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Economic consequences of deregulation: Evidence from the removal of voting cap in Indian banks

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A B S T R A C T

We examine the effect of the 2005 Banking Regulation Amendment Bill and the 2011 Banking Laws Amendment Bill proposals for removal of the 10 percent voting rights cap in Indian Banks. The 2011 Banking Laws Bill was first introduced in 2005, but lapsed with the dissolution of the 14th Lok Sabha. The Bill was passed in December 2012 and raised the voting cap in private sector banks from 10 to 26 percent. We present evidence that the removal of the voting cap enhances the value of votes of bank stocks by reducing the wedge between cash-flow and control rights, thus increasing monitoring and the probability of takeover. Post-deregulation analysis reveals that the passage of the Bill was followed by increasing blockholders' number and percentage of shares held in larger and government banks. Furthermore, a stronger negative relationship between banks' profitability and size, as well as share of non-performing loans is observed. This study makes an important contribution to the growing literature on the valuation impact and efficiency gains of liberalization of ownership restrictions in emerging markets, as well as the rich literature on corporate governance and control relating to the value of voting privilege in companies with disparate voting rights.

1. Introduction

The recent financial crises, the rapid globalization of the financial markets, and the "harmonization" and "convergence" of accounting rules have heightened interest in the economic value of regulation (Healey and Palepu, 2001; Leuz and Wysocki, 2008). Despite voluminous research on the consequences of regulatory developments, however, the evidence on this issue remains inconclusive.[4] Further, in contrast to the vast literature on the economic impact of new regulation, the research on economic consequences of deregulation is limited and focused primarily on the U.S. market. Recent studies on deregulation include Jayaratne and Strahan (1998), Beck et al. (2010) and Francis et al. (2014), all of which focus on the consequences of bank deregulation in the U.S. Jayaratne and Strahan (1998) found that the removal of branching restrictions resulted in improvements in the efficiency of the banking system. Beck et al. (2010) found that removing restrictions on intrastate branching led to higher incomes in the lower part of income distribution. Francis et al. (2014) reported that banking deregulation led to financially constrained non-banking firms holding lower liquid assets, which relieved their credit constraints.

We contribute to this literature with analysis of an important deregulation in the Indian banking sector – removal (relaxation) of the voting cap that until 2012 had significantly curtailed bank shareholders' voting rights. A voting cap limits the number of votes a shareholder can cast to a fixed number or percentage of outstanding shares, irrespective of the number or percentage of shares

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[4] The lack of consensus on the economic impact of regulation can be attributed to two major reasons: (1) difficulty in separating a treatment effect from a selection effect due to absence of appropriate control groups; and (2) failure to control for overall market movements, information environment and other contemporaneous events because the regulation often affected all exchange-traded firms so there was no natural comparison group.

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she owns. That is, all shares held in excess of the cap lose their votes. Consequently, a voting cap drives a wedge between cash-flow rights and voting rights (Burkart and Lee, 2008). Until 2012, the voting cap for shareholders in private Indian banks was set to 10 percent, while the cap was 1 percent for state banks. As such, a blockholder in a private bank with 50 percent ownership has only 16.7 percent voting control, and a blockholder with a 74 percent ownership has only 28 percent voting control, making a takeover virtually impossible.[5] The wedge is even more severe for government banks, where the voting cap was set to only 1 percent. We contend that since a voting cap acts as a defensive mechanism against takeover attempts, removal of the cap exposes the firm to the disciplining forces of the market for corporate control. In the case of government banks where the government's ownership is at least 51 percent, the proposal to lift the cap from 1 to 10 percent does not affect the threat of takeover. However, the increased threat of takeover of private banks enhances competition in the banking sector and forces government banks to improve performance. In essence, the increased monitoring, and threat of takeover and competition reduce agency cost and should induce positive stock revaluation.

To test the above proposition, we focus on the stock price effects surrounding the proposed 2005 Banking Regulation Bill to remove the voting cap in private banks and increase the voting cap in government banks to 10 percent, and that of the 2011 Banking Laws Amendment Bill, which increased the voting cap from 10 to 26 percent for private banks and did not make any changes to the existing 1 percent cap for government banks. Our tests, based on a portfolio of 41 publicly-traded banks including 24 government banks and 17 private banks, reveal significant valuation gains by private banks surrounding the 2005 Bill. On the other hand, the 2011 Bill elicited significant negative impact on government banks.

Next, cross-sectional analyses reveal that valuation gains around the 2005 announcement are positively related to the wedge between cash-flow and control rights, the proportion of non-performing loans to total assets, and negatively related to profitability of old private banks. This evidence is consistent with the notion that the removal of the voting cap increases banks' vulnerability to takeovers. Similarly, the 2012 announcement's negative effect on government banks is directly related to the wedge between cash-flow and voting rights for these banks. In addition, insider and foreign ownership are negatively related to the effects of the 2012 announcement. Our post-Bill analysis reveals that the deregulation did not result in any increase in foreign or insider ownership, but, rather, an increase in blockholders' ownership in government-controlled banks. Furthermore, post-deregulation, we observe a stronger negative relation between ROA and size, as well as share of non-performing loans.

Our study has important implications for the growing literature on the economic consequences of deregulation, as well as that of differential ownership rights on firm value. First, most mechanisms for disproportional ownership, including shares with differential voting rights, pyramidal structures, and cross-holdings, are management-initiated and approved by shareholders. As such, the extant evidence on the reaction to dual-class recapitalizations and unifications, and antitakeover provisions suffers from potential endogeneity (Adams and Ferreira, 2008). In contrast, the deregulation of the voting cap is an exogenous shock, and represents a natural experiment that mitigates the endogeneity concerns prevalent in prior research. Second, by limiting the voting control of large shareholders, a voting cap renders a takeover attempt virtually impossible and impedes effective monitoring of management (Burkart and Lee, 2008). Consequently, Indian banks faced no serious takeover threat, and their stock carried little value attributable to voting rights and shareholders' power to force a change in control. In essence, voting caps are equivalent to managerial entrenchment mechanisms such as poison pills and antitakeover amendments to corporate charters that firms often adopt to discourage hostile takeover attempts. Therefore, our findings are relevant also to the literature on the impact of antitakeover provisions.

Finally, voting caps exist in many countries across the world. Deminor (2005) reports that the three most frequent deviations from the one-share-one-vote principle are voting ceilings, multiple voting rights, and ownership ceilings, and that voting ceilings are in force in 10 percent of all companies analyzed. Indeed, the role of voting caps as a defense mechanism has been the focus in recent policy debates in several European countries. Goergen et al. (2005) report a gradual convergence towards the abolishment of voting caps, with an intent to stimulate the takeover market.[6] However, the authors note that banning voting caps in countries with concentrated ownership makes it difficult to control accumulation of power by large shareholders.[7] Interestingly, despite the prevalence of voting caps, an exhaustive search of the literature yielded but scant evidence on the impact of voting caps on firm value. Our evidence of shareholders' favorable reaction to proposed lifting of voting caps in the Indian banking sector provides important rationale to future policymakers contemplating removal of voting caps.

The rest of the paper proceeds as follows. In the next section, we provide a chronology of events leading to the introduction of the bill to remove the voting cap. In Section 3, we discuss the relevant literature. In Section 4, we present the model and develop our hypotheses. Our data and methodology are presented in Section 5 and Section 6, respectively. In Section 7, we discuss the stock price reaction to the 2005 and 2011 Bills, and the determinants of the observed valuation effects. In Section 8, we analyze the changes in bank ownership, size and profitability after passage of the 2011 Bill. Section 9 concludes the paper.

2. Evolution of the Indian banking sector

2.1. Nationalization and privatization

Here, we present a brief overview on the development of the Indian banking sector, specifically from the perspective of the market for corporate control.[8] Modern banking started in India with the setting up of three Presidency Banks – the Bank of Bengal in 1806, the Bank of Bombay in 1840, and the Bank of Madras in

[5] With 10 percent voting cap, a blockholder owning 50 percent of total shares outstanding has effective voting power of 10/(10+50) or 16.7 percent, and the effective voting power with 74 percent ownership is 10/(10+26) or 27.8 percent. A 74 percent ownership is critical because the liberalization enacted in 2004 allows foreign direct investors a maximum 74 percent ownership in Indian private banks. Clearly, even at such high ownership level, voting control is not attainable.

[6] On August 17, 2011, following complaints from analysts that voting limits have led to the failure of the takeover market, the Portuguese Government scrapped limits on shareholder voting during takeover bids for listed companies. The Government said, "The end of the voting limits in the case of takeover bids makes the market function in a more fluid way, favors investment, boosts liquidity, and improves company governance. The voting limits are defensive means… and are typically designed to favor incumbent shareholders during hostile bids" (Laxmidas, 2011).

[7] Indeed, voting caps are often defended as necessary to protect strategic companies and industries from takeover by opportunistic raiders motivated by control benefits. In May 2013, the Spanish Parliament passed an act restoring the entitlement of listed companies to include voting caps in their by-laws, while also providing that this defensive measure will not apply when a takeover bid is launched. The move was "…to respond to an unreasonable market that leaves Spanish champions in a very vulnerable position… and to prevent third-party investors from taking advantage… to take over the company" Ferré (2013).

[8] The literature on the history and evolution of the banking system in India is too numerous to cite. Shirai (2002), Banerjee et al. (2004) and Gauba (2012) provide excellent reviews of this topic.