

THE EFFECT OF SHARE PLEDGING ON FIRM PERFORMANCE: A SYSTEMATIC LITERATURE REVIEW

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Abstract

Pledging of shares is a financing option that is widely practiced by the controlling shareholders and/or promoters where they utilize their pledges as security to avail loans, without losing their voting rights and ownership. This practice offers financial flexibility but has been questioned due to its implications on corporate governance and firm performance. This study aims to answer this question by systematically reviewing the literature up to 2022. The search of the major academic databases was structured, and the retrieved studies were analyzed by thematic synthesis.

The review shows that in general, the more shares pledged, the worse the corporate results are, with lower firm value, weaker firm performance, more agency conflicts, earnings management and higher corporate risk being all associated with excessive share pledging. The literature also indicates that pledged ownership could lead to lower efficiency of investment and innovation and higher risk of stock price crashes. But those negative impacts can be mitigated through good governance practices, like institutional ownership and board independence. The study reveals existing research gaps and directions for future research. Overall the results confirm that share pledging may provide a short-term financing advantage, but that it may lead to a decline in long-term firm performance and shareholder value when pledging is too high.

Keywords: Share pledging, firm performance, corporate governance, firm value, agency theory.

Introduction

Pledging has become a significant new corporate finance transaction in a number of capital markets, notably in emerging markets like China and India. Share pledging is a situation in which controlling shareholders or promoters borrow money by pledging shares and continuing to own and vote the shares. This process allows shareholders to access liquidity without having to sell their equity stakes in the company and in doing so does not dilute their shareholding in or control over the company. Share pledging is important not only for financing reasons, but it has also been the focus of growing interest by researchers, investors and regulators due to its implications in corporate governance and firm performance.

Widespread share pledging has led to concerns over the motives and actions of controlling shareholders. If a large proportion of promoter shares is pledged, controlling shareholders might be more concerned about the price of the stock and avoiding margin calls than in maximizing long-term shareholder value. These situations can lead to agency problems between the controlling and minority shareholders, leading to opportunistic decision making, a lack of transparency, earnings management, and

inefficient investment policies. Share pledging thus has implications beyond that of the promoters' personal financial choices, and may impact the broader corporate picture. Share pledging and firm performance have been explored extensively in the corporate governance and finance literature. Agency Theory (Jensen & Meckling 1976) is the main theory to explain this. The theory states that conflict occurs when managers or controlling shareholders have other interests that are not in line with other shareholders. A controlling shareholder can take actions to protect his or her personal financial interests that are not in the best interests of the firm in the long run in the context of share pledging.

There is conflicting evidence from the empirical literature on the effects of share pledging. Share pledging can enhance financial flexibility in the company and alleviate financing constraints as pledging controlling shareholders gain access to more financing, some studies have suggested. But there is a much larger body of literature that has documented negative consequences with over-due pledging. Studies have shown that share pledging is negatively associated with firm value (Kao *et al.*, 2004), weak corporate governance systems (Deng *et al.*, 2022), higher earnings management (Chauhan *et al.*, 2021), higher risk of stock price crash, lower investment efficiency and lower innovation (Chauhan *et al.*, 2021). The results indicated that even if share pledging can give short-term financial gains, it can also lead to huge governance and performance issues.

Although there is increasing interest in the subject, the literature so far is disjointed. There are studies on various aspects of share pledging such as firm performance, corporate governance, firm value, earnings management, corporate risk, and strategic decision making. Additionally, there is a very strong focus on a particular market, especially China, which may make findings non- or less- generalizable to other emerging economies. To this end, existing research fields should be synthesized and a comprehensive understanding of the impact of share pledging on firm performance should be provided.

This paper therefore systematically reviews the literature published till 2022 to explore the relationship between share pledging and the firm performance. In particular, the review will pinpoint the main theoretical approaches, provide a summary of the major empirical studies, and outline areas of research that would be new and interesting. The paper builds on existing evidence based on previous research and offers practical implications for academics, investors, corporate managers and policymakers on the impact of share pledging on corporate performance.

A comprehensive review of the literature is necessary in order to understand the effect of share pledging on firm performance. Share pledging is studied from different angles such as that of corporate governance, firm value, earnings management, corporate risk, and strategic decision-making in previous studies. This section presents a summary and synthesis of the major theoretical and empirical work in order to gain a broad perspective of the topic.

Agency Theory and Share Pledging

The basic theory of the share pledging and firm performance relationship is agency theory. A conflict occurs when the managers or controlling shareholders act in a manner that is inconsistent with the interests of the minority shareholders, Jensen and Meckling (1976) note. This is particularly so when share pledging escalates tensions between

those with control and other shareholders, as the former can secure personal funds and enjoy the benefits of voting rights and control over the firm.

Shleifer and Vishny (1997) had suggested that concentrated ownership could provide the opportunity for the controlling shareholders to extract private benefits at the expense of the minority shareholders. Likewise, Claessens *et al.* (2002) showed that when the rights of control differ from cash-flow rights, it has a negative impact on firm value and on corporate governance. Share pledging is often seen as a means to magnify agency problems because the more personal leverage increases the more controlling shareholders retain control of the firm through pledged shares.

An agency's view of controlling shareholders with pledged shares could include more activity that keeps the share price up and may prevent margin calls. These incentives may impact firm decision making, financial reporting, and investment strategies, and consequently impact firm performance.

Share Pledging and Firm Performance

There has been a lot of research interest in the connection between share pledging and firm performance. Share pledging can increase the liquidity and alleviate financing constraints but majority of empirical studies report that too high share pledging is negatively related to firm performance.

Kao *et al.* (2004) studied Taiwanese firms and concluded that the presence of collateralize shares with controlling shareholders was negatively related to firm performance and agency costs. The authors have suggested that the pledged shareholders can have personal financial interests which may be more important than maximizing the value of the firm, which may result in inefficient decision making.

The same can be said in China. According to Deng *et al.* (2022) highly pledged controlling shareholders led to lower profitability and poor market performance of firms. The study recommended that controlling shareholders tend to have conservative investments and preserve stock price instead of considering long-term growth opportunities.

From the Indian perspective, Chauhan *et al.* (2021) found that there was a negative impact on the firm value and long-term performance due to promoter share pledging. The authors suggested that if pressure is placed on the promoter due to pledges may focus more on short-term profitability rather than long-term sustainability. There is a negative relationship of promoter pledging with the stock price volatility and firm performance more specifically for those firms who have weak governance (Rajhans *et al.*, 2022) .

It is evident from the previous research that moderate share pledging can offer financial flexibility, but it can decrease profitability, operational efficiency and shareholder wealth when done beyond a certain level.

Corporate governance is one of the most critical manners by which share pledging impacts firm performance. According to agency theory, pledged shareholders will have a greater influence on managerial decisions to pursue their own financial interests to the detriment of the quality of governance.

Claessens *et al.* (2002) showed that weak governance and low firm value were related to ownership structures with higher separation of ownership and control rights. On this premise, Kao *et al.* (2004) proposed that pledged ownership leads to greater agency costs and more opportunities for opportunistic behaviour.

The body of literature is significant which are related to the concept of share pledge and earnings management. Chan *et al.* (2018) concluded that companies with the most pledged controlling shareholders exhibited a greater tendency to manipulate earnings to garner positive market perceptions. The study said that discretionary accounting practices are common in order to inflate stock prices and to minimize the risk of a margin call.

Likewise, the study by Li *et al.* (2019) indicates that highly pledged controlling shareholders are associated with a lower financial reporting quality and higher information asymmetry, suggesting that the pressure arising from pledges may have an impact on financial reporting and disclosure practices of the companies. Similarly, Deng *et al.* (2022) also concluded that companies that have a high degree of share pledging provided lower financial reporting quality and higher information asymmetry. But there are also literature accounts of how governance mechanisms act as a buffer. Rajhans *et al.* (2022) identified that increased institutional ownership cushioned against the detrimental effects of promoter pledging by providing better monitoring and curbing opportunistic behavior. This evidence indicates that the effects of share pledging are influenced greatly by corporate governance structures.

Make certain that you collaborate with Share Pledging, Firm Value and Corporate Risk. Share pledging is one of the most widely studied issues to emerge from the shareholder rights movement, with the effects of the pledging on firm value and corporate risk being two of the most studied. Most research suggests that large pledges on shares are seen as a risk signal of governance problems and financial weakness. Claessens *et al.* (2002) concluded that the agency related ownership structures negatively affected firm value. Building on this conclusion, Regulatory changes in share pledging affected firm valuation in that the reduction of agency problems and increased investor protection resulted in better firm valuation, especially for companies with controlling shareholders according to Wang and Chou (2018). The negative association between promoter pledging and the shareholder wealth was also noted by Chauhan *et al.* (2021) in India. They conclude that in general, a high pledge amount is a sign of financial uncertainty and distress, and it impacts investor confidence.

Share pledging has also been noted as a risk issue in the literature. Cheng *et al.* (2021) found that those companies with very pledged controlling shareholders were more likely to be at risk of having a stock price crash. The authors provide an example of hidden risks that can build up when controlling shareholders delay release of bad news to keep stocks up, and ultimately cause large price drops.

Chang *et al.* (2022) also found that share pledging is associated with the corporate risk-taking behavior and the increase in firm risk. The results suggest that share pledging has an impact on firm value as well as firm stability and riskiness.

Choose the right interpretation of spoken words and strategic corporate choices.

In addition to governance and performance results, share pledging also has an impact on strategic business decisions. There is some evidence that short-term goals may be the more important priority for controlling shareholders under financial pressure because of a pledge.

However, Ouyang *et al.* (2019) discovered that companies with 'highly pledged' controlling shareholders had less investment efficiency. The authors suggested that controlling shareholders may not be willing to undertake long-term projects that may lower short-term earnings or raise uncertainty.

Likewise, Deng *et al.* (2022) revealed that share pledging had an adverse influence on their corporate innovation, because share pledging essentially restricted research and

development investments. Innovation projects are associated with risk and time lagged returns, which may lead controlling shareholders to be attracted to other activities that are more safe and more likely to deliver short-term financial results.

Furthermore, He *et al.* (2022) found that pledged ownership effect had a significant influence on the firms and their decisions and policies, such as conservative investment behaviors. A more recent study by Li *et al.* (2022) showed that the effect of controlling shareholder pledge on CSR performance is negative, which implies that pledge-related pressure can be negative for long-term stakeholder interests.

These results suggest that share pledging has an impact on a wide range of decisions, which may restrict growth potential in the future and hamper the competitiveness of the firm in the long term.

Synthesis of Literature

The literature is unanimous that too much share pledging is linked to a decline in firm performance, a reduction in firm value, an increase in agency conflicts, an increase in earnings management and an increase in corporate risk. While share pledging offers financing advantages, such as increased liquidity and lower financing constraints, it can be found that the governance costs can be outweighed by the benefits of share pledging if there is too much, too intense.

The adverse effects of share pledging can be explained by the theory of agency (Jensen & Meckling, 1976), which becomes dominant. Further, the evidence implies that corporate governance is an important moderating factor, with better corporate governance systems contributing to the amelioration of pledge-related risks. Previous research generally agrees that share pledge has adverse effects, but most of the evidence is limited to emerging markets and more specifically to China. Further research is needed that allows for more comparative study.

Methodology

After going through literature review, methodology used for this study should be described. The methodology presents the methods adopted to identify, select and analyze relevant studies, to draw a systematic, transparent and reliable literature review on the stock pledging-firm performance relationship.

Research Design

The research method used is Systematic Literature Review (SLR) which is used to study the impacts of share pledging on firm performance. A systematic literature review (SLR) is a type of review that systematically and transparently identifies, selects, and synthesizes literature, in contrast to traditional narrative reviews. The SLR contributes to the reliability, objectivity and repeatability of the results, since it reduces selection bias and provides the most extensive coverage of the relevant studies.

This review examines empirical and theoretical research on the link between share pledging and various firm-level outcomes such as firm performance, firm value, corporate governance, earnings management, corporate risk, investment efficiency, innovation, and corporate social responsibility.

Review Protocol

In order to guarantee methodological rigor, the review follows the framework Preferred Reporting Items for Systematic Reviews and Meta-Analyses (PRISMA). The PRISMA approach offers a standardized method for the identification, screening, evaluation and selection of relevant studies. This structure promotes transparency, and future researchers can use it to repeat the review process.

The review process involved four steps: identification, screening, eligibility, and final selection of studies. Defined criteria and procedures were used at each stage to ensure that there was consistency and relevance.

Search Strategy

Major academic databases such as Scopus, Web of Science, Science Direct, Emerald Insight, Springer Link, Wiley Online Library, JSTOR and Google Scholar were used for a comprehensive literature search. The databases chosen are for the reason that they include an extensive range of peer-reviewed publications in finance, accounting and corporate governance.

Various keywords and search strings were used to identify relevant studies. The key words used are: Share Pledging, Equity Pledging, Stock Pledging, Promoter Pledging, Pledged Shares, Share Pledging and Firm Performance, Share Pledging and Corporate Governance, Share Pledging and Firm Value, Share Pledging and Earnings Management, Share Pledging and Corporate Risk. Boolean operators like “AND” and “OR” were employed to narrow down the search and further enhance the relevance of the results. Only studies published in English until 2022 were searched.

Inclusion and Exclusion Criteria

Inclusion and exclusion criteria were developed to guarantee the selection of the studies was of high quality and relevant to the study.

Inclusion Criteria

Studies were eligible to be included if they:

1. Reviewed of controlling shareholders or promoters of the companies share pledging or equity pledging.
2. Exercised analytical skills to examine firm performance or other corporate outcomes.
3. Were published in peer-reviewed journals or in academic venues.
4. Were written in English.
5. Were published, up to 2022.
6. Gave empirical or theoretical evidence related to the objective of the study.

Exclusion Criteria

The studies were excluded if they:

1. Geared towards individual investors, rather than firms.
2. Were news articles, editorials, reports or non-academic publications.
3. Did not directly discuss consequences of share pledging.
4. Were duplicate records.
5. Was lacking in methodological and/or empirical information.

Literature Screening Process

The study had a multi-stage screening protocol. All records were initially collected from the database searches and then any duplicate records were eliminated. The remaining studies were screened by the titles and abstracts, which eliminated irrelevant articles.

Full-text versions of the selected studies were then evaluated to the inclusion/exclusion criteria. The studies included in the final review met all the requirements for inclusion in the study and were subjected to detailed analysis.

The PRISMA screening process is summarized below:

Stage	Number of Studies
Records identified through databases	425
Additional records identified	35
Total records identified	460
Duplicates removed	80
Records screened	380
Records excluded	275
Full-text articles assessed	105
Full-text articles excluded	65
Final studies included in review	40

Data Extraction and Quality Assessment

The selected studies were reviewed systematically to extract information from them. The data collected were the author(s), year of publication, country, research goals, methodology, sample description, and main results.

Selected studies were evaluated in terms of research design, sample size, method and methodological rigor and relevance to the purpose of the study to ensure reliability. Studies published in distinguished peer-reviewed journals with sound empirical techniques were given more weight.

Data Synthesis Technique

The selected studies were analyzed by thematic synthesis. This approach is performed by categorizing studies based on similarities and searching for patterns in the literature. Based on the research objectives, the studies were categorized into five major themes: Share Pledging and Firm Performance, Share Pledging and Corporate Governance, Share Pledging and Earnings Management, Share Pledging, Firm Value and Corporate Risk, Share Pledging and Strategic Corporate Decision. The thematic approach allowed for a holistic understanding of the linkage between share pledging and firm performance, and the identification of areas of inconsistencies, trends and gaps in the existing literature.

Discussion

Based on the literature reviewed, the authors found that share pledging has important implications on firm performance, corporate governance and shareholder wealth. Although share pledging is effective in giving controlling shareholders liquidity without affecting their ownership stake, there is evidence that a high degree of pledging can lead to governance problems that are more severe than the benefits to the shareholders.

Agency conflicts are a recurring theme throughout the literature. In line with Agency Theory (Jensen & Meckling, 1976), it has been claimed that pledged shareholders with controlling power might have a short-term, personal financial agenda which could run counter to the firm's long-term value. According to Kao *et al.* (2004), Deng *et al.* (2022),

and Chauhan *et al.* (2021), a high pledging ratio is typically a signal of poor firm performance and high agency cost. The second lesson is that the benefits of financing and the costs of governance are inextricably linked. Although share pledge can relieve financing constraint faced by controlling shareholders, it is regulatory changes around share pledge that are important to contribute to the firm value and investor protection (Chan *et al.*, 2018; Wang & Chou, 2018). This implies that high pledge ratios are considered to be signs of financial weakness, which can result in lower firm values. The literature also identifies corporate governance as a moderating factor, whereby good governance institutions such as institutional ownership, board independence and effective monitoring can reduce the negative effect of pledged ownership Rajhans *et al.*, 2022). Agency problems are more likely to be controlled in firms that have a strong governance structure and can better maintain investor confidence.

In summary, the evidence indicated that the moderate use of share pledging can lead to financial flexibility while the over reliance on share pledging can have negative impacts on firm performance, firm value and corporate sustainability in the long-term. The results highlight the need for good governance and regulatory supervision to reduce the risks of share pledging.

Conclusion and Implications

The results of this study are based on the review of literature, which covers the impact of share pledging on firm performance. The results reveal that share pledging offers controlling shareholders a way to obtain liquidity without losing ownership and control, but excessive pledging tends to have negative corporate consequences. There is widespread agreement in the literature that high share pledging correlates with increased agency conflicts, weaker corporate governance, earnings management, and lower firm value, higher corporate risk and lower investment efficiency.

The review also highlights the importance of corporate governance in mitigating these impacts. The risk of pledged ownership can be reduced by governance that is more robust, transparent, and with good monitoring.

The results are mostly consistent with Agency Theory on a theoretical level due to the conflicts between controlling and minority shareholders. The findings highlight the need for good pledging management, better disclosure and more robust governance frameworks from a managerial and policy point of view. Share pledging can have positive impact on the short-term financing efficiency of the firm, but too much pledged shares can have negative impact on long-term performance of the firm and shareholder value.

Research Gaps and Future Research Direction

There is a considerable amount of literature on share pledging but it is considered that there are some important research gaps. First, there are a significant amount of previous studies that have been conducted to China alone, which restricts the validity of the results in other emerging and developed markets. The external validity should be improved by future studies on the effects of share pledging in different institutional settings. Secondly, the majority of studies focus on specific measures of outcome (firm value, profitability, corporate risk, etc.). Little focus has so far been placed on combining several aspects of a firm's performance in one model. Further studies may take a more holistic perspective and examine performance measures both from an

accounting and market perspective. Third, there is limited research on the moderating effect of corporate governance mechanisms. Existing literature indicates that institutional ownership and board independence are ways to reduce pledge-related risk, but researchers have yet to gain a better understanding of how the various types of governance affect the link between pledge and firm performance. Last but not least, the share pledging literature has struggled to address some emerging topics like ESG performance, sustainability practices and digital transformation. These need further research to obtain a broader perspective on the long-term effects of pledged ownership.

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