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CORPORATE GOVERNANCE IN INDIA EVALUATION AND CHALLENGES

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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 World Com, 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 form Parmalat in Italy to the multinational newspaper group Hollinger Inc., reveled significant and deep – rooted problems in their corporative governance. Even the prestigious New York stock exchange had to remove its director, Disk Grasso, amidst public outcry over excessive 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 to 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 economics 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 casualty works. Effective corporate governance enhances access to external financing by firms, leading 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. 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 investment. 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 corporative governance mechanisms ensure better resource allocation and management raising the return to capital. The return on assets is about twice as high in the countries with the highest level of equity rights protection as countries with the lowest protection. Good corporative governance can significantly reduce the risk of national wide financial crises. There is a strong inverse relationship between the equality of corporative governance and currency depreciation. Indeed poor transparency and corporative 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 corporative governance can remove mistrust between different stakeholders, reduce legal costs and improve social and labor relationships and external economics 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 corporative 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 corporative 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 corporative governance a particularly important issue in India.

2.1 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, 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 of 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 if 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 residua powers must go to management.

The reality is even more complicated and based 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 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 Director in monitoring the activities management is particularly marked in the Anglo-Saxon corporate structure where real monitoring is expected to 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.

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 models that provided by the bank-based economics like Germany where the main bank(Hausbank" in Germany)lending to the company exerts considerable in fluencies and carries out continuous project-level supervision of the management and the supervisory board has representatives of multiple stakeholders of the firm. Common areas of management action that may be sub-optional 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

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put the retained earnings of the company. In the absence of profitable investment opportunies, 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 business and corporate groups are common in many countries including India. These range from Keirtus 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 relatives of individual companies in these behemoths. In addition, managerial control of these business are often in the hands of a small group of people , commonly a family, who either own the majority stake, or maintain control though 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 of expropriation of minority shareholder value through actions like "tunneling' of corporate gains or funds to other corporate entities within the group.

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 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 jeep 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.

CORPORATE GOVERNANCE IN INDIA:

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

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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. 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 investor's 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 (Developments 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 following decades and corruption, nepotism and inefficiency became the hallmarks of the Indian 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.

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 corporation's 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 lo 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. 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

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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 form the creditors’ claims for at least four years. 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 through feel short of those in the USA and other advanced countries. Noncompliance with disclosure norms and even the failure of auditors reports to conform to the 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. Minority shareholders have sometimes been frauded by the management undertaking clandestine side deals with the acquires in the relatively scarce event of corporate takeovers and mergers.

Boards of directors have been largely ineffective in India in monitoring thr 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. 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 law in the books.

Corporate Governance in India: Discipline the Dominant shareholder

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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 that 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 is that of disciplining

the dominant shareholder and protecting the minority shareholders. The paper discusses the role of two such forces – the regulator and the capital market.

Regulators face a difficult dilemma in that correction of governance abuses perpetrated by a dominant shareholder would often imply a micro – management of routine business which lie beyond the regulators mandate or competence. The capital market on the other hand lacks the coercive power of the regulator, but it has the ability to make business judgments.

The paper discusses the increasing power of the capital marker to discipline the dominant shareholder by denying him access to the capital market. The newly unleashed forces of deregulation, disintermediation, institutionalization, and globalization and tax reforms are making the minority shareholder more powerful and are forcing the companies to adopt healthier governance practices. These trends expected to become even stronger in future. In short, the key to better corporate governance in India today lies in a more efficient and vibrant capital market. Of course, things could change in future if Indian corporate structures also approach the Anglo-American pattern of near complete separation of management and ownership. Exercises only such powers as are delegated to it by the Board. It is indeed self evident that the remedies against these abuse can lie only outside the company itself.

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 minority stake(often as little as 20%) Second are the multinational companies(MNCs)where the foreign parent is the dominate(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 .

Insider trading:

Securities regulators around the world have framed various regulations to deal with the problem of insider trading. The existence of regulations does not necessarily mean that they are endorsed. In South Africa, for example, a recent report on insider trading pointed out that in the quarter century that the insider trading law has been in existence in that country, there has not been a single prosecution (King, 1997).

Most instances of insider trading have nothing to do with the dominant shareholder. Many of them involve small trades by junior employees who come to know of price sensitive information. In the context of this paper, indulged in by directors and other senior employees. Market gossip has long speculated on the prevalence of such trades in the build up to large mergers especially between group companies. Some promoters have merged small companies in which they have a large stake into a larger more widely held company at a swap ratio which is highly unfavorable to the widely held company. When SEBI recently initiated action for insider against a large multinational in a somewhat different situation, the action proved to be highly controversial and the ultimate resolution of this case remains uncertain.

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 problem in the Indian corporate section is that of disciplining the dominant shareholder and protecting the minority shareholders. A board which accountable to the owners 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 regulators 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. Many corporate governance problems are ill suited to this style of regulation. The capital market on the other hand lacks the coercive power of the regulator. What is has however is the ability to make business judgments and to distinguish between wheat is in the best interests of the company as a whole as against what is merely in the best interest of the dominant shareholders. The only effective sanction that the market once again. Denial of market access is a very powerful sanction except where the company is cash rich and has little future needs for funds.

The past few years have witnessed a silent revolution in Indian corporate governance where managements have woken up to the power of minority shareholders who vote with their wallets. In response to this power, the more progressive companies are voluntarily accepting

tougher accounting standards and more stringent disclosure norms than are mandated by law. They are also adopting more healthy governance practices.

It is evident that these tendencies would be strengthened by a variety of forces that are acting today and would become stronger in years to come:

- Deregulation: Economic reforms have not only increased growth prospects, but they have also made markets more competitive. This means that in order to survive companies will need to invest continuously on a large scale.
- Disintermediation: meanwhile, financial sector reforms have made it imperative for firms to rely on capital markets to a greater degree for their needs of additional capital.
- Institutionalization: simultaneously, the increasing institutionalization of the capital markets has tremendously enhanced and disciplining power of the market.
- Globalization: Globalization of our financial market has exposed issuers, investors and intermediaries to the higher standards of disclosure and corporate governance the prevail in more developed capital markets.
- Tax reforms: tax reforms coupled with deregulation and competition have titled the balance away from black money transactions. This makes the worst forms of misgovernance less attractive than in the past.
- While these factors will make the capital markets more effective in disciplining the dominant shareholder, there are many things that the government and the regulators can do to enhance this ability;
- Disclosure of information is the pre – requisite for the minority shareholders or for the capital market to act against errant managements. The regulator can enhance the scope, frequency, quality and reliability of the information that is disclosed.
- Regulatory measures that promote an efficient market for corporate control would create and effective threat to some classes of dominant shareholders as discussed earlier.
- Reforms in bankruptcy and related laws would bring the disciplining power of the debit holders to bear upon recalcitrant managements.
- Large blocks of shares in corporate India are held by Public sector financial institutions who have proved to be passive spectators. These share holdings could be transferred to other investors who could exercise more effective discipline on the company managements.

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In short, the key to better corporate governance in India today lies in a more efficient and vibrant capital market. Over a period of time, it is possible that Indian corporate structures may approach the Anglo – American pattern of near complete separation of management and ownership. At the stage, India too would have to grapple with governance issues like empowerment of the Board. Until then, these issues which dominate the Anglo – American literature on corporate governance are of peripheral relevance to India.

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