

Corporate Governance in India – Evolution and Challenges

Rajesh Chakrabarti

College of Management, Georgia Tech

800 West Peachtree Street,

Atlanta GA 30332, USA

Tel: 404-894-5109

Fax: 404-894-6030

E-mail: rajesh.chakrabarti@mgt.gatech.edu

Abstract:

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

I. 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 century¹ 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

¹ Starting from the seminal “agency problem” paper of Jensen and Meckling (1976).

between corporate governance standards and practices in these countries as a group and those in the developing world.²

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.³

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

² See Shleifer and Vishny (1997).

³ See Claessens (2003)

⁴ See La Porta *et al* (1997)

⁵ La Porta *et al* (2000)

signifying control transfer less the ordinary share price) between countries with the highest level of equity rights protection and those with the lowest.⁶

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

⁶ Dyck and Zingales (2000)

⁷ Claessens (2003)

⁸ Johnson *et al* (2000)

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.

2. 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 managers 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.⁹ 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

⁹ Shleifer and Vishny (1997)

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.

[Box 1 about here]

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.

Keeping a professional management in line is only one, though perhaps the most important, of the issues in corporate governance. Essentially corporate governance deals with effective safeguarding of the investors' and creditors' rights and these rights can be threatened in several other ways. For instance, family businesses and corporate groups are common in many countries including India. These range from *Keiretsus* in Japan and *Chaebols* in Korea to the several family business groups in India like Birlas and Ambanis. Inter-locking and "pyramiding" of corporate control within these groups make it difficult for outsiders to track the business realities of individual companies in these behemoths. In addition, managerial control of these businesses are often in the hands of a small group of people, commonly a family, who either own the majority stake, or maintain control through the aid of other block holders like financial institutions. Their own interests, even when they are the majority shareholders, need not coincide with those of the other – minority – shareholders. This often leads to expropriation of minority shareholder value through actions like "tunneling" of corporate gains or funds to other corporate entities within the group. Such violations of minority shareholders' rights also comprise an important issue for 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.¹⁰ 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.

3. 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

¹⁰ Morck *et al* (1988)

¹¹ See the path-breaking set of papers, La Porta *et al* (1997-2002)

law and Scandinavian civil law. The Indian legal system is obviously built on the English common law system. Researchers have used two indices for all these countries – a *shareholder rights index* ranging from 0 (lowest) to 6 (highest) and a *rule of law index* ranging 0 (lowest) to 10 (highest) – to measure the effective protection of shareholder rights provided in the different countries studied. The first index captures the extent to which the written law protected shareholders while the latter reflects to what extent the law is enforced in reality.

The English common law countries lead the four systems in the shareholder rights index with an average of 4 (out of a maximum possible 6) followed by Scandinavian-origin countries with an average score of 3 with the French-origin and German-origin countries coming last with average scores of 2.33 each. Thus, English-origin legal systems provide the best protection to shareholder rights. India, for instance has a shareholder rights index of 5, highest in the sample examined – equal to that of the USA, UK, Canada, Hong Kong, Pakistan and South Africa (all English-origin-law countries) and better than all the other 42 countries in the study including countries like France, Germany, Japan and Switzerland.

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). Most advanced countries have very high scores on this index while developing countries typically have low scores. India, for instance has a score of 4.17 on this index – ranking 41st out of 49 countries studied – ahead only of Nigeria, Sri Lanka, Pakistan, Zimbabwe, Colombia, Indonesia, Peru and Philippines. Thus it appears that Indian laws provide great

protection of shareholders' rights on paper while the application and enforcement of those laws are lamentable.

This difference in protection of shareholders' rights has led to completely different trajectories of financial and economic developments in the different countries. The English-origin systems spawn the highest number of firms per capita (on average 35.45 companies per million citizens as compared to 27.26 for Scandinavian-origin countries and 16.79 and 10.00 for German and French-origin countries respectively). They are also the best performers in mobilizing external finance. The ratio of the stock market capitalization held by minority shareholders (i.e. shareholders other than the three largest shareholders in each company) to the GNP of a country averages a remarkable 0.60 for the English-origin countries, substantially higher than the average ratio for German, Scandinavian and French-origin countries of 0.46, 0.30 and 0.21 respectively. India has 7.79 companies per million citizens, one of the lowest for English-origin countries but higher than many French-origin countries and Germany. As for the ratio of external capital to GNP, India has a score of 0.31 which puts it in the upper half of the sample.

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

¹² See Berglof and Claessens (2004)

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. In spite of their substantial variation in economic conditions and politico-legal backgrounds, most Asian countries are marked with concentrated stock ownership and a preponderance of family-controlled businesses while state-controlled enterprises form an important segment of the corporate sector in many of these countries. Corporate governance issues have been of critical importance in Asian countries particularly since the Asian crisis which is believed to have been partly caused by lack of transparency and poor corporate governance in East Asian countries.¹³

Research has established the evidence of pyramiding and family control of businesses in Asian countries, particularly East Asia, though this feature is prevalent in India as well. Even in 2002, the average shareholding of promoters in all Indian companies was as high as 48.1%.¹⁴ It is believed that this is a result of the ineffectiveness of the legal system in protecting property rights. Concentrated ownership and family control are important in countries where legal protection of property rights is relatively weak. Weak property rights are also behind the prevalence of family-owned businesses –

¹³ See Claessens and Fan (2003) for a survey the literature on corporate governance in Asia.

¹⁴ Topalova (2004)

organizational forms that reduce transaction costs and asymmetric information problems. Poor development of external financial markets also contributes to these ownership patterns. The effect of this concentrated ownership by management in Asian countries is not straightforward. Similar to the effects for US companies, in several East Asian countries, firm value rises with largest owner's stake but declines as the excess of the largest owner's management control over his equity stake increases.¹⁵ In Taiwan, family-run companies with lower control by the family perform better than those with higher control.¹⁶

Recent research has also investigated the nature and extent of "tunneling" of funds within business groups in India.¹⁷ During the 90's Indian business groups evidently tunneled considerable amount of funds up the ownership pyramid thereby depriving the minority shareholders of companies at lower levels of the pyramid of their rightful gains.

Empirical analyses of the effects of ownership by other (non-family) groups in Asia are relatively scarce. The state is an important party in some countries in Asia, notably India and China. The corporate governance mechanism and efficiency in state-controlled companies are generally deemed to inferior. Several studies show that accounting performance is lower for state-owned enterprises in China. The non-linear effects of entrenchment are also present with state ownership.¹⁸ Institutional investors fulfill an important certification role in emerging markets, but there is little evidence of their effectiveness in corporate governance in Asia. Equity ownership by institutional

¹⁵ Claessens *et al* (2002)

¹⁶ Yeh *et al* (2001)

¹⁷ Bertrand *et al* (2002)

¹⁸ Tian (2001)

investors like mutual funds has limited impact of performance in India.¹⁹ Ownership by other groups like directors, foreigners and lending institutions, on the other hand, appear to improve performance. In post-liberalization India, foreign ownership helps performance only if the foreigners constitute the majority shareholders.²⁰

Hostile takeovers are all but absent in Asian countries. The premium for control is significant in most Asian countries and as high as 10% of the share price in Korea²¹. External and minority representation in boards as well as participation by professionals are rare though increasing in Asian companies. Nevertheless, corporate governance is not entirely ineffective in Asia. In many Asian countries, including India, CEOs are more likely to lose their jobs when corporate performance is poorer.²² See Box 2 for a discussion of a few typical features of Asian companies and their implications for corporate governance.

[Box 2 about here]

In India, enforcement of corporate laws remains the soft underbelly of the legal and corporate governance system. The World Bank's Reports on the Observance of Standards and Codes (ROSC) publishes a country-by-country analysis of the observance of OECD's corporate governance codes. In its 2004 report on India²³, the ROSC found that while India observed or largely observed most of the principles, it could do better in certain areas. The contribution of nominee directors from financial institutions to monitoring and supervising management is one such area. Improvements are also necessary in the enforcement of certain laws and regulations like those pertaining to stock

¹⁹ Sarkar and Sarkar (2000)

²⁰ Chhibber and Majumdar (1999)

²¹ Bae *et al* (2002)

²² Gibson (forthcoming) and Das and Ghosh (2004)

²³ World Bank (2004)

listing in major exchanges and insider trading as well as in dealing with violations of the Companies Act – the backbone of corporate governance system in India. Some of the problems arise because of unsettled questions about jurisdiction issues and powers of the SEBI. As an extreme example, there have been cases of outright theft of investors' funds with companies vanishing overnight. The joint efforts of the Department of Company Affairs and SEBI to nail down the culprits have proved to be largely ineffective. As for complaints about transfer of shares and non-receipt of dividends while the redress rate has been an impressive 95%, there were still over 135,000 complaints pending with the SEBI. Thus there is considerable room for improvement on the enforcement side of the Indian legal system to help develop the corporate governance mechanism in the country.

4. 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.

²⁴ This section draws heavily from the history of Indian corporate governance in Goswami (2002).

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.

This sordid but increasingly familiar process usually continued till the company's net worth was completely eroded. This stage would come after the company has defaulted on its loan obligations for a while, but this would be the stage where India's bankruptcy reorganization system driven by the 1985 Sick Industrial Companies Act (SICA) would consider it "sick" and refer it to the Board for Industrial and Financial Reconstruction (BIFR). As soon as a company is registered with the BIFR it wins immediate protection from the creditors' claims for at least four years. Between 1987 and 1992 BIFR took well over two years on an average to reach a decision, after which period the delay has roughly doubled. Very few companies have emerged successfully from the BIFR and even for those that needed to be liquidated, the legal process takes over 10 years on average, by which time the assets of the company are practically worthless. Protection of creditors' rights has therefore existed only on paper in India. Given this situation, it is hardly surprising that banks, flush with depositors' funds routinely decide to lend only to blue chip companies and park their funds in government securities.

Financial disclosure norms in India have traditionally been superior to most Asian countries though fell short of those in the USA and other advanced countries. Noncompliance with disclosure norms and even the failure of auditor's reports to

conform to the law attract nominal fines with hardly any punitive action. The Institute of Chartered Accountants in India has not been known to take action against erring auditors.

While the Companies Act provides clear instructions for maintaining and updating share registers, in reality minority shareholders have often suffered from irregularities in share transfers and registrations – deliberate or unintentional. Sometimes non-voting preferential shares have been used by promoters to channel funds and deprive minority shareholders of their dues. Minority shareholders have sometimes been defrauded by the management undertaking clandestine side deals with the acquirers in the relatively scarce event of corporate takeovers and mergers.

Boards of directors have been largely ineffective in India in monitoring the actions of management. They are routinely packed with friends and allies of the promoters and managers, in flagrant violation of the spirit of corporate law. The nominee directors from the DFIs, who could and should have played a particularly important role, have usually been incompetent or unwilling to step up to the act. Consequently, the boards of directors have largely functioned as rubber stamps of the management.

For most of the post-Independence era the Indian equity markets were not liquid or sophisticated enough to exert effective control over the companies. Listing requirements of exchanges enforced some transparency, but non-compliance was neither rare nor acted upon. All in all therefore, minority shareholders and creditors in India remained effectively unprotected in spite of a plethora of laws in the books.

5. 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.²⁵

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

²⁵ Goswami (2002)

Committee on International Financial Standards and Codes also submitted its own recommendations in 2001.

[Table 1 about here]

A comparison of the three sets of recommendations in Table 1 reveal the progress in the thinking on the subject of corporate governance in India over the years. An outline provided by the CII was given concrete shape in the Birla Committee report of SEBI. SEBI implemented the recommendations of the Birla Committee through the enactment of Clause 49 of the Listing Agreements. They were applied to companies in the BSE 200 and S&P C&X Nifty indices, and all newly listed companies, on March 31, 2001; to companies with a paid up capital of Rs. 10 crore or with a net worth of Rs. 25 crore at any time in the past five years, as of March 31, 2002; to other listed companies with a paid up capital of over Rs. 3 crore on March 31, 2003. The Narayana Murthy committee worked on further refining the rules.

The recommendations also show that much of the thrust in Indian corporate governance reform has been on the role and composition of the board of directors and the disclosure laws. The Birla Committee, however, paid much-needed attention to the subject of share transfers which is the Achilles' heel of shareholders' right in India.

Figure 1 shows the frequency of compliance of companies to the different aspects of the corporate governance regulation. Clearly much more needs to be accomplished in the area of compliance. Besides in the area of corporate governance, the spirit of the laws and principles is much more important than the letter. Consequently, developing a positive culture and atmosphere of corporate governance is essential is

obtaining the desired goals. Corporate governance norms should not become just another legal item to be checked off by managers at the time of filing regulatory papers.

[Figure 1 about here]

6. 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.²⁶

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

²⁶ Levine (2003)

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.²⁷ 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

²⁷ Reddy (2002) summarizes the reforms-era policies for corporate governance in Indian banks.

properly manage the banks within the broad prudential norms set by RBI. Rules like non-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.

7. 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 surveys²⁸ 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, however, 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.

²⁸ Gregory (2000) and (2001)

References

- Bae, K. H., J. K. Kang, and J. M. Kim. 2002. "Tunneling or Value Addition? Evidence from Mergers by Korean Business Groups." *Journal of Finance* 57 (6): 2695–740.
- Berglof, E. and S. Claessens, 2004. Corporate Governance and Enforcement, Working Paper, University of Amsterdam.
- Bertrand, M., P. Mehta, and S. Mullainathan. 2002. "Ferreting out Tunneling: An Application to Indian Business Groups." *Quarterly Journal of Economics* 117(1): 121–48.
- Chhibber, P.K., and S.K. Majumdar (1999), Foreign Ownership and Profitability: Property Rights, Control, and the Performance of Firms in Indian Industry, *Journal of Law and Economics*, 42, 209-238.
- Claessens, S., 2003. Corporate Governance and Development, Global Corporate Governance Forum, World Bank, Washington D.C.
- Claessens, S. and J.P.H. Fan, 2003. Corporate Governance in Asia: A Survey, Working Paper, University of Amsterdam
- Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang, 2002. Disentangling the Incentive and Entrenchment Effects of Large Shareholdings, *Journal of Finance* 57 (6): 2741–71.
- Das, A. and S. Ghosh, 2004. Corporate Governance in Banking System: An Empirical Investigation, *Economic and Political Weekly*, March 20, 2004, pp. 1263-1266.
- Dyck, A. and L. Zingales (2002), Private Benefits of Control: An International Comparison, CEPR Discussion Paper No. 3177.
- Gibson, M.S. (forthcoming), Is Corporate Governance Ineffective in Emerging Markets?, *Journal of Financial and Quantitative Analysis*.
- Goswami, Omkar, 2002, "Corporate Governance in India," *Taking Action Against Corruption in Asia and the Pacific* (Manila: Asian Development Bank), Chapter 9.
- Gregory, Holly J., 2000, International Comparison of Corporate Governance: Guidelines and Codes of Best Practice in Developing and Emerging Markets, Weil, Gotshal & Manges LLP.
- Gregory, Holly J., 2001, International Comparison of Corporate Governance: Guidelines and Codes of Best Practice in Developed Markets, Weil, Gotshal & Manges LLP.
- Jensen, M.C., and W.H. Meckling (1976), Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics*, 3, 305-360.
- Johnson, S., P. Boone, A. Breach, and E. Friedman 2000. Corporate Governance in the Asian Financial Crisis, *Journal of Financial Economics*, 141-186.
- La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny 1997. Legal Determinants of External Finance, *Journal of Finance*, 52, 1131-1150.
- La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny 1998. Law and Finance, *Journal of Political Economy*, 106, 1113-1155.
- La Porta, R., F. Lopez-De-Silanes, and A. Shleifer 1999. Corporate ownership around the world, *Journal of Finance*, 54, 471-518.
- La Porta, R., F. Lopez-de-Silanes, A. Shleifer, R. Vishny 2000. Investor Protection and Corporate Governance, *Journal of Financial Economics*, 58, 3-27.

- La Porta, R., F. Lopez-de-Silanes, A. Shleifer, R. Vishny 2002, Investor Protection and Corporate Valuation, *Journal of Finance*, 57, 1147-1170.
- Levine, R. 2003. The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence, Global Corporate Governance Forum, World Bank.
- Morck, R., A. Shleifer, and R. Vishny (1988), Management Ownership and Market Valuation: An Empirical Analysis, *Journal of Financial Economics*, 20, 293-315.
- Reddy, Y.V., 2002. Public sector banks and the governance challenge - the Indian experience, BIS Review 25/2002, Bank for International Settlements, Basle.
- Sarkar, J. and S. Sarkar (2000), Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India, *International Review of Finance*, 1, 161-194.
- Tian, G.L.H. (2001), State Shareholding and the Value of Chinese Firms, Working Paper, London Business School.
- Topalova, Petia, 2004. "Overview of the Indian Corporate Sector: 1989-2002." IMF Working Paper No. 04/64.
- World Bank, 2004. Report on the Observance of Standards and Codes (ROSC), Corporate Governance Country Assessment : India, ROSC, World Bank-IMF, Washington DC.
- Yeh, Y.H., T.S. Lee, and T. Woidtke (2001), Family Control and Corporate governance: Evidence from Taiwan, *International Review of Finance*, 2, 21-48.

Box 1: Alternative corporate governance mechanisms

While corporate governance mechanisms differ from country to country, there are two broad categories of financial systems which differ in their very basic structure. These are the market-based system exemplified by the British and American systems and the bank-based system typified by Japan and Germany. Varying paths of financial evolution situate countries at different points in this market-institution spectrum with their positions determined by the nature of their economic endowments and the historical and political forces that shape their societies.

The market-based system or the Anglo-Saxon system, marked with effective distancing of ownership and control, trusts financial markets with the ultimate role of corporate governance. It is characterized by effective an all-powerful CEO, frequently also the chairman of the board of directors that barely accountable to a highly dispersed group of shareholders who generally find selling shares an easier way to express their dissatisfaction with inefficient management than creating a stir against it. Good performance and high share price are essential to keep future cost of equity capital low. The market for management control and the concomitant takeover threat then works to make sure that management does not lower shareholder interests. Block shareholders have relatively less power though financial institutions like pension funds do hold big chunks of stocks. Banks have practically no control over management.

Corporations in the bank based systems in Germany and Japan function quite differently. In Germany for instance, share ownership is less diffuse and banks play a much more important role as providers of finance and monitors of day-to-day activity. The board structure is substantially different with corporations being run by giant sized supervisory boards, *Aufstichtsrat*, about half of whose members are labor representatives. Management is carried out by another board, the *Vorstand*, appointed by and answerable to the supervisory board. The company has a very close relationship with its *Hausbank*, a universal bank that owns shares in the company and usually has board representation. The company can rarely take a major step without the consent of its *Hausbank*. The power (as well as salaries) of the top management is far less than that in the Anglo-American model.

The Indian situation may be thought of as a combination of these two conflicting models. Though the basic corporate legal structure is Anglo-Saxon, share ownership is far less dispersed and financial institutions play a much bigger role in financing corporate activity. Share ownership and board representation of financial institutions give these bodies the abilities to serve as important monitors of management activities though the relationship. The powers, however, are considerably limited as compared to those in typical bank-based systems and universal banking is not widespread. Nevertheless, financial institutions, have, in general, failed to fulfill even their limited role in corporate governance.

Table 1: Recommendations of various committees on Corporate Governance in India

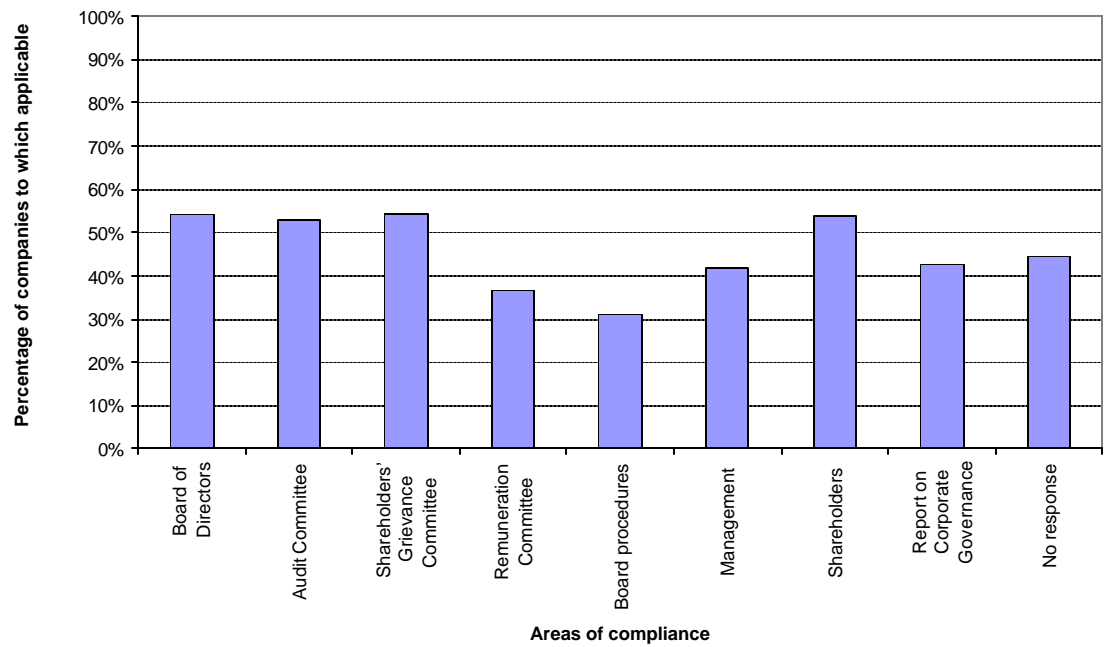
| CII Code recommendations (1997) | Birla Committee (SEBI) recommendations (2000) | Narayana Murthy committee (SEBI) recommendations (2003) |
|---|---|---|
| <u>Board of Directors</u> | | |
| <p>a) No need for German style two-tiered board</p> <p>b) For a listed company with turnover exceeding Rs. 100 crores, if the Chairman is also the MD, at least half of the board should be Independent directors, else at least 30% .</p> <p>c) No single person should hold directorships in more than 10 listed companies.</p> <p>d) Non-executive directors should be competent and active and have clearly defined responsibilities like in the Audit Committee.</p> <p>e) Directors should be paid a commission not exceeding 1% (3%) of net profits for a company with(out) an MD over and above sitting fees. Stock options may be considered too.</p> <p>f) Attendance record of directors should be made explicit at the time of re-appointment. Those with less than 50% attendance should not be re-appointed.</p> <p>g) Key information that must be presented to the board is listed in the code.</p> <p>h) <u>Audit Committee</u>: Listed companies with turnover over Rs. 100 crores or paid-up capital of</p> | <p>a) At least 50% non-executive members</p> <p>b) For a company with an executive Chairman, at least half of the board should be independent directors[♦], else at least one-third.</p> <p>c) Non-executive Chairman should have an office and be paid for job related expenses .</p> <p>d) Maximum of 10 directorships and 5 chairmanships per person.</p> <p>e) <u>Audit Committee</u>: A board must have an qualified and independent audit committee, of minimum 3 members, all non-executive, majority and chair independent with at least one having financial and accounting knowledge. Its chairman should attend AGM to answer shareholder queries. The committee should confer with key executives as necessary and the company secretary should be he secretary of the committee. The committee should meet at least thrice a year -- one before finalization of annual accounts and one necessarily every six months with the quorum being the higher of two members or one-third of members with at least two independent directors. It should have access to information from any employee and can investigate any</p> | <p>a) Training of board members suggested.</p> <p>b) There shall be no nominee directors. All directors to be elected by shareholders with same responsibilities and accountabilities.</p> <p>c) Non-executive director compensation to be fixed by board and ratified by shareholders and reported. Stock options should be vested at least a year after their retirement. Independent directors[♦] should be treated the same way as non-executive directors.</p> <p>d) The board should be informed every quarter of business risk and risk management strategies.</p> <p>e) <u>Audit Committee</u>: Should comprise entirely of “financially literate” non-executive members with at least one member having accounting or related financial management expertise. It should review a mandatory list of documents including information relating to subsidiary companies. “Whistle blowers” should have direct access to it and all employees be informed of such policy (and this should be affirmed annually by management). All “related party” transactions must be approved by audit committee. The committee should be responsible for the appointment,</p> |

[♦] Independent directors defined separately within each code. The Narayana Murthy committee’s definition is stricter.

| | | |
|---|--|--|
| <p>Rs. 20 crores should have an audit committee of at least three members, all non-executive, competent and willing to work more than other non-executive directors, with clear terms of reference and access to all financial information in the company and should periodically interact with statutory auditors and internal auditors and assist the board in corporate accounting and reporting.</p> <p>i) Reduction in number of nominee directors. FIs should withdraw nominee directors from companies with individual FI shareholding below 5% or total FI holding below 10%.</p> | <p>matter within its TOR, can seek outside legal/professional service as well as secure attendance of outside experts in meetings. It should act as the bridge between the board, statutory auditors and internal auditors with far-ranging powers and responsibilities.</p> <p>f) Remuneration Committee: The remuneration committee should decide remuneration packages for executive directors. It should have at least 3 directors, all non-executive and be chaired by an independent director.</p> <p>g) The board should decide on the remuneration of non-executive directors and all remuneration information should be disclosed in annual report</p> <p>h) At least 4 board meetings a year with a maximum gap of 4 months between any 2 meetings. Minimum information available to boards stipulated.</p> | <p>removal and remuneration of chief internal auditor.</p> <p>f) Boards of subsidiaries should follow similar composition rules as that of parent and should have at least one independent director s of the parent company.</p> <p>g) The Board report of a parent company should have access to minutes of board meeting in subsidiaries and should affirm reviewing its affairs.</p> <p>h) Performance evaluation of non-executive directors by all his fellow Board members should inform a re-appointment decision.</p> <p>i) While independent and non-executive directors should enjoy some protection from civil and criminal litigation, they may be held responsible of the legal compliance in the company's affairs.</p> <p>j) Code of conduct for Board members and senior management and annual affirmation of compliance to it.</p> |
| <u>Disclosure and Transparency</u> | | |
| <p>a) Companies should inform their shareholders about the high and low monthly averages of their share prices and about share, performance and prospects of major business segments (exceeding 10% of turnover).</p> <p>b) Consolidation of group accounts should be</p> | <p>a) Companies should provide consolidated accounts for subsidiaries where they have majority shareholding.</p> <p>b) Disclosure list pertaining to "related party" transactions provided by committee till ICAI's norm is established.</p> | <p>a) Management should explain and justify any deviation from accounting standards in financial statements.</p> <p>b) Companies should move towards a regime of unqualified financial statements.</p> |

| | | |
|---|---|---|
| <p>optional and subject to FI's and IT department's assessment norms. If a company consolidates, no need to annex subsidiary accounts but the definition of "group" should include parent and subsidiaries.</p> <p>c) Stock exchanges should require compliance certificate from CEOs and CFOs on company accounts</p> <p>d) For companies with paid-up capital exceeding Rs. 20 crore, disclosure norms for domestic issues should be same as those for GDR issues.</p> | <p>c) A mandatory Management Discussion & Analysis segment of annual report that includes discussion of industry structure and development, opportunities, threats, outlook, risks etc. as well as financial and operational performance and managerial developments in HR/IR front.</p> <p>d) Management should inform board of all potential conflict of interest situations.</p> <p>e) On (re)appointment of directors, shareholders must be informed of their resume, expertise, and names of companies where they are directors.</p> | <p>c) Management should provide a clear description, followed by auditor's comments, of each material contingent liability and its risks.</p> <p>d) CEO/CFO certification of knowledge, veracity and comprehensiveness of financial statements and directors' reports and affirmation of maintaining proper internal control as well as appropriate disclosure to auditors and audit committee.</p> <p>e) Security analysts must disclose the relationship of their employers with the client company as well as their actual or intended shareholding in the client company.</p> |
| <u>Other issues</u> | | |
| <u>Creditors' Rights</u> | <u>Shareholders' Rights</u> | <u>Special Disclosure for IPOs</u> |
| <p>a) FIs should rewrite loan covenants eliminating nominee directors except in case of serious and systematic debt default or provision of insufficient information.</p> <p>b) In case of multiple credit ratings, they should all be reported in a format showing relative position of the company</p> <p>c) Same disclosure norms for foreign and domestic creditors.</p> <p>d) Companies defaulting on fixed deposits should not be permitted to accept further deposits and make inter-corporate loans or investments or declare dividends until the default is made good.</p> | <p>a) Quarterly results, presentation to analysts etc. should be communicated to investors, possibly over the Internet.</p> <p>b) Half-yearly financial results and significant events reports be mailed to shareholders</p> <p>c) A board committee headed by a non-executive director look into shareholder complaints/grievances</p> <p>d) Company should delegate share transfer power to an officer/committee/registrar/share transfer agents. The delegated authority should attend to share transfer formalities at least once in a fortnight.</p> | <p>a) Companies making Initial Public Offering ("IPO") should inform the Audit Committee of category-wise uses of funds every quarter. It should get non-pre-specified uses approved by auditors on an annual basis. The audit committee should advise the Board for action in this matter.</p> |

**Figure 1: Compliance with Clause 49 of Listing Agreement,
(Sep 30, 2002, BSE companies)**



Source: Narayana Murthy Committee report, SEBI