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A COMPARATIVE ANALYSIS UPON VARIOUS DEVELOPMENTS IN CORPORATE GOVERNANCE IN INDIA: EVOLUTION AND CHALLENGES

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A Comparative Analysis upon Various Developments in Corporate Governance in India: Evolution and Challenges

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Abstract – The nascent debate on corporate governance in India has tended to draw heavily on the large Anglo-American literature on the subject. This paper argues however that the corporate governance problems in India are very different. The governance issue in the US or the UK is essentially that of disciplining the management who have ceased to be effectively accountable to the owners. The problem in the Indian corporate sector (be it the public sector, the multinationals or the Indian private sector) is that of disciplining the dominant shareholder and protecting the minority shareholders. Clearly, the problem of corporate governance abuses by the dominant shareholder can be solved only by forces outside the company itself. The paper discusses the role of two such forces - the regulator and the capital market.

Good governance means that processes and institutions produce results that meet the needs of society while making the best use of resources at their disposal. Good corporate governance (GCG) is a mandatory requirement in today's corporate world by every stakeholder groups.

It is useful at this point to take a closer look at corporate governance abuses by dominant shareholders in India. The problem of the dominant shareholder arises in three large categories of Indian companies. First are the public sector units (PSUs) where the government is the dominant (in fact, majority) shareholder and the general public holds a minority stake (often as little as 20%). Second are the multi-national companies (MNCs) where the foreign parent is the dominant (in most cases, majority) shareholder. Third are the Indian business groups where the promoters (together with their friends and relatives) are the dominant shareholders with large minority stakes, government owned financial institutions hold a comparable stake, and the balance is held by the general public.

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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 Parmalat 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 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 bankbased 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.

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.

HISTORICAL PERSPECTIVE

At the time of Independence in 1947, India had functioning stock markets, an active manufacturing sector, a fairly developed banking sector, and also a comparatively well-developed British-derived convention of corporate practices. From 1947 through 1991, the Indian Government pursued markedly socialist policies when the State nationalized most banks and became the principal provider of both debt and equity capital for private firms.

The government agencies that provided capital to private firms were evaluated on the basis of the amount of capital invested rather than on their returns on investment. Competition, especially foreign competition, was suppressed. Private providers of debt and equity capital faced serious obstacles in exercising oversight over managers due to long delays in judicial proceedings and difficulty in enforcing claims in bankruptcy.

Public equity offerings could be made only at government-set prices. Public companies in India were only required to comply with limited governance and disclosure standards enumerated in the Companies Act of 1956, the Listing Agreement, and the accounting standards set forth by the Institute of Chartered Accountants of India (ICAI).

Faced with a fiscal crisis in 1991, the Indian Government responded by enacting a series of reforms aimed at general economic liberalization. The Securities and Exchange Board of India (SEBI)—India's securities market regulator—was formed in 1992, and by the mid-1990s, the Indian economy was growing steadily, and Indian firms had begun to seek equity capital to finance expansion into the market spaces created by liberalization and the growth of outsourcing.

The need for capital, amongst other things, led to corporate governance reform and many major corporate governance initiatives were launched in India since the mid-1990s; most of these initiatives were focused on improving the governance climate in corporate India, which, at that time, was somewhat rudimentary.

CORPORATE GOVERNANCE INITIATIVES IN INDIA

Soon after independence, India, like most underdeveloped economies, was caught in a low-income-level trap, which occurred at low levels of physical capital, both productive and infrastructural, and was maintained by low levels of accumulation and by Malthusian population growth. That implied a powerful case for government activism as a way of breaking out of the trap. Accordingly, the Government of India adopted a model of economic development that could be best described as “mixed economy”. The state operated from the “commanding heights” and aimed at the highest level of socio-economic good for the largest number. This development paradigm, a “big push” of sorts, accorded a strategic position to the public sector in the economy. It was in line with the first Industrial Policy Resolution of 1956 which sought to achieve a self-reliant economic and social growth. The private sector was also encouraged to prosper, but played second fiddle to the public sector. It was the policy of mixed economy that initiated the creation of large number of SOEs. The policy was to address the aspiration of a new nation towards quick industrialization. The basic argument has been that Indian industrialization has to be anchored on the core sectors that were highly capital intensive with long gestation periods. Since the private sector of the nascent economy was not strong enough to invest in such sectors, state initiative was imperative. Later, the policy got mixed up with trade union pressure for nationalization of many enterprises. By the last decade of the last century SOEs in India were spread over from core sectors like steel, power, and machinery to many consumer goods that included even bakery products. The reversal of fortunes for SOEs occurred in the eighties, which saw a gradual opening up of the

Indian economy. But it was in 1991 when the Government of India decided to give a further impetus to accelerate the process of liberalization and opening up of the economy, which boosted the chances of private enterprises. Yet, according to Nair, although India‘s growth accelerated, this performance could not be sustained in later years. The average growth rate during the five-year period 1997-02 was only 5.4 percent as against the targeted 6.5 percent. However, economic growth rate picked up later, to more than 8 percent during the years 2004-05 and was expected to slow down to around 6.5 percent beginning 2006. The erratic economic behavior suggested that the reform was not simply about "getting the price right" but "getting the institutions right".

Realizing that good governance plays a crucial role in developing an efficient economy, the Indian government embarked on a course that put emphasis on corporate behavior. A 2004 study of the World Bank recognized this effort and acknowledged a marked improvement in corporate governance in India (Economic Times, 16 May 2005). Several major corporate governance initiatives have been launched in India since the mid-nineties. The first was by the Confederation of Indian Industries (CII), India‘s largest industry and business association, which came up with the first voluntary Code of Corporate Governance in 1998. The confederation was driven by the conviction that good corporate governance was essential for Indian companies to access domestic as well as global capital at competitive rates. The code focused on listed companies. While this code was well received and some progressive companies adopted it, it was felt that under Indian conditions a statutory rather than a voluntary code would be more purposeful. Consequently, the second major initiative in the country was undertaken by the Securities and Exchange Board of India (SEBI) which envisaged that corporate norms would be enforced through listing agreements between companies and the stock exchanges. In early 2000, the SEBI board incorporated new regulations into Clause 49 of the Listing Agreement of the Stock Exchanges. This clause has been further revised in 2002, and again, in 2004. Clause 49 lays down guidelines for composition of the board including the number and qualities of independent directors, remuneration of board members, code of conduct, and the constitution of various committees (including audit), disclosures, and suggested contents of annual reports.

RECENT DEVELOPMENTS IN CORPORATE GOVERNANCE IN INDIA

Liberalization of the Indian economy began in 1991. Since then, we have witnessed wide-ranging changes in both laws and regulations, and a major positive transformation of the corporate sector and the corporate governance landscape. 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 in 1992 and its gradual and growing 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 1990‘s—particularly 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, coupled with a perceived need of opening up the corporate sector to the forces of competition and globalization, gave rise to several investigations into ways to fix the corporate governance situation in India. One of the first such endeavors was the Confederation of Indian Industry Code for Desirable Corporate Governance, developed by a committee chaired by Rahul Bajaj, a leading industrial magnate. The committee was formed in 1996 and submitted its code in April 1998. Later the SEBI constituted two committees to look into the issue of corporate governance--the first chaired by Kumar Mangalam Birla, another leading industrial magnate, and the second by Narayana Murthy, one of the major architects of the Indian IT outsourcing success story. The first Committee submitted its report in early 2000, and the second three years later. These two committees have been instrumental in bringing about far reaching changes in corporate governance in India through the formulation of Clause 49 of Listing Agreements.

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.

One way to solve the corporate governance problem is to align the interests of the managers with that of the shareholders. The recent rise in stock and option related compensation for top managers in companies around the world is a reflection of this effort. A more traditional manifestation of this idea is the fact that family business empires are usually headed by a family member. Managerial ownership of corporate equity, however, has interesting implications for firm value. As managerial ownership (as a percentage of total shares) keeps on rising, firm value is seen to increase for a while (till ownership reaches about 5% for Fortune 500 companies), then falling for a while (when the ownership is in the 5%-25% range, again for Fortune 500 companies) till it begins to rise again. The rationale for the decline in the intermediate range is that in that range, managers own enough to ensure that they keep their jobs come what may and can also find ways to make more money through uses of corporate funds that are sub-optimal for shareholders.

PUBLIC SECTOR UNITS (PSUS)

The governance structures of PSUs date back to the days when they were typically wholly owned by the government and were merely an extended arm of the state. These structures allowed the administrative departments in the concerned ministry to exercise virtually complete control over the functioning of these enterprises. It is now evident that these structures are incompatible with the efficient and successful operation of the PSUs in an increasingly competitive and deregulated economy. These issues are discussed extensively elsewhere in this volume (Vittal, 1997), and I shall not go into them again here.

It is interesting however to observe how totally irrelevant the Board really is in the governance of the PSUs today. The Board has no role to play in any of the areas where US and UK reformers have sought to strengthen the Board. The Board has very little say in the selection of the CEO or in the composition of the Board. The government as the majority shareholder takes these decisions through the concerned ministry with the help of the Public Enterprises Selection Board. The Board cannot fire the CEO nor can it vary his compensation package. As far as audit is concerned, again the dominant role is that of the Comptroller and Auditor General (CAG). There is very little that an Audit Committee could add to what the CAG does. In many PSUs, the Board may still be powerful on paper because the delegation of financial and operating powers to the CEO is very limited. Many operating decisions have to be brought to the Board for decision making. This does not however make for an effective Board because it pushes the Board into "managing" rather than "directing". As discussed elsewhere in this volume (Balasubramaniam, 1997), there is a clear difference between directing and managing, and the Board's legitimate function is directing. The current governance structure allows the Board to play a highly obstructive role if it chooses by opposing the CEO on operational matters. What it does not allow the Board to do is to play a meaningful strategic role since all strategic decisions are taken by the dominant shareholder through the concerned ministry.

MULTI NATIONAL CORPORATIONS (MNCS)

Government regulations have required most MNCs in India to operate through subsidiaries which are not 100% owned by the parent. In the 70s, the government enacted a law limiting foreign ownership in most industries to 40% while allowing 51% in a few high technology areas. This law was liberalized in the 90s and now 51% is permitted in most industries while 74% or even 100% ownership is allowed in some cases. These regulations have created severe corporate governance problems in several key areas as may be seen from the examples below. In the 70s, MNCs were forced to issue shares to the Indian public to comply with the law. The controls that then existed on pricing of public issues meant that these issues were at substantial discounts to the market price. In the 90s when the law permitted higher foreign ownership, these MNCs raised the foreign stake by issuing shares at very deep discounts to the market price. This obviously meant a large loss to the minority shareholders. One particular case where shares were issued to the parent at less than one-tenth the market price was analysed in detail by Barua and Varma (1993a and 1993b). They calculated that the net gain to the foreign parent after compensating for the loss that it suffered in the 70s (together with interest thereon at market rates of interest) amounted to over $200 million. This and other similar share issues by MNCs were made with the explicit consent of the shareholders in general meeting. The parent companies with their dominant shareholding were able to get the resolutions passed with impressive majorities. In fact when the government introduced regulations to prevent such preferential issues, the MNCs protested against what they called an assault on "shareholder democracy".

INDIAN BUSINESS GROUPS

The situation in this category of companies is more complex than in the PSUs and the MNCs where there are clearly defined dominant shareholders. In the Indian business groups, the concept of dominant shareholders is more amorphous for two reasons. First, the promoters'

shareholding is spread across several friends and relatives as well as corporate entities. It is sometimes difficult to establish the total effective holding of this group. Second, the aggregate holding of all these entities taken together is typically well below a majority stake. In many cases, the promoter may not even be the largest single shareholder. What makes the promoters the dominant shareholders is that a large chunk of the shares is held by state owned financial institutions which have historically played a passive role. So passive have they been that in the few cases where they did become involved in corporate governance issues, they were widely seen as acting at the behest of their political masters and not in pursuance of their financial interests. So long as the financial institutions play a passive role, the promoters are effectively dominant shareholders and are able to get general body approval for all their actions.

CONCLUSION

This paper has argued that structural characteristics of the Indian corporate sector make the corporate governance problems in India very different from that in say the US or the UK. The governance issue in the US or the UK is essentially that of disciplining the management who have ceased to be effectively accountable to the owners. The solution has been to improve the functioning of vital organs of the company like the board of directors. The problem in the Indian corporate sector (be it the public sector, the multinationals or the Indian private sector) is that of disciplining the dominant shareholder and protecting the minority shareholders. A board which is accountable to the owners would only be one which is accountable to the dominant shareholder; it would not make the governance problem any easier to solve. Clearly, the problem of corporate governance abuses by the dominant shareholder can be solved only by forces outside the company itself. This paper has discussed the role of two such forces – the regulator (the company law administration as well as the securities regulator) and the capital market.

Corporate governance abuses perpetrated by a dominant shareholder pose a difficult regulatory dilemma in that regulatory intervention would often imply a micro-management of routine business decisions. The regulator is forced to confine himself to broad proscriptions which leave little room for discretionary action. Many corporate governance problems are illsuited to this style of regulation.

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