Counter-productive resistance

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The major problem with Pakistan's equity markets is that most listed firms, apart from multinationals, are owned (in majority terms) and fully controlled by a family.

Some of the firms listed on the stock exchanges have expressed reservations about the Corporate Governance mechanism reforms suggested by the Securities and Exchange Commission of Pakistan through the new CG Code and related legislation and guidelines. Where one can understand reservations about the desirability or applicability of individual reforms, one cannot understand the generalized resistance to CG measures voiced by some firms. To understand this, we have to understand CG in a broader perspective.

The demands for CG reform have acquired more urgency since Pakistan has opened up its capital account, wants to attract foreign investments in its capital markets, and needs to so manage these investments that they stay in Pakistan once they come. We know the cost of not managing the CG mechanism well is very high. The problems some transition economies face are partially explained by inadequacies in their CG frameworks. Researchers across the political spectrum agree that a poor CG framework contributed substantially even to bringing about the East Asian Crisis, making it more severe, and slowing down the recovery,. And last but not least, crises like Enron have shown that even the most sophisticated and developed markets need to be very vigilant about maintaining and improving governance structures.

We also know that the development of a well functioning capital market is important for sustaining a higher growth path, ensuring supply of funds to the corporate sector at reasonable cost, and for engendering confidence in the capital markets for future expansion as well. For Pakistan it is even more important to develop the equity-based capital market since the easy-credit days of DFIs seem over. If we are going to come out of the current recession and revive investment and growth, an important prerequisite will be developing a well functioning equity-based capital market. CG reform is integral to that.

Why are equity markets needed for expanding firms? Consider a small firm where the entrepreneur is the supplier of capital too: the normal single-person firm. As it expands, if it does not have access to outside capital, its growth will be restricted by either the entrepreneur's past savings or the business' ability to generate profits that can be retained for expansion. But expansion tends to be bulky, and past savings, for most entrepreneurs, will be exhausted soon. Retained earnings too are usually not enough to fund bulky investments. Thus the entrepreneur needs outside funding.

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with a suitable price for lending it, will be returned. Hence investing in a good CG framework is in the corporates' interest themselves.

An argument could be that we let competition settle the issue of capital supply. But this solution is problematic. The desirable welfare properties of competition hold for spot markets, and while competition is one of the best ways of achieving efficiency, it does not work well in situations where there are 'sunk' costs. A capital provider, once he parts with capital, has 'sunk' it, and cannot now remove funds on spot market basis. Hence the nature of capital markets require that institutional design be explicit and conscious.

An entrepreneur has two broad options for raising capital. He can borrow from a bank (or other lenders). But there are costs. The entrepreneur bears all business risk in debt contracts, and has to pay a fixed sum. Banks need immovable collateral, and a horde of other requirements need to be settled (their guarantee that the money will come back). So some entrepreneurs might not get access to credit even when they want to, and can, pay the interest, and more importantly, debt as an instrument, might not be optimal for entrepreneurs who want to share the business risk.

The other option is to raise capital through equity participation. The entrepreneur asks another person to become a partner, let us say a 60-40 partnership. If the partner is not active in the firm, he will be under a severe information asymmetry about its functioning. This creates a peculiar situation. First, how can the capital provider know his money will come back? He needs some sort of guarantee. But this is the least of our problems.

entrepreneur can get away with it. But knowing this incentive structure ex ante, the capital provider will shy away from giving capital unless there is a governance structure which ensures he is protected from this fleecing. In more technical terms, while equity participation dilutes ownership, control remains concentrated. The entrepreneur controls the entire firm while owner of a smaller portion. Hence his interest in capturing larger rents than are his share.

This is the major problem with Pakistan's equity markets. Most listed firms, apart from the multinationals, are owned (in majority terms) and fully controlled by a family. This sets up the issue explained above.

Contrast this with the problem US equity markets face. There, for larger listed companies, ownership as well as control is dispersed. A professional management controls the firm and ownership is usually very widely held. That creates a separate issue, known as agency problem in economics, of ensuring a mechanism where a dispersed ownership can devise ways of controlling a professional management and make them pursue the owners' interests, rather than their own managerial interests.

The Pakistani situation resembles the turn of 20th-century situation in the UK. There too families controlled firms and wanted equity participation, without sharing control. Only other family members and trusted friends would invest. Full capital market development and wider ownership dispersion, could only take place when appropriate protections for investors were brought in through CG mechanisms in mid-century.

Pakistani firms resisting CG have to understand that if they want to raise money through equity participation, and if the country wants to develop capital markets, we must devise ways of making these firms more transparent (to address information asymmetry), and accountable (to provide recourse). This can only be done through a CG code aligning the controller's interests with the equity holders'. It will also mean that the entrepreneurs will have to cede some control. They will have to bring in independent board directors, reduce the family directors, open up the audit process, make the company more responsible to the directors, allow directors of minorities, and even think about inducting a professional management.

But this is for firms who want to raise equity capital. If an entrepreneur has enough savings or access to family funds, he need not enlist on the equity markets. But if there is going to be an equity market, and there has to be if we want to ensure national development, investors must have the right protections. A CG code should then be seen as a facilitator by firms desirous of raising money on equity markets.

It should be now clear why some family owners of listed companies are resisting the introduction of CG. But they should realize it is essential for equity marfunding.

It is not obvious why, if the entrepreneur can get money from someone, who has nothing more to contribute to the business (a pure capital input), he should return the money. Default here makes a lot of sense. Providers of capital know this ex-ante. So either they will not give money or would like to devise institutional structures and mechanisms giving them ample optimal guarantees that their money will indeed be returned. This mechanism is the CG framework. So firms have to understand that if they want outside money, they have to develop a framework in which the provider of funds feels confident that his money, needs some sort of guarantee. But this is the least of our problems.

Suppose the firm makes a profit of 100, 40 should go to the equity provider and 60 to the entrepreneur. But the entrepreneur, who controls the firm and knows a whole lot more, has an incentive to take more than 60. Suppose he gives himself a hefty salary of 30 as manager, reducing the profit to 70. The equity provider now gets only 28, while the entrepreneur gets 72, being his share of net profits and all of the salary.

The problem is clear. The entrepreneur has an incentive to create private benefits and fleece the partner. Since the partner cannot monitor the business well, the

It should be now clear why some family owners of listed companies are resisting the introduction of CG. But they should realize it is essential for equity markets' development. Otherwise the small investor will not come into the market, or should not. For a country a good CG mechanism is thus necessary. If a firm does not want money from the market, it should be able to de-list. But a good CG mechanism will help firms who do want to raise money and expand rapidly. Resistance to CG mechanism is futile. And counterproductive.

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