The Empirical Study on Institutional Investors’ Monitoring Controlling Shareholders

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Abstract: Under the circumstance of centralized shareholding, the principal contradiction for corporate governance is not that between shareholders and the management but that between major shareholders and minority shareholders. That is, the majority will take advantage of their special positions to invade the benefits of the minority. The attention paying to the China’s situation that the controlling shareholders of listed companies invade the minority’s benefits by the means of grabbing Private Benefits of Control (PBC) is more worthwhile than that to countries which boast the more developed markets. With the accomplishment of Split Share Structure Reform, institutional investors play more and more important role in China’s stock market. The essay focuses on whether institutional investors supervise listed companies and especially on whether the former monitor controlling shareholders. PBC is employed to measure the degree of the controlling shareholders’ invasion. The research statistics suggest that the more shares the institutions hold, the less PBC is. It also shows that situational investors hold shares and monitor the controlling shareholders in listed companies, which makes controlling shareholders control less private benefits. However, the result is not statistically significant; indicating that although institutional investors play a certain part in monitoring listed companies, and the former can’t prevent controlling shareholders from "hollowing out" behavior obviously. Therefore, institutional investors’ monitoring controlling shareholders leaves much to be desired.

Keywords: Institutional investors, Controlling shareholders, Active-monitoring

1 Literature Review

Since the Theory of Separation of Ownership and Management was proposed by Berle and Means (1932), great literature in the early time focused on the issue of agency when the two rights mentioned above were extensively separated, that is, the “authorizing-and-agent” relationship between shareholders and management. However, from the end of 1980s, with the extension of the corporate governance’s research field, numerous studies have shown that many companies in most countries and regions have centralized ownership structure, except USA, Britain and Canada. Under the circumstance of centralized shareholding, the principal contradiction for corporate governance is not that between shareholders and the management but that between majority shareholders and minority shareholders. That is, the majority will take advantage of their special positions to invade the benefits of the minority.

On the basis of analyzing share-structure of China’s listed companies, the result suggests that state-owned shares head the list, occupying the absolute position of controlling ownership with a highly centralized shareholding. Even though in 2007 when Split Share Structure Reform had accomplished, state-owned shares in Chinese security markets still occupied as high as 39.63%. The 5 biggest shareholders in listed companies owned the very proportion. The sum total of the 5 shareholders’

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[2] The statistics is calculated according to the documents by Shanghai Stock Exchange website.
The proportion on average was 58.56%. The statistics indicate the high centralization of equity stake in China’s stock market. As a result, the attention paying to the China’s situation that the controlling shareholders of listed companies invade the minority’s benefits by the means of grabbing Private Benefits of Control (PBC) is more worthwhile than that to countries which boast the more developed markets.

Another burgeoning power in China’s capital market is institutional investor. The rising of institutional investors can’t be ignored in recent China’s stock market. Until October, 2007, 46% of current tradable share was held by various institutional investors. (Reported by China Securities News)

With the accomplishment of Split Share Structure Reform, the age of all-tradable of stock has approached. Institutional investors play more and more essential role in China’s stock market. Who owns the listed company decides who will have the absolute power of discourse to monitor the listed company. Retail investors would like to be “free rider” rather than to monitor the listed companies because of the high cost of monitoring. On the contrary, having held the large amount of shares and boasting the professional and capital advantages, institutional investors have enough power to monitor the listed companies, which makes supervising listed companies become possible.

Is it possible for Institutional investors who have absolute advantage in holding tradable shares, to become the backbone to stabilize stock market and supervise listed companies?

There are many studies on whether Chinese institutional investors should supervise listed companies, some of which are limited to concerning about the exchange behavior and shareholding preference of institutional investors. However, the studies concerning about whether institutional investors’ major supervised object is the majority shareholder (or management) are rare. What’s more, when concerns about the investigation whether institutional investors should participate in the corporate governance, because of the difficulty in finding evidence positively, most studies pay attention to shareholding preference. But it lacks more persuadable evidence to infer whether institutional investors had active monitoring based on the shareholding preference.

The essay focuses on whether institutional investors monitor listed companies or not, especially on whether monitor controlling shareholders. By far, the other Chinese scholars haven’t done any researches. Does Chinese institutional investors monitor listed companies? Do Chinese institutional investors monitor controlling shareholders of listed companies? The two questions are the main objects in the essay. Great attention will be paid to finding the relationship between the proportion of institutional investors’ ownership and the company’s PBC so as to explore whether institutional investors’ holding shares will do good to the reduction of the controlling shareholders’ invasion behavior.

2 Sample Selection

The listed companies with the situation that non-circulation shares during 2003-2007 were agreement-transferred are sorted out as the research object in the essay based on the following principles: 1. Equity interest has been exchanged; 2. the controlling right of stock transaction has been transferred; 3. the biggest turnover was selected if there existed more than two equity replacements; 4. dealing quantity plus turnover to combine into one record, if there is only one buyer and more than one sellers in one transaction; 5. as for more than one sellers, if the turnovers are different, the average is feasible, that is dividing total turnover by total sum; 6. the net asset value per-share should exceed 0; 7. the exchange is a marketlizing behavior, non-marketlizing transactions such as the governmental free transferring being excluded; 8. investor’s rational expectation towards the target enterprises is defined as the average.

\* The statistics is arranged according to the data by CCER.
Rate On Equity (ROE) of the first 3 years. If the rate is a minus value, 0 will be selected; 9. prices of equity transfer, rates and so on can be acquired in public.

The data about the rate of institutional investors’ shareholding is gained in terms of Wind Data System. The other data is obtained from CCER. Based on the principles above to select data, 82 valid samples have been selected, including 8 in 2003, 26 in 2004, 22 in 2005, 24 in 2006 as well as 2 in 2007.

3 Definition of Variables

3.1 Dependent Variable

The dependent variable of the model is PBC (Private Benefit of Control). Here drawing on the method of measurement by Tang Zongming, Jiang Wei (2002), Ma Lei and Xu Xiangyi (2007), we use the net asset value per-share to replace the price of Non-tradable shares tradable. PBC is the balance between price of agreement transfer and net asset value per-share, with the exclusion of investor’s rational expectation\(^1\) towards the increasing rate of the target enterprises when equity exchange takes place.

Therefore, in particular, the result of PBC in the essay is calculated according to the following formula:

(Formula 1) \[ PBC = \alpha \left( \frac{P - NP}{NP} - AROE \right) \]

Meanwhile, \(PBC\) stands for the scale of Private Benefit of Control; \(P\) stands for the price of non-tradable shares; \(AROE\) stands for average Rate On Equity (ROE) of the target company in the first 3 years; \(NP\) stands for the net assets per share of the company; \(\alpha\) stands for the rate of non-tradable shares occupying in the total amount of the ordinary shares.

3.2 Independent Variable

The independent invariable in the essay is the INSTRATIO, which is the rate of various institutional investors’ total shareholding of the listed company at the end of each year occupying in the tradable shares.

3.3 Controlled Variable

To control the influence of the other properties of the listed company to the analyzed results, the following characteristic variables are selected, considering the prior founding and the practical needs:

\(LNASSET\): company size—natural logarithm of the total asset of the company
\(LEV\): asset-liability ratio—total debt/total asset
\(ROE\): return on equity
\(TOPSHARE\): the rate of the biggest shareholder’s equity—ratio of the biggest shareholder’s equity occupying in the total equity in the listed company until the end of the year.
\(INDEPDIRECTOR\): ratio of the independent directors—numbers of independent directors/numbers of the board of directors.

4 Empirical Analysis and Results

In empirical analysis, the descriptive statistical result of variables has been shown at first. Then, two methods will be employed to testify whether there exists a kind of relationship between INSTRATIO and PBC. One is Regressional Analysis method; the other is Grouping Analysis method.

\(^1\) Rational expectation towards the increasing rate of the target enterprises is replaced by earning rate the net assets of the first 3 years of the target listed companies.
Table 1 Descriptive Statistical Result of Relevant Variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Number of samples</th>
<th>Average</th>
<th>Standard deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>PBC</td>
<td>82</td>
<td>0.0460</td>
<td>0.1921</td>
<td>-0.4800</td>
<td>1.1900</td>
</tr>
<tr>
<td>INSTRATIO</td>
<td>82</td>
<td>9.2016</td>
<td>15.3761</td>
<td>0.0000</td>
<td>64.8900</td>
</tr>
<tr>
<td>ROE</td>
<td>82</td>
<td>0.0185</td>
<td>0.4035</td>
<td>-2.9691</td>
<td>1.2187</td>
</tr>
<tr>
<td>TOPSHARE</td>
<td>82</td>
<td>32.6246</td>
<td>14.7049</td>
<td>0.6300</td>
<td>74.2500</td>
</tr>
<tr>
<td>INDEPDIRECTOR</td>
<td>82</td>
<td>0.3356</td>
<td>0.0644</td>
<td>0.0833</td>
<td>0.4444</td>
</tr>
<tr>
<td>LNASSET</td>
<td>82</td>
<td>20.9960</td>
<td>0.8242</td>
<td>19.5472</td>
<td>23.7460</td>
</tr>
<tr>
<td>LEV</td>
<td>82</td>
<td>0.5480</td>
<td>0.3922</td>
<td>0.0683</td>
<td>3.6245</td>
</tr>
</tbody>
</table>

4.1 Regressional Analysis

4.1.1 Hypothesis

Based on the conclusions of the analysis above, we have founded the hypothesis of the essay:

HO: INSTRATIO is not relevant to PBC.

4.1.2 Model of Regression

To testify the hypothesis, OLS Regressional Analysis method will be adopted. The Metrological Model writes as follows:

\[ PBC = \alpha + \beta_{1}\text{INSTRATIO} + \beta_{2}\text{ROE} + \beta_{3}\text{LEV} + \beta_{4}\text{LNASSET} + \beta_{5}\text{INDEPDIRECTOR} + \beta_{6}\text{TOPSHARE} + \varepsilon \]

Model 1

4.1.3 Results of Regression

We use the Stata10 and the results have been calculated as follows;

<table>
<thead>
<tr>
<th>Independent Variable</th>
<th>Coefficient</th>
<th>T value</th>
<th>P value</th>
</tr>
</thead>
<tbody>
<tr>
<td>CONS</td>
<td>0.6095</td>
<td>1.3800</td>
<td>0.1710</td>
</tr>
<tr>
<td>INSTRATIO</td>
<td>-0.0005</td>
<td>-0.4900</td>
<td>0.6270</td>
</tr>
<tr>
<td>ROE</td>
<td>-0.2984***</td>
<td>-7.4600</td>
<td>0.0000</td>
</tr>
<tr>
<td>TOPSHARE</td>
<td>0.0022**</td>
<td>2.0200</td>
<td>0.0470</td>
</tr>
<tr>
<td>INDEPDIRECTOR</td>
<td>-0.3330</td>
<td>-1.3500</td>
<td>0.1800</td>
</tr>
<tr>
<td>LNASSET</td>
<td>-0.0282</td>
<td>-1.3800</td>
<td>0.1720</td>
</tr>
<tr>
<td>LEV</td>
<td>0.1392***</td>
<td>3.3700</td>
<td>0.0010</td>
</tr>
<tr>
<td>TYPE</td>
<td>0.0035***</td>
<td>3.2700</td>
<td>0.0020</td>
</tr>
</tbody>
</table>

Notes: *, **, *** represent that it is statistical significant at 10%, 5% and 1% level

Here is the analysis of significance of regression coefficients.

INSTRATIO: Its coefficient is -0.0005, the sign of which is consistent with the theoretical expectation. However, t value is not significant. It reflects that having participating in monitoring controlling shareholders of the listed company, institutional investors who also hold shares, make PBC lessen but the effect is not obvious. To some extent, it also indicates that institutional investors’ participating in corporate governance can’t prevent controlling shareholders from "hollowing out" obviously. Nowadays, the phenomenon hasn’t been improved obviously that one shareholder occupying the absolute position of controlling ownership with a highly centralized shareholding. Although institutional investors play a certain part in supervising listed companies, they still can’t act as a counterweight to controlling shareholders. Thus, PBC doesn’t drop remarkably with the institutional investors’ participation. To sum up, the institutional investors’ supervision needs much room to be improved.
ROE: The coefficient is statistical significant negative at 1% level, which reflects the better performance the listed company has, the smaller scale PBC has. This conclusion is consistent with the study result proposed by Tang Zongming and Jiang Wei (2002). If the operation-state of the transferred company is not good, controlling shareholders can take advantage of the listed company’s poor financial condition to obtain PBC conveniently. Consequently, the lower ROE is, the higher PBC will be.

TOPSHARE: The coefficient is statistical significant positive at 5% level, which reflects the more the first majority shareholder holds equity, the bigger the scale of PBC is. The conclusion is consistent with the theoretical expectation. The more the controlling shareholder owns equity, the more right of discourse he will have in the daily operation. Therefore, the shareholder will have more power to make private profits for himself.

INDEPDIRECTOR: The coefficient is a negative value which is consistent with the theoretical expectation. The higher INDEPDIRECTOR is, the smaller the scale of PBC will be. Because of the existence of independent directors as supervisors, the controlling shareholders’ “hollowing out” behavior has been restrained to some extent. However, its T value is -1.35 which is not statistical significant. From this aspect, the institutional investors’ supervision needs much room to be improved.

LNASSET: Natural logarithm of the total asset, whose coefficient is not statistical significant.
LEV: The coefficient is significantly positive value at 1% level, which reflects that the higher LEV is, the bigger the scale of PBC will be.

4.2 Grouping Analysis Method
Grouping Analysis is employed to test out the relationship between INSTRATIO and PBC with the adoption of the same variables. The method is applied to testify whether the mean of samples which include higher INSTRATIO and the lower INSTRATIO are significantly different. Furthermore, the relationship between INSTRATIO and PBC will be determined.
The 82 samples we have collected are divided into two groups on the basis of the following principle: INSTRATIOs have been sequenced. Then the samples are divided into two groups according to the amount of shares institutional investors hold. The Group 1 includes 41 samples of the lower INSTRATIO; the Group 2, 41 samples of the higher INSTRATIO.
The average values of the variables in the two groups are shown in Table 3. Finally, comparing Group 1 and Group 2, we use value “t” to testify whether the mean of PBC in the two groups are significant.

<table>
<thead>
<tr>
<th>Range of INSTRATIO</th>
<th>0-1.6%</th>
<th>1.6%-64.89%</th>
</tr>
</thead>
<tbody>
<tr>
<td>(lower, Group 1)</td>
<td>Average:0.27%</td>
<td>Average:18.14%</td>
</tr>
<tr>
<td>Number of samples</td>
<td>41</td>
<td>41</td>
</tr>
<tr>
<td>Average of PBC</td>
<td>0.0728</td>
<td>0.0188</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Range of INSTRATIO</th>
<th>0-1.6% (lower)</th>
<th>1.6%-64.89% (higher)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average:0.27%</td>
<td>Average:18.14%</td>
<td></td>
</tr>
<tr>
<td>Number of samples</td>
<td>41</td>
<td>41</td>
</tr>
<tr>
<td>Average of PBC</td>
<td>7.28%</td>
<td>1.88%</td>
</tr>
</tbody>
</table>

By means of stata10, the results have been calculated as follows: t is 1.3075, p is 0.0993; the value of t is significant at 10% level. Consequently, the hypothesis is rejected at the confidence level of 10%, with the opinion that the mean in Group 1 is higher than Group 2.
Therefore, to be concluded, the higher INSTRATIO the group has, the lower PBC will be.

5 Conclusion and Suggestion

The two methods have been employed to testify whether there exists a kind of relationship between INSTRATIO and PBC. The empirical analysis of the two methods has the nearly same conclusion that institutional investors’ holding equity has an influence on PBC. From Grouping Analysis, it is concluded that the higher INSTRATIO the group has, the lower PBC will be. So we think institutional investors play a certain role in listed corporate governance. The higher INSTRATIO the company has, the smaller PBC is. The probable reason is that institutional investors’ participating in corporate governance plays as an active supervision, which reduce the loss of the listed company and protect the interests of minority shareholders.

The result drawn by using least square method shows that the higher INSTRATIO the company has, the lower PBC will be. It reflects that institutional investors’ participating in monitoring controlling shareholders since the investors have hold equity, which helps to reduce PBC. However, the effect is not statistical significant, which shows that although institutional investors play a certain part in supervising listed companies, they still can’t act as a counterweight to controlling shareholders. Thus, PBC doesn’t drop remarkably with the institutional investors’ participation. To sum up, the institutional investors’ supervision needs much room to be improved.

Consequently, institutional investors’ shareholding which helps to reduce PBC of the listed company reflects that institutional investors have an active-monitoring in corporate governance. However, it leaves much to be desired.

Compared with institutional investors abroad, Chinese institutional investors are restrained in many aspects such as means and paths when participating in corporate governance. That is, the “tools” for active monitoring is very limited. Although they desire to do such supervision, the current policies and regulations can’t provide with a proper stage. For example, the governor hasn’t made a final decision on whether institutional investors can enter the board of directors to participate in corporate governance. Actually, the governor should provide more conveniences for institutional investors’ active monitoring.

References