
LEV	–4.031*** (0.00175)	
Sargan test	37.314 (0.0363)	
Hansen test (*p* - value)	0.2763	
AR (1) test	–2.6912 (0.0014)	
AR (2) test	–1.3723 (0.1917)	
Observations	100	

Note. The figures in parentheses are the estimated *p* - values. The asterisks *** and ** denote significance at 1% and 5% significance levels, respectively.

majority of the studies in the recent past indicate a positive or negative relationship between CEO duality and firm value (Kolias et al., 2019; Liu, 2019; Uppal, 2020; Yang & Zhao, 2014). Studies showing no relationship are few, including the recent study by Dávila-Velásquez and Lagos-Cortés (2020) for listed firms in Mexico. The differing results are on account of studies in different regions and the choice of the sample or sector taken for the study.

Interestingly, Elsayed (2007) found that the impact of CEO duality on firm performance varies across industries. In the Indian context, most recent studies have found the relationship between CEO duality and firm performance to be insignificant (Arora & Sharma, 2016; Jackling & Johl, 2009; Saibaba & Ansari, 2012). Thus, in the Indian context, the result that CEO duality has an insignificant impact on firm value is consistent with most recent studies.

The study's results also indicate that board independence plays a significant role in enhancing the market value of a firm. According to recent research by Thenmozhi and Sasidharan (2020), which covered 53 State Owned Enterprises (SOEs) listed on the NSE and 110 listed firms on Shanghai Stock Exchange, China, covering the period from 2010 to 2017 finds that the board independence adds value to the SOE's. This is consistent with prior studies, including Gondrige et al. (2012), Mohapatra (2016), and Souther (2021).

Amongst the control variables, the size of the firm has a positive and significant relationship with firm value. This means large financial firms have a higher value (Nursetya & Nur Hidayati, 2021). Large financial firms are seen to be less prone to failure, and being of systemic importance, they are considered "too big to fail" and are often rescued when in financial distress. Thus, large financial firms are seen as less likely to fail; hence, the investor perception of these firms is positive, leading to higher valuations.

The seminal work of Miller and Modigliani proposed that the value of a firm is independent of capital structure in the absence of taxes (Glickman, 1996). However, in the real world and with taxes, firms exploit the tax shield advantage and enhance the firm's value. However, leverage beyond a threshold point increases the risk perception of the investors and is viewed negatively, thus impacting firm value. Financial firms, by the nature of their business and revenue model, are highly leveraged. The study's results reveal that leverage has a negative and significant impact on firm value. This is in line with the findings of a recent study covering all listed firms in India. The study by Kumar and Prusty (2017), covering the period from 2013 – 19, found a significant and negative association between financial leverage and the market value added of listed firms in India.

In the corporate world, value maximization is the end objective of all decisions taken by firms. The study shows that corporate governance practices of financial services firms in India impact their value. The finding that higher levels of "ownership concentration" positively influence firm value has implications for both firm management and retail equity investors. Higher equity participation of financial institutions in these firms should be welcomed and seen as a value creator. Besides, these firms can explore ways to increase the "independent directors" ratio on the board for additional value creation. Although, from 2020 onwards, the top 500 listed companies have to ensure CEO non-duality, the findings of the study indicate that this is unlikely to create additional value for these firms.

Conclusion and Implications

The study based on financial services firms in India attempts to analyze the relationship between firm value and corporate governance. The empirical findings suggest high ownership concentration and institutional ownership in financial services firms. Both these variables are found to have a positive and significant impact on the value of a firm. This reaffirms the "convergence of interest" hypothesis and combined with higher insider monitoring by large shareholders, or financial institutions, enables enhanced performance and value creation for firms. Thus, the existence of large shareholdings by promoters and institutions can also be a value creator for the small/retail investor. Although roughly one-third of the firms have an individual occupying both the positions of the CEO and

the Chairman of the board, this has no impact on firm value. The study finds boards with a larger ratio of independent directors create more value for the firm.

Across the globe, their respective governments have always protected systemically important financial firms during financial crises or failures. The size of these firms is an immunizing cover against failures. Thus, these firms are viewed as more valuable by investors. The study finds a positive and significant relationship between size and firm value. All financial firms are highly leveraged, and the study reveals that as firms become more leveraged, there is a decline in the firm value. The results of the study are consistent with most of the prior work in cross-country research over different periods and across different samples of firms.

Limitations of the Study and Scope for Further Research

The data sample includes firms' part of the financial services index. While the study captures the relationship at the level of the financial services, given that the index comprises banks and other non-banking financial institutions, the nature and extent of the relationship may vary with the type of services rendered by the financial institution. This is a limitation of the study. Further scope of research could be in examining the relationship at the disaggregated level of banks, housing finance companies, insurance companies, and other non-banking financial institutions.

Authors' Contribution

Dr. Gautam Negi conceived the idea of working on the chosen topic. Arpit Jain extracted papers relevant to the topic. Based on the available literature, it was mutually decided on the choice of methodology (sample firms/use of GMM and duration of the study). Arpit Jain procured all secondary data. The GMM model on the data was applied by Arpit Jain. Dr. Gautam Negi did the interpretation of the results. The introduction and literature review were written by Arpit Jain, while Dr. Gautam Negi wrote the methodology and empirical findings part. Dr. Gautam Negi did the final review and editing of the manuscript.

Conflict of Interest

The authors certify that they have no affiliations with or involvement in any organization or entity with any financial interest or non-financial interest in the subject matter or materials discussed in this manuscript.

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