Regulations and Investment-Cash Flow Sensitivity: The Role of Group Affiliation, Ownership and Governance

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Abstract

We examine the usefulness of regulations in improving decision-making efficiency of capital providers by focusing on a firm's access to external financing. While disclosure of such information is desirable, the effectiveness of mandatory disclosures depends on its enforcement. It is in this backdrop that we particularly study regulations requiring ownership and governance disclosures in an emerging market characterized by weaker enforcement, more concentrated ownership, complex group structures and higher information asymmetry. We also explore the differential impact of regulations on firms with different responses to reduced information asymmetry. India provides a context and setup that enables more robust empirical testing of the above. Thus, using a large sample of Indian listed firms, we find that while group-affiliated firms enjoyed better access to external capital before regulation (i.e., displayed lower investment-cash flow sensitivity), they were worse off after regulation (i.e., had higher investment-cash flow sensitivity) when compared to standalone firms. On further analysis of only group-affiliated firms, we find that this increase in sensitivity is restricted to only firms with higher insider ownership that have weaker governance or perform poorly in the future. In short, we find that regulation in India has been effective in providing external capital to firms that needed it and furthermore, investors have been able to separate out the efficient group-affiliated firms from the opportunistic ones using the disclosures mandated by Clause 35 and 49.

JEL: D82, G30, G31, G32, G38, M48

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