

# Investor Protection and Agency Theory in Corporate Governance in Pakistan

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## Abstract

*The paper discusses the minority shareholders' protection under the quantum of agency cost in corporate governance in Pakistan. The agency theory states that in most of the cases, the controlling shareholders and the top management are normally involved in expropriating the funds of the company. This phenomenon increases the agency cost. The agency cost is directly proportional to the cost of functioning of the company. In other words, the agency cost is inversely proportional to the profit of the company. According to the agency theory, if the agency cost is decreased, the profit for investor increases. The Pakistani corporate sector is dominated by the business families, the state and an opportunity to get the private benefits at the cost of other stakeholders. There are the different mechanisms as discussed and applied around the world to minimize the agency cost so as to make company financially strong and better profit for the investors. In Pakistan, the agency cost is very high. Hence, there is a need to revamp the corporate governance mechanism to reduce the agency cost in order to provide a better protection to minority shareholders in a particular in the context of the global trend keeping in the view of the nature of corporate structure in Pakistan.*

**Keywords:** Corporate Law; Corporate Governance; Minority Protections; Agency Cost; Pakistan.

## 1. Introduction

The agency problem resembles with a triangle. This triangle has three corners - the executives, minority shareholders and majority shareholders. The agency problem was the first highlighted by two well-known American scholars namely Adolf Berle and Gardiner Means almost a century ago. Further, they presented a model that is commonly known as Berle and Means Model (BMM) (Coffee, 1999; Porrata-Doria, 1989). In their model; they argued that the corporate world had been controlled by the executives which provide them opportunities to get the private and personal benefits. Such the model was premised on the assumption of disseminated ownership structures (El-Kassar, Messarra, & Elgammal, 2015). In this structure of dispersed ownership (Coffee, 2001), the investors were dispersed with the small amount of investment. They did not have any interest in the functioning of companies due to less investment. They did not have any control in the company. The executives were in the control due to less interest of the majority of

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shareholders who had small amount of investment. Therefore, the executives had chances to exploit money of the companies at the price of the company and its investors. Hence, the situation created a conflict between shareholders and the executives.

In the present corporate world; the BMM model is not a common. This model is mostly found in the corporate sector of the US as well the UK. The remaining world is dominated by the corporate world where the strong business families, groups and the states are in control. In this scenario, the conflict highlighted through BMM for instance, between the executives and shareholders is less visible. The real conflict exists between the shareholders *inter se* likewise between the majority and minority shareholders. The reason is an obvious; the minority investors do not have sufficient shares to undertake any action against the executives in the meetings of shareholders. On the other hand, the majority shareholders normally have direct control over the executives. They act as executives themselves or appoint their family members, close friends as directors in their companies. Thus, they are in such a position to force the executives to perform in this pattern that can earn the benefits for them. Hence, in ownership structure which is concentrated, the core agency conflict occurs between the minority and the other two remaining corners of the triangle, namely the executives and controlling shareholders. This means that there are actually two agency problems in the corporate form. The first is between the executives and shareholders as a group. While the second between the majority and minority shareholders.

The discussion in this paper would be limited to the first kind of agency problem, namely between the executives and shareholders. Further, the focus in the present paper based on discovering the causes of the agency problem and the mechanism to decrease agency cost in the context of the corporate governance of Pakistan. The methodology employed in this paper focuses on the comparative study. The diagnostic approach is used to find the suitable mechanism which can reduce the agency cost and enhance the profits for minority shareholders. The domain of comparison is the mixture of jurisdictions including United States and United Kingdom as well others countries ; however, there is no plain canvas of comparison done among these countries rather a discrete phenomenal compassion is drawn in order to relate it with the problem existed in Pakistan. The comparative reference point highlights the best practice of other jurisdictions, and is served as a model to be taken into consideration.

The organization of the paper consists of four major parts - the first part after the introduction and literature review build a conceptual framework to the concept of agency, and the agency cost in corporate governance. The second part examines the factors affecting the agency cost and the collateral elements that have direct and indirect relationship with the agency cost. In the third part, there is discussion about the mechanism and the ways to reduce the agency cost. The forth part consist of conclusion. The conclusion also entails the recommendations of practical nature that can address the problem of

agency cost in a sound pattern, and contribute positively in the corporate governance in Pakistan.

## 2. The Nature of Agency Cost

The contract of agency is created when one person delegates his decision making authority to someone else. The person who delegates his power is called principal while to whom authority is delegated is recognized as an agent. Therefore, an agency cost means the cost that may be incurred by the principal for nominating and thereafter monitoring the activities of his agent. Applying this analogy in the corporate governance; it means the investors being the real owners of any company have to pay cost for monitoring the activities of the management. In a company, the shareholders are considered as principal, and the executives as their agents. The mechanism of running a company is that the shareholders elect the directors to work on their behalf, and thereby delegate their decision-making authority. The dilemma of corporate world is that the investment is made by shareholders whereas company is controlled by the director. In other words, the agency problems arose due to the very nature of functioning of the company. This is not much problematic in the private companies where the investors are executives themselves. However, the issue is flared up in the public companies where there is a separation of ownership and control. Thus, the agency problem between the shareholders and the executives is problematic. This phenomenon increases the cost of investment. One cannot ignore element of negligence on the part of executives as they use the property and money of others (Smith, 1961). Therefore, in order to make firm a going concern; it is necessary to control the agency cost (Fama & Jensen, 1998)

Jensen and Meckling (1998) have expressed the agency *cost* in mathematical way as follows:-

$$\text{The monitoring expenditure by the principal} + \text{the bonding expenditure by the agent} + \text{the residual loss} = \text{Agency cost}$$

In this definition, the term monitoring expenditure by the principal stands for the cost that may be incurred by the principal so that the activities of the agent can be monitored. The term bonding expenditure by the agent includes the expenditure of resources by the agent whereby he gives a guarantee that he will not take the certain actions which may harm the principal. Further, he ensures that he will also compensate for these actions that are harmful for the interests of the principal. The residual loss includes the loss that may be incurred by the principal due to divergence of decisions as taken by the agents that would have otherwise been advantageous for the principal.

This definition is a wide in the sense that it also covers those factors which are beyond the control of agent as well the Principal. For instance, the residual cost - depends mostly on the decision made by the agent, is most of

the time is out of the control of the agent. The decision is made on the basis of best judgement, but sometimes even good decision do not provide the optimum result due to external factors which are out control of everyone. Nevertheless, a bad decision of incompetent manager can harm business, and put extra burden of cost on the principal.

The corporate contracts cannot be enforced without incurring cost which has increased an agency cost (Fama & Jensen, 1998). This problem is due to nature of corporate sector. In the corporate sector, the investors and managers are separate, and companies are most run by professional who are not selected by the investors. The investors are mostly not involved in the direct management of the companies. In modern form of company, the investors change their hands very frequently, and become the shareholders by mere purchasing shares in the market. Further, they do not have luxury of negotiating the terms of the contract nor are the corporate contracts changed so frequently to accommodate them. This increases the cost of agency. There is another dilemma of agency cost that it cannot be easily controlled through general meetings and enforcement. This also increases an agency cost. In this scenario, it can be said that agency cost cannot be eliminated, but it can be reduced to some extent. How the corporate contracts are drafted is important, and corporate laws, common laws as well human skill can help to determine the magnitude of the agency cost. The different stakeholders always try to reduce the agency cost. This may enhance good governance in the corporate sector (Jensen & Meckling, 1976). The law makers try to solve such the problem through the various techniques including non-statutory regulations. These regulations include the codes of corporate governances. Such the codes are implemented on a self-regulatory basis in most of the jurisdictions of the social world.

### **3. Causes of Agency Cost**

#### **3.1 Separation of Ownership and Control**

The agency problem exists in the company mainly on account of the separation between ownership and control. This is because of the conflict of interests between agents and principals. Another problem is the nature of company in which it operates. In most of the cases, it is not feasible for principal to specify the terms and conditions for the utilisation of capital in the more precise pattern. This problem is the more sever in public companies as compared to the private companies.

Classical model presented by A. Berle and G. Means (1932) states that the executives have an opportunity in the most of the cases to steal the funds of the company because of the structure and nature of the company. However, this does not mean that management controls and expropriates the funds of the company at their free will (Demsetz & Lehn, 1985). In modern corporate regime, diverse types of techniques have been developed which could control management powers, and thereby reduce an agency cost. Moreover, there is another dimension of the agency cost. It is explicitly visible in dispersed

ownership structures than concentrated structures. In dispersed ownership structure; there is a separation between ownership and control. The investors invest in numbers and no one has enough shareholding to control the company. The company is run by professionals elected by the shareholders. They may run the company in a way that is the beneficial for them instead of the investors. On the other hand, the investors invest in blocks and have the sufficient control over the company, and they either run the company at their own or at least can control the executives to run the company in best interest of the shareholders. However, if shareholders do not own sufficient shares to remove directors or if the mechanism of removal of directors is tough in the system, the agency problem will remain even in concentrated ownership. There is another dimension of agency problem present in concentrated ownership structure. The clash between minority and majority shareholders is the visible in this structure. Since the majority can control the executives, therefore, the executives normally focus on the interest of majority and minority remain at losing end. In this scenario, the conflict is between majority and minority. In other words, we can say the actual problem is between those who do not have, and those who have control.

The Pakistani corporate sector is highly dominated by the business families and the state. The negative aspect of this system is that the control and ownership are directly or indirectly vested in the same group of people. In companies, where families are dominant, the management is in the hands of family members, or the persons of their confidence. Similarly, in companies controlled by the state, the executives are the persons who have some political affiliation. Henceforth, the conflict is between the controlling shareholders and minority shareholders. Nevertheless, the actual agency problem is between the executives and the shareholders, especially the minority investors.

### **3.2 Motivations for personal benefits and expropriation of funds**

The way the modern forms of companies run, the executives have the sufficient controlling power and discretion to get the private benefits at the cost of other stakeholders. There are the different factors which provide them this discretion. Firstly, there is a problem in the corporate sector that the shareholders cannot force executive's *ex ante* to utilize their investments. This phenomenon provides some discretion to the executives to invest the finance at their discretion. Secondly, the investors do not have the sufficient expertise to monitor the actions of the executives. Thirdly, it is not practically possible that all shareholders are involved in daily affairs. Fourthly, the judiciary, especially in the UK, do not involve themselves in the routine affairs of the companies unless they feel that there are substantial violations from the executives. On the other hand, the courts in the US have shown more active role as compared to the UK. However, despite this, the so-called 'business judgment rule', practiced in the US, had kept courts out of the daily affairs of companies in many instances. Fifthly, small investors are normally poorly informed how to exercise their rights provided by the law. Sixthly, it is not

practicable for the small stockholders to take an action through meeting of shareholders. Seventhly, the cost of litigation and time consumption is another factor which prevents investors to approach courts. Eighthly, the investors who control the company; they normally are reluctant to take an action against the executives as they are themselves involved in the management. It is like taking action against by the controlling shareholders against themselves. Therefore, the executives and controlling shareholders control the company and its funds. This offers them chance to get personal benefits at the cost of other stakeholders.

There are the different techniques to get the private benefits of control. These included, but not limited to Related Party Transactions (RPT), executive compensation, tunnelling of funds and empire building. In RPT, the controlling shareholders and the executives may make the transactions, sell the assets and products at lower levels than normal market price to the companies where they have more interests and thereby get the more benefit by indirect methods. In empire building, the controlling shareholders and the executives, instead of distributing profits to the small investors - may utilize the funds of the company by establishing more subsidiary companies and business units. This phenomenon enhances their control, and they get the more benefits at the cost of investors (Shleifer & Vishny, 1997).

In the tunnelling of funds, the controlling shareholders and executives may involve themselves in secret transferring of funds from the companies; they have control to the companies, and they directly or indirectly own. To provide loans at lowest interest rate, or on easy terms, transferring resources and assets for their personal benefits and RPT are manifestations of secret transferring of funds.

In executive compensation, the executives get the excessive pay packages; and consume perquisites like luxury vehicles and aeroplanes (Burrough & Helyar, 2010). They may also enjoy other benefits which include costly trips; luxury rented offices and personal accommodations; hiring relatives and friends on highly paid jobs. The executives continue in job even if they are no longer required by the company (Shleifer & Vishny, 1986), or offer the resistance even if company performs poorly which are expenditures of company, and its investors have to pay (Jensen & Ruback, 1983). In short, the executives and controlling shareholders focus on their own personal benefits by using the resources of the company which otherwise should have been used for the benefits of the company and its shareholders (Shleifer & Vishny, 1997).

The executives are monitored by the owners, but if they have controlling shares then they are executives and monitors at the same time. In this situation, it is not expected from them that they will monitor themselves and will stop stealing the funds of the company. Thus, in concentrated ownership structures, there is a need to separate ownership and monitoring.

In Pakistan, the corporate sector is controlled by the state and business families. They own and control more than 70% stocks of companies as listed

on stock market. They avoid major shareholding in the market to maintain their control over these companies. The non-availability of shares creates liquidity problem in the market. The control can be shifted from one group to another through takeovers. If the market is not liquid then, it is not a possible to operate and takeover mechanism, and shift control from one group to another. There are the other tools for maintaining control like cross-shareholding, pyramiding, and interlocking management. The technique of issuing shares having more voting rights or with no voting rights is used for this purpose. They issue shares of the first category to themselves, and the second categories to others. This increases their voting rights and decreases voting rights of others. In this manner, they possess excessing control as compared to their cash-flow rights. This phenomenon provides an opportunity to dominate the management which in turn, provides them opportunities to steal the funds of the companies at the price of the minority investors and other stakeholders.

#### **4. Mechanisms to Reduce Agency Cost**

Agency cost is considered as a market product. The companies that can produce and manufacture products at the lowest possible cost, and can sell at minimum price that can survive. Likewise, if agency cost is not reduced, the survivals of the companies become the difficult. In companies, where agency cost is at a high level, it may reduce the profit margin for the investors. The investors will be reluctant to invest and organizational forms may ultimately fail (Fama & Jensen, 1998). There is growing concern for reducing agency cost. For this purpose, some innovative techniques have been discussed and suggested by authors to reduce agency cost such as using computer technology (Kaal, 2019).

In the context of Pakistan, the following factors may be an effective to reduce the agency cost:

##### **4.1 Ex-ante and ex-post mechanisms**

In an *ex-ante* mechanism, advance information is provided to the investors before they invest in the company. This may include, but not limited to Reports of Directors, Annual Accounts and other periodical reports. On the other hand, in an *ex-post* mechanism, the power is given to executives to run the company. The investors are given an accountability power. They may remove non-performing directors, and they can even take the action through courts.

##### **4.2 Mechanism of separating monitoring and control**

The separation of monitoring from control is another *ex-ante* mechanism. Power is given to the executives to run the company. However, since the interest of the executives is not aligned with those of Shareholders, t thus, the agency problem is created. The majority shareholders might be considered as the best monitors of the executives. But if they are involved themselves in the

management, then it is not expected that they may monitor themselves. In this scenario, if control is separated from monitoring, then this may help to reduce an agency cost (Shleifer & Vishny, 1986).

In Pakistan, where there is highly concentration of ownership. The state and business families dominate the corporate sector. The management is in their control. The agency problem can be controlled if monitoring of management is separated from the control. There are the different techniques to separate monitoring and control. Firstly, there is a need to enhance the role of independent directors. Since, they do not have direct interest; therefore, they may work independently and monitor the management in an effective way. Secondly, enhancing the role of minority shareholders can be useful. They do not possess controlling power in the company. Thus, they might work for the betterment of the company as a whole. Some seats of directors may be allocated to the minority shareholders. Appointing directors from the minority shareholders can be useful in the sense that this will provides them access to information. They can work and will safeguard the interests of minority shareholders. They can collaborate with other independent directors to discuss concerns of the minority shareholders, and success of the company (Kraakman et al., 2017).

Thirdly, institutional investors can also play a vital role in order to monitor the management in company. They have the sufficient shareholdings in listed companies. Thus, they can put the pressure on the management to pursue good corporate governance practices. In addition to this, there is a dire need to increase the role of institutional investors. The institutional investor having shares, power, control and ability to monitor management can be effective tool to discipline management and to lead the companies towards good corporate governance. This can be an effective mechanism in the context of Pakistan where strong business families dominate and control the whole business and activities of the companies.

### **4.3 Legal protection**

Legal protection is considered as an important approach in order to sole agency problems and to reduce agency cost. The small stockholders do not have enough shares to save their interests in the meetings of the companies. This insecurity may be compensated in the form of legal protection. When strong legal protection is provided in the system, the investors feel secure and invest without any fear. If there is no legal protection, the controlling shareholders and executives may expropriate the finances of the company and small and minority shareholders would be affected of such the whole scenario.

To control agency problem, there must be some mechanism to control expropriation of funds from the hands of controlling shareholders and management. This can be done by *ex-ante* mechanism like a disclosure strategy or an *ex-post* mechanism like providing small and minority shareholders protection so that they can sue directors and controlling shareholders (Porta, Lopez-de-Silanes, & Shleifer, 1999). Exacerbated agency

problem in Pakistan is due to lack of legal protection to the minority shareholders. As far as the mechanism of legal protection is concerned, it may be provided through the different legal frameworks. This includes statutory laws including company law and securities law and non-statutory regulations such as code of corporate governance and regulators including Securities and Exchange Commission of Pakistan (SECP), State Bank and Pakistan Stock Market. However, the more effective tool of providing legal protection is the judicial system. If judicial system is the strong the minority shareholders would be the comfortable and can't be reluctant in investing their life savings.

## **5. Conclusion**

The research article discussed the issues related to the agency problems in Pakistan. There is high concentration of ownership in the corporate sector of Pakistan. The separation of control and ownership is a problem that has been widely experienced in the dispersed ownership that causes an agency problem. Nevertheless, the agency problem is also the visible in concentrated ownership structures. There may be conflict between the management and the shareholders especially the minority shareholders in concentrated ownership. In context of Pakistan the different techniques may be employed to solve, control or, at least, reduce the agency problems. These may include *ex-ante* or *ex-post* mechanisms. Firstly, small and minority shareholders should be given some representation on the board of directors. In this way, there will be separation of control and monitoring. The representatives from the institutional investors on the board can also be an effective. Similarly, the presence of independent and non-executive directors on the board can also add value. This may solve or at least reduce the agency problem.

Secondly, the institutional investor industry is not developed so far in Pakistan. Active role of institutional investors may boost up the good corporate governance in the country that can help to reduce agency problem. Thirdly, the legal protection of minority shareholders can also help to solve the problem. It may make expropriation tough for the executives and controlling shareholders. A better minority shareholders' protection mechanism may help to develop corporate governance in Pakistan.

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