Chapter 76
Role of Institutional Owners in Devising Firms' Risk-Taking Behavior:
Evidence From a Developing Economy

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ABSTRACT

Role of institutional owners is becoming vital regarding strategic decision making in modern day business corporations. Financial institutions are capable to monitor the empowered company insiders and to regulate the capital market positioning of firms due to their specialized expertise and low cost of monitoring the managers. This article is an attempt to investigate the role of institutional owners on firms' risk-taking behavior in an emerging market. By using the sample of 58 non-financial firms listed at Karachi Stock Exchane-100 (KSE-100) index for a period of 2010 to 2017, these results revealed that institutional ownership can influence firms risk taking decisions. This influence depends on type of institutional ownership; passive owners play negative role in risk taking while active owners play a positive role in risk taking. Size of institutional ownership does not matter in risk taking.

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1. INTRODUCTION

Failure of some giant corporations such as WorldCom, Enron, Anderson Global Crossing, Etoys, Merrill Lynch created awareness among investors and corporate regulators regarding the ethical collapse of organizations. These corporate failures astounded the world by their plethora of unethical and unlawful activities and ignited discussions about governance issues in business firms. These corporate failures are attributed to malpractices such as dubious accounting standards, conflict of interest, lucrative compensation management, deceitful operations, power abuses, raw directors, unequal voting rights and free rider problems (Afza & Nazir, 2015). This vulnerability damages economic system and undermine investors return significantly. Moreover, the global financial crisis of 2007-2009 also highlighted several flaws in governance mechanisms regulating the business firms in developed and emerging economics (Akbar et al., 2017).

Corporate governance has a significant impact on strategic business decisions like external financing, risk bearing policies and investment portfolios (Huang et al., 2016; Srivastav & Hagendroff, 2016). Some core ingredients of corporate governance are: responsibilities of board and managers, transparent conduct and accountability, information flow, regulatory and legal environment, and authentic risk management parameters. Implementation of corporate governance is a real task because having rules and regulations is not enough, but implementation is the real milestone to be attained. The amalgam of ethical and legal mechanism to guarantee the business probity proves to be the best remedy of corporate dilemmas. Application of such mechanism comes in various forms of conflicts named as agency conflicts, evoked by (Berle & Means, 1932). Berle and Means (1932) provided evidence to portray such conflicts which are rooted in separation of ownership and control, further refined by Jensen and Meckling (1976) into Agency Theory. These conflicts can arise among shareholders and managers, minority shareholders and large shareholders, managers and debt holders as well so they can be of any nature.

Corporate risk-taking has been a topic of research since last many decades and it is a well-recognized issue. As investors take a high risk to earn more profits, whereas this same kind of trade-off exists at firm level. Managers should invest in those projects which have high idiosyncratic risk to maximize the shareholders wealth in corroboration of "High risk - High return", but reality is very different where managers are hesitant to invest in risky projects to safeguard their personal interests and their risk averse nature (Fama, 1980). Shareholders have options to diversify away the firm specific risk, but managers do not want that, and they even gave up risky but rewarding projects due to their conservative underinvestment approach. The first preference of the managers is their personal wellbeing as compared to the firm profits, continuing with this behavior, their decision-making is in personal favor by lowering down the firm's risk profile and also decreasing shareholders wealth (May, 1995; Holmstrom, 1999). According to Bertrand and Mullainathan (2003) whenever there is an opportunity to take risk, managers always go for less risk. On the similar lines, Amihud and Lev (1981) purposed that sometimes managers support unrelated mergers to lower the risk related to human capital, but such mergers are precarious for corporate health and devastate shareholders wealth.

However, In the corporate governance context ownership structure plays a vital role in shaping up risk-taking behavior of firms. It is an effective mechanism to monitor the risk-taking decisions of the firms and help in reducing agency conflicts between managers and shareholders (Barbosa & Louri, 2002). According to agency theory, managers are conventionally risk-averse, and they prefer their job security over not opting for risky but rewarding projects leading to underinvestment (Akbar et al., 2017). Presence of institutional shareholders with large equity stakes can be a powerful source to constrain detrimental

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