POLITICAL CONNECTIONS, STOCK PLEDGING, BANKRUPTCY REFORMS & FIRM RISK: EVIDENCE FROM INDIA

Extension Seminar Report

By

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Extended Abstract

This paper examines the impact of political connections on stock-pledging activities by promoters or controlling shareholders of Indian firms. We also analyse whether stock pledging activities by politically connected affect firms' risk-taking characteristics through investment decisions. We also evaluate margin call pressure to assess the adverse impact of stock-pledging activities. Our sample consists of listed firms on the National Stock Exchange (NSE) of India from 2009 to 2019.

Generally, common stock pledging is an arrangement that serves as collateral for debt acquisition by retail shareholders, owners, promoters, or founders of any firm (Wang et al., 2018). Promoters used to pledge shares to raise capital externally to fund projects in their firms or subsidiary firms. Lenders could be banks, non-banking financial companies, or any other regulatory-authorized financial institution. Promoters may then use this money to fund new ventures, add to their capital in existing ventures, carry out acquisitions or even meet personal requirements. Pledging of shares is common in those firms where promoters' stake is relatively higher. During stock-pledging, a large proportion of the promoter's wealth is likely to be held as shares. Moreover, share-pledging agreements help entrepreneurs build up quick money when needed, temporarily protect the insiders or promoters from the firm's risk (hedging effect), and undermine the incentive purpose of equity compensation (Larcker and Tayan, 2010). This activity is legal in many countries like India, Australia, Japan, China, etc. (Pang and Wang, 2020). However, pledging shares is not a reasonable use of equity (Shen et al., 2021). It has also been considered a problematic practice (Institutional Shareholder service (ISS), 2012), as there are risks when promoters pledge a significant proportion of their holding with their lenders, especially in volatile markets[1]. At the time of pledging shares, lenders and promoters agree on a minimum contract value for the shares to build a margin of safety into their loans. Nevertheless, if a sudden adverse event or bear attack on a stock trigger it to fall sharply, the value of collateral shrinks, and prior studies entitle these to crash risk (Dou et al., 2019). In that scenario, the lender asks promoters to bring more collateral to maintain the loan-to-collateral ratio. This is known as the Margin call (Chauhan et al., 2021). Promoters cover up this shortfall by paying the difference or

[1] It is published in The business Line Hindu-
https://www.thehindubusinessline.com/opinion/columns/slate/all-you-wanted-to-know-about-promoter-pledging/article26305212.ece

pledging additional shares. If promoters fail to meet the margin call, the lenders invoke the pledge, sell the pledged shares in the market, and realize the money. A more significant stock price fall is stimulated if multiple lenders invoke promoter pledges simultaneously.

Our sample consists of all the listed and traded Indian firms on National Stock Exchange (NSE). We collect stock-specific information from the ProwessIQ database maintained by the Centre for Monitoring Indian Economy (CMIE). The total number of firms in our final sample is 1,835. In our total sample of 1,835 firms, 480 firms are identified as politically connected (Connect), 220 firms as politically connected via donations (Connect_don), and 327 firms connected via promoters or owners (Connect_prom). The donations are mainly made via electoral trust.[2] However, certain firms donated money directly to political parties.[3] All donation-related information was authenticated using annual reports of the respective firms.

This study contributes to the emerging literature on political connection and stock pledging in multiple ways. First, this study examines the association of the political proximity of firms with stock pledging activities. Previous studies (Boubakri et al., 2013) show that politically connected firms hold significant cash in their books, and politician or promoters considers these firms as cash cows. Therefore, these firms are exposed to agency problems. Our study shows that politically connected firms are primarily involved with stock pledging activities by controlling shareholders or promoters. Next, the study explores channels through which political connections add value to firms. We show that politically connected firms report higher firm values but connected firms that pledge their shares generate lower performance. Furthermore, the study also explores channels through which political connections influence firms' investment behavior and examine the impact of pledging activities on firms' investment decisions. We also examines the volatility of stock returns and firms' political connections. The study shows that politically connected firms show less volatility in stock returns whereas pledged firms are highly volatile in returns. We also show that politically connected pledged firms have less volatile returns. We consistently find that political connections encourage firms' investment decisions even though pledging shares mitigate investment activities.

[2] Firm donations were collected from the Election Commission of India website https://eci.gov.in/candidate-political-parties/contribution-reports/contribution-reports-et/
[3] Direct funding to political parties and electoral trust donation also documented, https://myneta.info/party/