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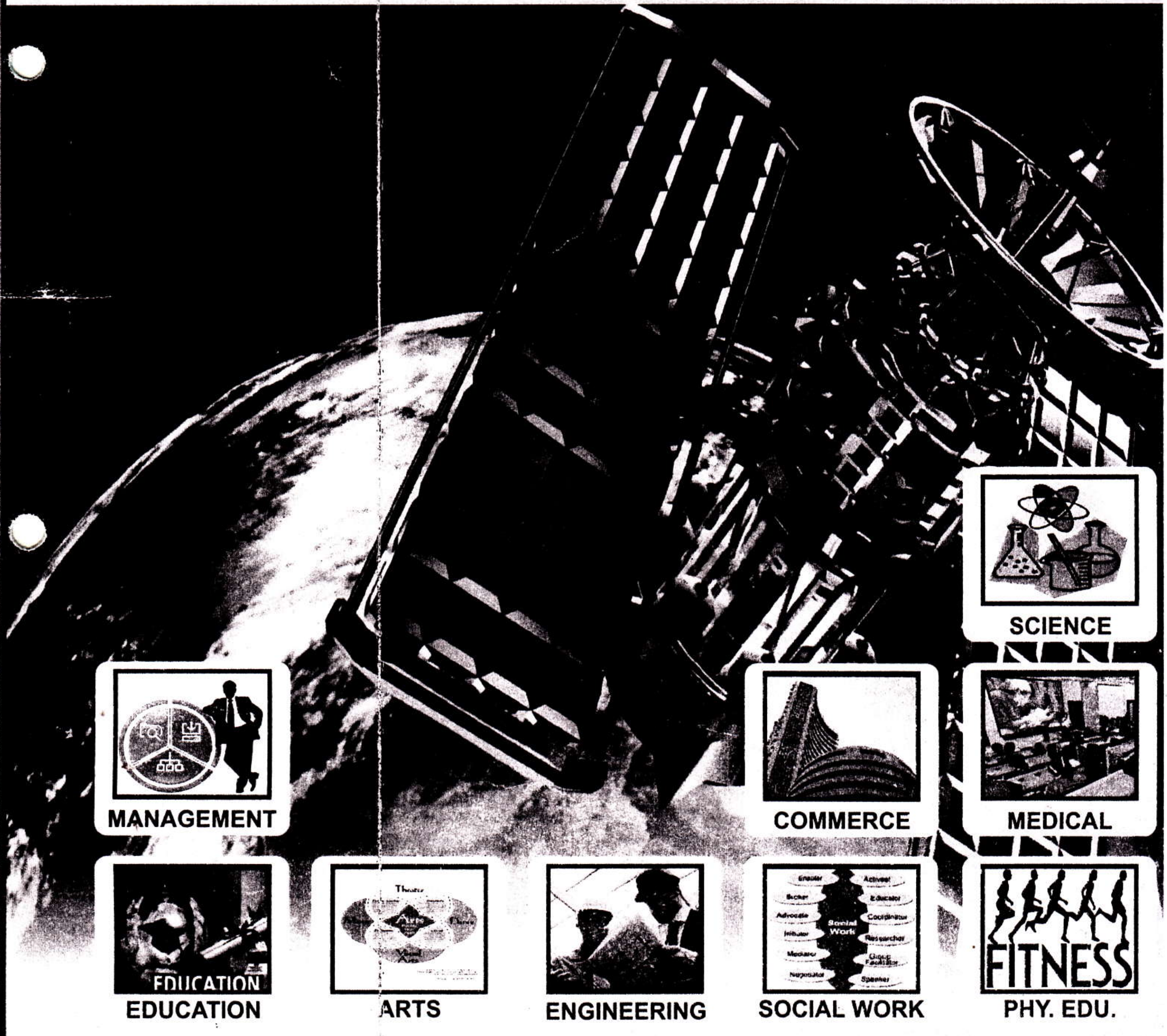

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Corporate Governance in India - Evolution and Challenges

Abstract : The subject of corporate governance leapt to global business limelight fromrelative 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.

I. Introduction

The subject of corporate governance leapt to global business limelight fromrelative 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 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:-

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

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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 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.

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 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.

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.

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.

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. These concerns about corporate governance stemming from the corporate scandals as well as opening up to the forces of ompetition 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.

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. 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.

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 surveys and their number is steadily increasing. India has been no exception to the rule. Several committees and groups have looked into this issue that undoubtedly deserves all the attention it can get. In the last few years the thinking on the topic in India has gradually crystallized into the development of norms for listed companies. The problem for private companies,

that form a vast majority of Indian corporate entities, remains largely unaddressed. The agency problem is likely to be less marked there as ownership and control are generally not separated. Minority shareholder exploitation, ho wever, can very well be an important issue in many cases. Development of norms and guidelines are an important first step in a serious effort to improve corporate governance. The bigger challenge in India, however, lies in the proper implementation of those rules at the ground level. More and more it appears that outside agencies like analysts and stock markets (particularly foreign markets for companies making GDR issues) have the most influence on the actions of managers in the leading companies of the country. But their influence is restricted to the few top (albeit largest) companies. More needs to be done to ensure adequate corporate governance in the *average* Indian company.

Even the most prudent norms can be hoodwinked in a system plagued with widespread corruption. Nevertheless, with industry organizations and chambers of

commerce themselves pushing for an improved corporate governance system, the future of corporate governance in India promises to be distinctly better than the past.

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