Report on Corporate Governance

"...Fundamental objective of corporate governance is the enhancement of the long-term shareholder value while at the same time protecting the interests of other stakeholders."

While recent high-profile corporate governance failures in developed countries have brought the subject to media attention, the issue has always been central to finance and economics. The issue is particularly important for developing countries since it is central to financial and economic development. Recent research has established that financial development is largely dependent on investor protection in a country – *de jure* and *de facto*. With the legacy of the English legal system, India has one of the best corporate governance laws but poor implementation together with socialistic policies of the pre reform era has affected corporate governance. Concentrated ownership of shares, pyramiding and tunneling of funds among group companies mark the Indian corporate landscape. Boards of directors have frequently been silent spectators with the DFI nominee directors unable or unwilling to carry out their monitoring functions. Since liberalization, however, serious efforts have been directed at overhauling the system with the SEBI instituting the Clause 49 of the Listing Agreements dealing with corporate governance. Corporate governance of Indian banks is also undergoing a process of change with a move towards more market-based governance.

Corporate Governance in India – Evolution and Challenges

Introduction

The subject of corporate governance leapt to global business limelight from relative obscurity after a string of collapses of high profile companies. Enron, the Houston, Texas based energy giant, and WorldCom, the telecom behemoth, shocked the business world with both the scale and age of their unethical and illegal operations. Worse, they seemed to indicate only the tip of a dangerous iceberg. While corporate practices in the US companies came under attack, it appeared that the problem was far more widespread. Large and trusted companies from Parmal at in Italy to the multinational newspaper group Hollinger Inc., revealed significant and deep-rooted problems in their corporate governance. Even the prestigious New York Stock Exchange had to remove its director, Dick Grasso, amidst public outcry over excessive compensation. It was clear that something was amiss in the area of corporate governance all over the world. Corporate governance has, of course, been an important field of query within the finance discipline for decades. Researchers in finance have actively investigated the topic for at least a quarter century[1] and the father of modern economics, Adam Smith, himself had recognized the problem over two centuries ago. There have been debates about whether the Anglo-Saxon market- model of corporate governance is better than the bank based models of Germany and Japan. However, the differences in the quality of corporate governance in these developed countries fade in comparison to the chasm that exists between corporate governance standards and practices in these countries as a group and those in the developing world. Corporate governance has been a central issue in

developing countries long before the recent spate of corporate scandals in advanced economies made headlines. Indeed corporate governance and economic development are intrinsically linked. Effective corporate governance systems promote the development of strong financial systems irrespective of whether they are largely bank-based or market-based – which, in turn, have an unmistakably positive effect on economic growth and poverty reduction. There are several channels through which the causality works. Effective corporate governance enhances access to external financing by firms, leading to greater investment, as well as higher growth and employment. The proportion of private credit to GDP in countries in the highest quartile of creditor right enactment and enforcement is more than double that in the countries in the lowest quartile.[4] As for equity financing, the ratio of stock market capitalization to GDP in the countries in the highest quartile of shareholder right enactment and enforcement is about *four* times as large as that for countries in the lowest quartile. Poor corporate governance also hinders the creation and development of new firms.

Good corporate governance also lowers of the cost of capital by reducing risk and creates higher firm valuation once again boosting real investments.[5] There is a variation of a factor of 8 in the "control premium" (transaction price of shares in block transfers signifying control transfer less the ordinary share price) between countries with the highest level of equity rights protection and those with the lowest. Effective corporate governance mechanisms ensure better resource allocation and management raising the return to capital. The return on assets (ROA) is about twice as high in the countries with the highest level of equity rights protection as in countries with the lowest protection. [7] Good corporate governance can significantly reduce the risk of nation-wide financial crises. There is a strong inverse relationship between the quality of corporate governance and currency depreciation. [8] Indeed poor transparency and corporate governance norms are believed to be the key reasons behind the Asian Crisis of 1997. Such financial crises have massive economic and social costs and can set a country several years back in its path to development. Finally, good corporate governance can remove mistrust between different stakeholders, reduce legal costs and improve social and labor relationships and external economies like environmental protection. Making sure that the managers actually act on behalf of the owners of the company – the stockholders – and pass on the profits to them are the key issues in corporate governance. Limited liability and dispersed ownership – essential features that the joint-stock company form of organization thrives on – inevitably lead to a distance and inefficient monitoring of management by the actual owners of the business. Managers enjoy actual control of business and may not serve in the best interests of the shareholders. These potential problems of corporate governance are universal. In addition, the Indian financial sector is marked with a relatively unsophisticated equity market vulnerable to manipulation and with rudimentary analyst activity; a dominance of family firms; a history of managing agency system; and a generally high level of corruption. All these features make corporate governance a particularly important issue in India.

Central issues in Corporate Governance

The basic power structure of the joint-stock company form of business, in principle, is as follows. The numerous shareholders who contribute to the capital of the company are the actual owners of business. They elect a Board of Directors to monitor the running of the company on their behalf. The Board, in turn, appoints a team of managers who actually handle the day-to-day functioning of the company and report periodically to the Board. Thus mangers are the agents of shareholders and function with the objective of maximizing shareholders' wealth. Even if this power pattern held in reality, it would still be a challenge for the Board to effectively monitor management. The central issue is the nature of the contract between shareholder representatives and managers telling the latter what to do with the funds contributed by the former. The main challenge comes from the fact that such contracts are necessarily "incomplete". It is not possible for the Board to fully instruct management on the desired course of action under every possible business situation. The list of possible situations is infinitely long. Consequently, no contract can be written between representatives of shareholders and the management that specifies the right course of action in every situation, so that the management can be held for violation of such a contract in the event it does something else under the circumstances. Because of this "incomplete contracts" situation, some "residual powers" over the funds of the company must be vested with either the financiers or the management. Clearly the former does not have the expertise or the inclination to run the business in the situations unspecified in the contract, so these residual powers must go to management. The efficient limits to these powers constitute much of the subject of corporate governance. The reality is even more complicated and biased in favor of management. In real life, managers wield an enormous amount of power in joint-stock companies and the common shareholder has very little say in the way his or her money is used in the company. In companies with highly dispersed ownership, the manager (the CEO in the American setting, the Managing Director in British-style organizations) functions with negligible accountability. Most shareholders do not care to attend the General Meetings to elect or change the Board of Directors and often grant their "proxies" to the management. Even those that attend the meeting find it difficult to have a say in the selection of directors as only the management gets to propose a slate of directors for voting. On his part the CEO frequently packs the board with his friends and allies who rarely differ with him. Often the CEO himself is the Chairman of the Board of Directors as well. Consequently the supervisory role of the Board is often severely compromised and the management, who really has the keys to the business, can potentially use corporate resources to further their own self- interests rather than the interests of the shareholders. The inefficacy of the Board of Directors in monitoring the activities of management is particularly marked in the Anglo-Saxon corporate structure where real monitoring is expected to come from financial markets. The underlying premise is that shareholders dissatisfied with a particular management would simply dispose of their shares in the company. As this would drive down the share price, the company would become a takeover target. If and when the acquisition actually happens, the acquiring company would get rid of the existing management. It is thus the fear of a takeover rather than shareholder action that is supposed to keep the management honest and on its toes. This mechanism, however, presupposes the existence of a deep and liquid stock market with considerable

informational efficiency as well as a legal and financial system conducive to M&A activity. More often than not, these features do not exist in developing countries like India. An alternative corporate governance model is that provided by the bank-based economies like Germany where the main bank ("Hausbank" in Germany) lending to the company exerts considerable influence and carries out continuous project-level supervision of the management and the supervisory board has representatives of multiple stakeholders of the firm. Box 1 gives a brief comparison of the two systems Common areas of management action that may be sub-optimal or contrary to shareholders' interests (other than outright stealing) involve excessive executive compensation; transfer pricing, that is transacting with privately owned companies at other-than- market rates to siphon off funds; managerial entrenchment (i.e. managers resisting replacement by a superior management) and sub-optimal use of free cash flows. This last refers to the use that managers put the retained earnings of the company. In the absence of profitable investment opportunities, these funds are frequently squandered on questionable empire-building investments and acquisitions when their best use is to be returned to the shareholders.

Legal environment, ownership patterns and Corporate Governance

The legal system of a country plays a crucial role in creating an effective corporate governance mechanism in a country and protecting the rights of investors and creditors. The legal environment encompasses two important aspects – the protection offered in the laws (*de jure* protection) and to what extent the laws are enforced in real life (*de facto* protection). Both these aspects play important roles in determining the nature of corporate governance in the country in question. Recent research has forcefully connected the origins of the legal system of a country to the very structure of its financial and economic architecture arguing that the connection works through the protection given to external financiers of companies – creditors and shareholders.[11] Legal systems in most countries have their roots in one of the four distinct legal systems – the English common law, French civil law, German civil law and Scandinavian civil law. The Indian legal system is obviously built on the English common law system. The Rule of law index is another story. Here the Scandinavian-origin countries have an average score of 10 – the maximum possible – followed by the German-origin countries (8.68), English-origin countries (6.46) and French-origin countries (6.05). The primary difference between the legal systems in advanced countries and those in developing countries lies in enforcement rather than in the nature of laws- in books. Enforcement of laws play a much more important role than the quality of the laws on books in determining events like CEO turnover and developing security markets by eliminating insider trading.[12] In an environment marked by weak enforcement of property rights and contracts, entrepreneurs and managers find it difficult to signal their commitment to the potential investors, leading to limited external financing and ownership concentration. This particularly hurts the development of new firms and the small and medium enterprises (SMEs). In such a situation many of the standard methods of corporate governance – market for corporate controls, board activity, proxy fights and executive compensation – lose their effectiveness. Large block-holding emerges as the most important corporate governance

mechanism with some potential roles for bank monitoring, shareholder activism, employee monitoring and social control.
Apart from the universal features of corporate governance, Asian economies as a group share certain common features that affect the nature of corporate governance in the region.

Corporate Governance in India – a background

The history of the development of Indian corporate laws has been marked by interesting contrasts. At independence, India inherited one of the world's poorest economies but one which had a factory sector accounting for a tenth of the national product; four functioning stock markets (predating the Tokyo Stock Exchange) with clearly defined rules governing listing, trading and settlements; a well-developed equity culture if only among the urban rich; and a banking system replete with well-developed lending norms and recovery procedures.[24] In terms of corporate laws and financial system, therefore, India emerged far better endowed than most other colonies. The 1956 Companies Act as well as other laws governing the functioning of joint-stock companies and protecting the investors' rights built on this foundation. The beginning of corporate developments in India were marked by the managing agency system that contributed to the birth of dispersed equity ownership but also gave rise to the practice of management enjoying control rights disproportionately greater than their stock ownership. The turn towards socialism in the decades after independence marked by the 1951 Industries (Development and Regulation) Act as well as the 1956 Industrial Policy Resolution put in place a regime and culture of licensing, protection and widespread red-tape that bred corruption and stilted the growth of the corporate sector. The situation grew from bad to worse in the following decades and corruption, nepotism and inefficiency became the hallmarks of the Indian corporate sector. Exorbitant tax rates encouraged creative accounting practices and complicated emolument structures to beat the system. In the absence of a developed stock market, the three all-India development finance institutions (DFIs)– the Industrial Finance Corporation of India, the Industrial Development Bank of India and the Industrial Credit and Investment Corporation of India,– together with the state financial corporations became the main providers of long-term credit to companies. Along with the government owned mutual fund, the Unit Trust of India, they also held large blocks of shares in the companies they lent to and invariably had representations in their boards. In this respect, the corporate governance system resembled the bank-based German model where these institutions could have played a big role in keeping their clients on the right track. Unfortunately, they were themselves evaluated on the quantity rather than quality of their lending and thus had little incentive for either proper credit appraisal or effective follow-up and monitoring. Their nominee directors routinely served as rubber-stamps of the management of the day. With their support, promoters of businesses in India could actually enjoy managerial control with very little equity investment of their own. Borrowers therefore routinely recouped their investment in a short period and then had little incentive to either repay the loans or run the business. Frequently they bled the

company with impunity, siphoning off funds with the DFI nominee directors mute spectators in their boards.

Changes since liberalization

The years since liberalization have witnessed wide-ranging changes in both laws and regulations driving corporate governance as well as general consciousness about it Perhaps the single most important development in the field of corporate governance and investor protection in India has been the establishment of the Securities and Exchange Board of India (SEBI) in 1992 and its gradual empowerment since then. Established primarily to regulate and monitor stock trading, it has played a crucial role in establishing the basic minimum ground rules of corporate conduct in the country. Concerns about corporate governance in India were, however, largely triggered by a spate of crises in the early 90's – the Harshad Mehta stock market scam of 1992 followed by incidents of companies allotting preferential shares to their promoters at deeply discounted prices as well as those of companies simply disappearing with investors' money. These concerns about corporate governance stemming from the corporate scandals as well as opening up to the forces of competition and globalization gave rise to several investigations into the ways to fix the corporate governance situation in India. One of the first among such endeavors was the CII Code for Desirable Corporate Governance developed by a committee chaired by Rahul Bajaj. The committee was formed in 1996 and submitted its code in April 1998. Later SEBI constituted two committees to look into the issue of corporate governance – the first chaired by Kumar Mangalam Birla that submitted its report in early 2000 and the second by Narayana Murthy three years later. Table 1 provides a comparative view of the recommendations of these important efforts at improving corporate governance in India. The SEBI committee recommendations have had the maximum impact on changing the corporate governance situation in India. The Advisory Group on Corporate Governance of RBI's Standing Committee on International Financial Standards and Codes also submitted its own recommendations in 2001.

Corporate Governance of Banks

Nowhere is proper corporate governance more crucial than for banks and financial institutions. Given the pivotal role that banks play in the financial and economic system of a developing country, bank failure owing to unethical or incompetent management action poses a threat not just to the shareholders but to the depositing public and the economy at large. Two main features set banks apart from other business – the level of opaqueness in their functioning and the relatively greater role of government and regulatory agencies in their activities. The opaqueness in banking creates considerable information asymmetries between the "insiders" – management – and "outsiders" – owners and creditors. The very nature of the business makes it extremely easy and tempting for management to alter the risk profile of banks as well as siphon off funds. It is, therefore, much more difficult for the owners to effectively monitor the functioning of bank management. Existence of explicit or implicit deposit insurance also reduces the

interest of depositors in monitoring bank management activities. It is partly for these reasons that prudential norms of banking and close monitoring by the central bank of commercial bank activities are essential for smooth functioning of the banking sector. Government control or monitoring of banks, on the other hand, brings in its wake, the possibility of corruption and diversion of credit of political purposes which may, in the long run, jeopardize the financial health of the bank as well as the economy itself. The reforms have marked a shift from hands-on government control interference to market forces as the dominant paradigm of corporate governance in Indian banks. Competition has been encouraged with the issue of licenses to new private banks and more power and flexibility have been granted to the bank management both in directing credit as well as in setting prices. The RBI has moved to a model of governance by prudential norms rather from that of direct interference, even allowing debate about appropriateness of specific regulations among banks. Along with these changes, market institutions have been strengthened by government with attempts to infuse greater transparency and liquidity in markets for government securities and other asset markets. This market orientation of governance disciplining in banking has been accompanied by a stronger disclosure norms and stress on periodic RBI surveillance. From 1994, the Board for Financial Supervision (BFS) inspects and monitors banks using the "CAMELS" (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and controls) approach. Audit committees in banks have been stipulated since 1995. Greater independence of public sector banks has also been a key feature of the reforms. Nominee directors – from government as well as RBIs – are being gradually phased off with a stress on Boards being more often elected than "appointed from above". There is increasing emphasis on greater professional representation on bank boards with the expectation that the boards will have the authority and competence to properly manage the banks within the broad prudential norms set by RBI. Rules like no lending to companies who have one or more of a bank's directors on their boards are being softened or removed altogether, thus allowing for "related party" transactions for banks. The need for professional advice in the election of executive directors is increasingly realized. As for old private banks, concentrated ownership remains a widespread characteristic, limiting the possibilities of professional excellence and opening the possibility of misdirecting credit. Corporate governance in co-operative banks and NBFCs perhaps need the greatest attention from regulators. Rural co-operative banks are frequently run by politically powerful families as their personal fiefdoms with little professional involvement and considerable channeling of credit to family businesses. It is generally believed that the "new" private banks have better and more professional corporate governance systems in place. However, the recent collapse of the Global Trust Bank has seriously challenged that view and spurred serious thinking on the topic.

Conclusions

With the recent spate of corporate scandals and the subsequent interest in corporate governance, a plethora of corporate governance norms and standards have sprouted around the globe. The Sarbanes-Oxley legislation in the USA, the Cadbury Committee recommendations for European companies and the OECD principles of corporate governance are perhaps the best known among these. But developing countries have not

fallen behind either. Well over a hundred different codes and norms have been identified in recent surveys [28] and their number is steadily increasing. India has been no exception to the rule. Several committees and groups have looked into this issue that undoubtedly deserves all the attention it can get. In the last few years the thinking on the topic in India has gradually crystallized into the development of norms for listed companies. The problem for private companies, that form a vast majority of Indian corporate entities, remains largely unaddressed. The agency problem is likely to be less marked there as ownership and control are generally not separated. Minority shareholder exploitation, ho wever, can very well be an important issue in many cases. Development of norms and guidelines are an important first step in a serious effort to improve corporate governance. The bigger challenge in India, however, lies in the proper implementation of those rules at the ground level. More and more it appears that outside agencies like analysts and stock markets (particularly foreign markets for companies making GDR issues) have the most influence on the actions of managers in the leading companies of the country. But their influence is restricted to the few top (albeit largest) companies. More needs to be done to ensure adequate corporate governance in the *average* Indian company. Even the most prudent norms can be hoodwinked in a system plagued with widespread corruption. Nevertheless, with industry organizations and chambers of commerce themselves pushing for an improved corporate governance system, the future of corporate governance in India promises to be distinctly better than the past.