# Corporate Governance and Capital Market in India

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**Abstract**

In recent years, more and more Indian companies have been raising capital overseas by getting themselves listed on international stock exchanges. These efforts have been accompanied by the Indian government's drive to attract more foreign direct investment (FDI). Both factors have gone hand in hand with the realization that if Indian companies want more access to global capital markets, they will need to make their operations and financial results more transparent. In other words, they will need to improve their standards of corporate governance. The Securities and Exchange Board of India, or SEBI, which regulates India's stock markets, took a major step in this direction a year ago. It asked Indian firms above a certain size to implement Clause 49, a regulation that strengthens the role of independent directors serving on corporate boards.

While taking a deep look at the present scenario in capital market in India, the shortcomings of the present system of corporate governance in India will be explained. In this effort the emerging issues in corporate governance in India will be highlighted.

**Introduction**

India's capital markets have experienced sweeping changes since the beginning of the last decade. The sharp rise in India's stock markets since 2003 reflects its improving macroeconomic fundamentals. However, the large size of insider holdings and the small presence of institutional investors contradict these impressive figures. Its market infrastructure has advanced while corporate governance has progressed faster than in many other emerging market economies. The global ratings agencies Moody's and Fitch have awarded India investment grade ratings, indicating comparatively low sovereign risks.

But in contrast to several developed countries and Asian economies, India's capital markets are still shallow, implying that further reforms are needed to make India a world-class financial centre.

The development of India's equity capital markets has taken a more progressive trajectory than the bond market, largely reflecting the government's laissez faire approach in the segment. At 90% of GDP (Based on the capitalisation of the Bombay Stock. Exchange as of December 2006.), its size is comparable to that of other emerging countries, although is still small relative to many developed markets.

In total, India's debt and equity markets were equivalent to 130% of GDP at the end of 2005. This is an impressive stride, coming from just 75% in 1995, suggesting issuers' growing confidence in market based financing. However, the size of the country's capital markets relative to the United States', Malaysia's and South Korea's remains low, implying a strong catch-up process for India. Impressive though the developments may be, India's stock markets still have some room for improvement. For one, the shareholder pattern needs to be broadened, as ownership is concentrated in the promoters

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(Promoters include family members, relatives and close associates) and company insiders show an increasing presence. This implies that minority shareholders' interest is minimal, which needs to be increased for the sake of improved corporate governance.

A vibrant secondary market is characterised by the active participation of retail and institutional investors, underpinned by their long-term investment goals, with adjustments made in accordance with their short-term liquidity needs and in response to the business cycle. With a population of over 1 billion, India offers a large pool of potential investors. Indian households are by far the largest saver in the economy, constituting nearly 80% of the economy's aggregate saving.

Insurance companies, pension funds, mutual funds and foreign institutional investors (FIIs) form India's institutional investor base. Combined, their assets account for about 25% of GDP. This represents a significant increase compared to the mid-1990s, prior to the opening up of many of the sectors, such as the insurance industry, to competition. But, to put it in perspective, the combined size of the Indian institutional investors sector amounts to less than half of US mutual fund assets alone. By and large, Indian investors tend to be conservative in their investment decisions, with a general preference for safe returns and capital preservation. As for large domestic institutional investors such as pension funds and insurance companies, their investment style has largely been the result of regulation.

How many households are investing in the capital markets? A joint survey by the Securities and Exchange Board of India and National Council for Applied Economics Research (SEBI-NCAER) in March 2003 estimated that only 13 million households out of the total 177 million surveyed have investments in the capital markets. This is equivalent to a mere 7% of total Indian households. The robust economic expansion since the survey and the resulting increase in per capita GDP may have widened the household investor base, but possibly not enough to considerably increase market volumes. India's equity markets have experienced several scandals in the past, resulting occasionally in substantial capital losses to many investors. This has essentially discouraged a considerable number of them to return to the stock markets, although in the past two years confidence has gradually regained some ground.

A key ingredient to reduce households' risk aversion is improving their understanding of long-term investment, particularly in the equity market. Regarding bonds, there is a concerted effort among the RBI and SEBI, as well as the BSE and NSE, to raise retail investors' knowledge about the mechanics and risk/return tradeoffs of debt securities. However, the thin volumes can be expected to persist so long as the government continues to provide savings schemes, which reduce incentives to invest in fixed-income instruments.

**Corporate Governance Practices in India -An update**

Continuing efforts by the SEBI to upgrade the corporate governance framework have positioned India at an above-average level against other emerging market economies, according to the Institute of International Finance (IIF), the global association of financial institutions. Since March 2006, listed companies have been required to submit quarterly compliance reports to the SEBI, facilitating the valuation of companies and bringing it in line with the Sarbanes-Oxley Act. Under rules announced by the Securities and Exchange Board of India (SEBI), companies listed on any of the country's stock exchanges were required to comply with clause 49 of the Listing Agreement of Stock Exchanges by the end of 2005. Although many large Indian companies are already complying with clause 49, these new steps reflect India's bid to improve compliance within small and medium companies to attract foreign investment. Clause 49 includes requirements relating to corporate boards, audit committees, directors' remuneration, board procedures and other related issues. A revised clause 49 was published in 2004 and included stricter standards to be applied when considering the independence of a director. The responsibilities of audit committees were strengthened and boards are now required to adopt a formal code of conduct. Now, one half of all board positions must be filled by independent directors and audit committees must have at least three directors, two of whom must be independent. Yearly corporate governance reports must be produced and must explain any departures from clause 49. Similar to the requirements imposed

on US company executives under SOX, Indian executives will also be required to certify their financial statements.

One must also keep in mind, however, that the Indian governance system as it is evolving — while it borrows features from the United States — actually also borrows from other countries. Although India does have a functional legal system, the country's law enforcement still lags behind the more advanced economies of Hong Kong and Singapore according to the World Bank.

*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.*

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.

*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.*

**Part II**

In this part of the paper an observation is shared that the corporate governance problems in India are very different. The governance issue in the US or the UK is essentially that of disciplining the management who has ceased to be effectively accountable to the owners.

*The problem in the Indian corporate sector (be it the public sector, the multinationals or the Indian private sector) is that of disciplining the dominant shareholder and protecting the minority shareholders.*

Turning to the Indian scene, one finds increasing concern about improving the performance of the Board. This is doubtless an important issue, but a close analysis of the ground reality in India would force one to conclude that the Board is not really central to the corporate governance melancholy in India. The central problem in Indian corporate governance is not a conflict between management and owners as in the US and the UK, but a conflict between the dominant shareholders and the minority shareholders. The Board cannot even in theory resolve this conflict. One can in principle visualize an effective Board which can discipline the management. At least in theory, management exercises only such powers as are delegated to it by the Board. But, how can one, even in theory, envisage a Board that can discipline the dominant shareholders from whom the Board derives all its powers?

*Some of the most glaring abuses of corporate governance in India have been defended on the principle of "shareholder democracy" since they have been sanctioned by resolutions of the general body of shareholders. The Board is indeed powerless to prevent such abuses. It is indeed self evident that the remedies against these abuses 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.

* Public sector units (PSUs) where the government is the dominant (in fact, majority) shareholder and the general public holds a minority stake (often as little as 20%).
* Multi national companies (MNCs), where the foreign parent is the dominant (in most cases, majority) shareholder.
* 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.

The governance problems posed by the dominant shareholders in these three categories of companies

are slightly different. Let us analyse it one by one.

It is interesting however to observe how totally irrelevant the Board really is in the governance of the PSUs today in India. The Board has no role to play in any of the areas where USA and UK reformers have sought to strengthen the Board.

* The Board has very little say in the selection of the CEO or in the composition of the Board. The government as the majority shareholder takes these decisions through the concerned ministry with the help of the Public Enterprises Selection Board.
* The Board cannot fire the CEO nor can it vary his compensation package.
* As far as audit is concerned, again the dominant role is that of the Comptroller and Auditor General (CAG). There is very little that an Audit Committee could add to what the CAG does.

Many operating decisions have to be brought to the Board for decision making. This does not however make for an effective Board because it pushes the Board into "managing" rather than "directing". There is a clear difference between directing and managing, and the Board's legitimate function is directing (Balasubramaniam, 1997). The current governance structure allows the Board to play a highly obstructive role if it chooses by opposing the CEO on operational matters. What it does not allow the Board to do is to play a meaningful strategic role since all strategic decisions are taken by the dominant shareholder through the concerned ministry.

The situation in this category of companies is more complex than in the PSUs and the MNCs where there are clearly defined dominant shareholders. Yet another problem is the payments that parent companies increasingly demand for all the services that they provide to their subsidiaries. One example can be a company where the parent company can collect royalties for the use of a brand. In this case, India is actually the principal market for this brand and the Indian company had assiduously cultivated the brand through decades of advertising paid for in part by the minority shareholders. Minority shareholders could only watch in dismay as the royalties knocked off a sizeable chunk of the earnings of the company.

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

This allows the promoters to play all the games that dominant shareholders play in PSUs and MNCs - structuring of businesses and transfer of assets between group companies, preferential allotments of shares to the dominant shareholder, payments for "services" to closely held group companies and so on.

***Emerging Issues***

**The Regulatory Dilemma -Balancing between Dominant Shareholder and rights of minority shareholder**

A much talked about regulatory dilemma is that of balancing the rights of minority shareholders against the principle of shareholder democracy. It is important to bear in mind that the relation between the company and its shareholders and the relation between the shareholders *inter-se* is primarily contractual in nature. The essence of this contractual relationship is that each shareholder is entitled to a share in the profits and assets of the company in proportion to his shareholding. Flowing from this is the fact that the Board and the management of the company have a fiduciary responsibility towards each and every shareholder and not just towards the majority or dominant shareholder. This thing can be

observed when Reliance Industries split into two.

**Dilemma of Micro management**

Regulatory intervention must perforce be confined to a few clearly defined prohibitions and restrictions that require minimal exercise of regulatory discretion. This approach carries with it the danger that broad prohibitions would also stand in the way of many legitimate business transactions.

**Special majority**

Another safeguard in the company law is the requirement that certain major decisions have to be approved by a special majority of 75% or 90% of the shareholders by value.

Effective participation by small shareholders is possible only if there is a cost effective way of waging a proxy campaign. This would enable dissenting shareholders to collect proxies from others and prevent measures which are prejudicial to the minority shareholders.

**Conclusions**

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

Corporate Governance in India is improving today, relative to a situation where this was not an issue much discussed by management at all. Now both corporate governance and governance of public institutions are hot topics. As in other parts of the world, good governance has become a cottage industry. But there is a long way to go. This is partly because it's not clear that the system that works best in one country will necessarily do so elsewhere. Further, even if it does transfer, the implementation is non-trivial. In India, similarly, there is a long way to go.

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