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**THE TIDE RISES, GRADUALLY
CORPORATE GOVERNANCE IN INDIA**

by

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The Tide Rises, Gradually Corporate Governance in India

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Since the second half of the 19th. century, most modern industries and services in India have been structured under the English common law framework of joint-stock limited liability. Despite this long corporate history, the phrase “corporate governance” remained unknown until 1993.¹ It came to the fore due to a spate of corporate scandals that occurred during the first flush of economic liberalisation.

The first was a major securities scam that was uncovered in April 1992, which involved a large number of banks, and resulted in the stock market nose-diving for the first time since the advent of reforms in 1991.² The second was a sudden growth of cases where multinational companies started consolidating their ownership by issuing preferential equity allotments to their controlling group at steep discounts to their market price.³ The third scandal involved disappearing companies of 1993-94. Between July 1993 and September 1994, the stock index shot up by 120%. During this boom, hundreds of obscure companies made public issues at large share premia, buttressed by sales pitch of obscure investment banks and misleading prospectuses. The management of most of these companies siphoned off the funds, and a vast number of small investors were saddled with illiquid stocks of dud

¹ This is not surprising. In the USA, corporate governance came into prominence only after the second oil shock in 1979 — when activist pension funds started demanding board level performance for its investors, and junk-bond funded raiders began to target under-performing companies. In the United Kingdom, corporate governance started to be spoken of only in the late 1980s and early 1990s in response to the collapse of the BCCI and malpractices of the Maxwell group, which led to the press questioning the City on its efficacy in monitoring British public limited companies.

² Essentially, a cartel of bull players in the stock market led by a person called Harshad Mehta illegally used the liquidity provided by inter-bank credit and debit receipts to drive up the prices of pivotal stocks. Given the lack of width and depth of the market at that point of time and the herd mentality of followers, Mehta’s cartel succeeded in pushing up the index (the Bombay Stock Exchange Sensex) by almost 150% between December 1991 and April 1992. When the ‘scam’ was discovered, the markets crashed from a peak of 4475 on 22 April 1992 to 2548 on 5 August 1992, and then to a low 2218 on 29 March 1993, before the next boom began. The crash destroyed a large number of small retail investors and brokers who followed every move of Mehta’s, and questioned the ability of banking and capital market regulators to ensure transparency and safety.

³ This was designed as a low-cost strategy for equity consolidation and hence, as protection against corporate takeovers. It was facilitated by section 79(2) of The Companies Act, 1956, which allowed companies to issue shares at a discount so long as this was authorised by shareholders through a resolution and ratified by the Company Law Board. Such blatant instances of corporate misgovernance — where one block of equity holders were treated more equal than others — was publicised by the financial press until the government put an end to it in November 1994. For details, see Omkar Goswami, ‘Legal and Institutional Impediments to Corporate Growth’ in Charles Oman (ed.), *Policy Reform in India*, OECD Development Centre (Paris 1996), 124-25.

companies. This shattered investor confidence, and resulted in the virtual destruction of the primary market for the next six years.

These three episodes led to the prominence of “corporate governance” within the financial press, banks and financial institutions, mutual funds, shareholders, the more enlightened business associations, the regulatory agencies and the government. The point to note is that, unlike South-east and East Asia, the corporate governance movement did not occur due to a national or region-wide macroeconomic and financial collapse. Indeed, the Asian crisis barely touched India. And the need for good governance and better financial and non-financial disclosures became prominent well before the Thai baht began to nosedive in June 1997.

Today, more and more listed companies have begun to realise the need for transparency and good governance to attract foreign as well as domestic capital. A growing tribe of chief executive officers now recognise that complex cross-holdings, opaque financial disclosures, rubber-stamp boards and inadequate concern for minority shareholders is a recipe for being shut out of competitive capital markets. Almost nine years after the beginning of economic liberalisation, it is possible to discern the beginnings of desirable corporate governance practices, and indicators suggests that the trend will intensify in the next few years.

This article attempts to weave business history, economic theory and empirical evidence to delineate the story of corporate governance in India — its present score card as well as future directions. Section 1 gives a historical overview. This is essential to understand the structure of corporate India and why corporate governance meant so little until the last three or four years. Section 2 describes the present structure of corporate India. It gives details of the number of companies, the percentage that is listed, the size of stock exchanges and so on. Section 3 comments on two types of agency costs in the Asian context: one that affected efficiency and hence corporate value, and another that aided expropriation of minority shareholder rights. Section 4 looks at the legal and procedural barriers to good corporate governance. For analytical convenience, the barriers are divided into two categories — the rights of debt-holders and those of equity-holders. Thus, the section examines bankruptcy restructuring, liquidation and loan recovery on the one hand, and the market for takeovers and corporate control on the other. Section 5 examines corporate financial and non-financial disclosures, and how these match up with the best international practices. Section 6 analyses the *de jure* and *de facto* role of the board of directors. Section 7 discusses corporate governance of state-owned enterprises (SOEs), which account for a significant share of secondary and services sector GDP. Section 8 describes recent corporate governance initiatives, and how have these positively affected governance, disclosure, fairness and transparency. Section 9 concludes the essay.

1 The Historical Backdrop: From 1900 to 1990

In more ways than one, India was unlike any other de-colonised country in Asia or Africa. At the time of independence in 1947, India was one of the poorest nations in the world with a per capita income of less than \$30. Yet, manufacturing accounted for almost a fifth of the country’s national product, and half of that (10% of GDP) was contributed by the modern

factory sector which included cotton textile mills, jute mills and collieries, iron and steel mills, nascent engineering units and foundries, cement, sugar and paper.⁴

From the 1870s, growth of this sector was structured along corporate lines through joint-stock limited liability companies — most of which were floated in India and listed on local stock exchanges.⁵ The Bombay Stock Exchange (BSE) was formed in 1875 under the name of Native Share and Stockholders Association, and it began trading three years before the Tokyo Stock Exchange. At the beginning of the 20th. century had four fully functioning stock exchanges in Bombay, Calcutta, Madras and Ahmedabad, with well defined listing, trading and settlement rules. By independence, there were over 800 listed rupee companies, and many of them had sizeable floating stock.

The vehicle for corporate growth was the ‘managing agency’. It worked something like this. Every major corporate group had a closely held company or partnership called a managing agency. In effect, these functioned like holding companies. Managing agencies would float companies, and their imprimatur sufficed to ensure massive over-subscription of shares.⁶ Given excess demand, most of these companies could split shareholdings into small enough allotments to ensure that nobody — barring the managing agency — had sufficiently large stocks to ensure their presence in the board of directors. Thus, dispersed ownership allowed managing agencies to retain corporate control with relatively low equity ownership — a trend that continued right up to the mid-1980s and early 1990s. From the corporate governance point of view, therefore, the tendency for management in India to enjoy control rights that are disproportionately greater than its residual cash flow rights goes back to the early years of the 20th. century.⁷

On the positive side, however, because much of corporate growth in pre-independent India was financed through equity, India’s urban investors developed a sophisticated equity culture by the mid-20th. century. Moreover, the banking sector was surprisingly well developed for a country as poor as India. Every major bank that exists in India today was in operation well before independence. They were privately owned, advanced working capital, maintained prudential lending and accounting norms, and were backed up by sound recovery laws and efficient processes.

Since modern industrial growth was structured along corporate lines, it is not surprising that colonial India quickly put in place a substantive body of corporate law. For instance, the

⁴ For detailed expositions on the growth of Indian industry since the early 20th. century, see Bagchi (1972), Ray (1979) and Morris (1983). For national income estimates during the period 1900-47, see Sivasubramonian (1965, 1977) and Heston (1983).

⁵ Carr-Tagore and Company, the first joint-stock limited liability company in India was incorporated as early as 1848; and one of the ‘promoters’ of this company was an Indian — Dwarkanath Tagore. For details of this company, see Kling (1976).

⁶ Those who floated (or promoted) companies were called ‘promoters’ — a term that exists in ordinary and legal lexicon until this day. Promoters invariably managed the companies they floated.

⁷ Occasionally, this strategy had its dangers. In some industries, Indian merchants who were long term corporate vendors or purchasers also happened to be stockholders. Given the rudimentary nature of technology and low barriers to entry, some of these traders began to accumulate shares in the secondary market and then demand seats on the boards. This happened in a significant way in the jute and coal industry even during the colonial era. Goswami (1985, 1988, 1990) chronicles the market for takeovers in the jute industry and collieries during 1920-1950. Even so, it would be fair to say that low equity ownership coupled with complex cross-holdings allowed most promoters to control listed companies with relatively low ownership.

present Companies Act, 1956 — which, with its periodic amendments, substantially governs the legal and regulatory aspects of public and private limited companies — derives from the Indian Companies Acts of 1866, 1882 and 1913. Similarly, most of today’s legal jurisdiction for corporate matters and disputes pre-date independence. The Indian Trusts Act was passed in 1882 to regulate the functioning of all public and private trust funds. Legislation aimed at prudent regulation of banks began with the Reserve Bank of India Act, 1934 and was extended by the Banking Regulation Act, 1949. The law which regulates stock exchanges and the transactions of securities, The Securities Contracts (Regulation) Act, was passed in 1956.

Thus, India in 1947 had a sizeable corporate sector accounting for at least 10% of GDP; it had well functioning stock markets and a developed banking system; it had a substantial body of laws relating to the conduct of companies, banks, stock markets, trusts and securities; and it had an equity culture among the a section of the urban populace. It was probably *the* de-colonised country that was best equipped to practice good corporate governance, maximise long term corporate and protect stakeholder rights.

But it didn’t. To understand why and how India squandered its early advantages, it is necessary to examine the post-independent regulatory regime.

The first barrier to investments came with the Industries (Development and Regulation) Act, 1951 (IDRA), which required all existing and proposed industrial units to obtain licences from the central government. The IDRA continued for four decades before being dismantled in June 1991. The pervasive licensing regime under IDRA fostered entry barriers through pre-emption of industrial licences which, in turn, facilitated widespread rent seeking. Entrepreneurial families and business houses that had built their fortune in textile, coal, iron and steel and jute now used licences to secure monopolistic and oligopolistic privileges in new industries such as aluminium, paper, cement and engineering. Over the years, licensing became increasingly stringent and was accompanied by multiple procedures that required clearances from a large number of uncoordinated ministries. For instance, a typical private sector manufacturing company in needed government permission to establish a new plant, manufacture a new article, expand capacity, change location, import capital goods and do many other things that fell under the rubric of normal corporate activity.

A more serious barrier to entry occurred in 1956, when the Industrial Policy Resolution (IPR) adopted the maxim of ‘a socialist pattern of society’ and prescribed that the public sector would occupy ‘the commanding heights’ of the economy. Schedule A of the IPR listed 17 industries whose future development would be “the exclusive responsibility of the State”, and 12 Schedule B industries where “the State will increasingly establish new undertakings”.⁸ By a single stroke, India succeeded in creating yet another barrier to private investment. With it, the government also created a massive state-owned industrial and services sector which brought its specific dysfunctionalities, inefficiencies, cost disadvantages and corporate governance problems. These are discussed in section 7.

The late 1960s and early 1970s witnessed a more intensified trend to limit private investment and foster inefficient manufacturing scales. The Monopolies and Restrictive Trade Practices Act, 1969 (popularly known as MRTP) linked industrial licensing with an asset-

⁸ The genesis, growth and problems of India’s state owned enterprises is discussed by Mohan and Aggarwal (1990) and Bhandari and Goswami (2000).

based classification of monopoly.⁹ With the passing of MRTP, private sector businesses whose assets exceeded a paltry amount varying from Rs.10 million to Rs.1 billion had to apply for additional licences to increase capacities. More often than not, such applications were rejected. MRTP was followed by widespread nationalisation, which began in 1969 with the insurance companies and banks and, in 1970 encompassed petroleum companies and collieries. Among other things, nationalisation made employment preservation a political objective. The 1970s and early 1980s saw successive governments taking over financially distressed private sector textile mills and engineering companies — thus converting private bankruptcy to high cost public debt.

In addition, the government made a fetish out of ‘small is beautiful’. This occurred in two ways. First, successive governments sponsored the setting up of mini-plants, and the 1980s saw a mushrooming of technologically non-viable mini-steel, mini-cement and mini-paper units whose profitability hinged upon heavy tax concessions, high initial leveraging, subsidised long term finance, high tariffs and import quotas and the munificence of government orders. Second, governments actively encouraged small-scale industries. While this is not necessarily a bad thing — small and medium enterprises are often more efficient and flexible compared to larger firms — the small-scale sector was fostered through a plethora of artificial means, such as tax concessions and product reservations. Even today, there are over 800 product lines reserved for the small scale sector, of which more than 600 aren’t even manufactured in India!

Naturally, these distortions could not have existed in an outward oriented, open economy. They were eventually supported by a regime of high tariffs and import quotas. Despite preferential tariffs for Britain and the Empire countries, there were no major barriers to trade during the colonial era. Consequently, the major industries that existed prior to independence — cotton textiles and yarn, jute, tea and coal — were internationally competitive, and two of them (jute and tea) were driven by exports. Things began to change from the mid-1960s, intensifying with the import substituting regime of the 1970s and early 1980s. Import substitution made it incumbent upon a company to demonstrate to bureaucrats the ‘essentiality’ of any import, and the doctrine of ‘indigenous availability’ ensured the purchase of Indian inputs even at higher price-lower quality configurations.

Import substitution was sustained by quantitative restrictions and high tariffs. Quotas came in the form of various types of import licences. Among them were Actual Users (Industrial) Licenses, Actual Users (Non-industrial) Licenses, Capital Goods Licenses, Customs Clearance Permits, Supplementary Licenses, Import Replenishment Licenses, Special Import Licenses, Additional Licenses, canalisation of imports and Open General Licenses. Over the years industrial tariffs continued to be raised until the peak rate exceeded 300%. By 1985, the mean tariff rate for intermediate goods was 146% (standard deviation 56%); and for capital goods it was 107% (standard deviation 48%).¹⁰

To be sure, some of the policies helped setting up industrial capacities, especially in engineering, drugs and pharmaceuticals, chemicals, fertiliser and petrochemicals. But these also created highly protected markets, fostered uncompetitiveness and promoted large scale rent-

⁹ Interestingly, MRTP did not apply to state owned enterprises — on a wishful assumption that public monopolies were not inimical to either the nation’s or the consumer’s interest.

¹⁰ At that point of time, China’s mean tariff rates were 79% for intermediates and 63% for capital goods. See Kelkar, Kumar and Nangia (1990).

seeking through a nexus between companies and bureaucrats and politicians — a fertile ground for sowing the seeds of corporate misgovernance.

Added to this was the corporate and personal income tax structure. At its peak, the corporate tax rate was as high as 55%, and the maximum marginal personal income tax rate was an astronomical 98.75%. Such rates created phenomenal incentives for cheating which took many forms — undeclared cash perquisites, private expenses footed on company account, complicated emolument structures and complex cross-holdings of shares to confound calculations regarding dividend and wealth tax. The message was simple and profoundly negative. What mattered was how to expropriate larger slices of a small pie, and do so in ways that escaped the tax net. There were absolutely no incentives to grow the pie, create wealth and share it among stakeholders in transparent and equitable ways.

Curiously, the instrument that the government used to foster widespread industrial growth — subsidised long term loans as ‘development finance’ for creating fixed assets — militated against good corporate governance. In many ways, the story is similar to that of South Korea and requires some elaboration.

After independence, the Government of India set up three all-India development finance institutions (DFIs). These were the Industrial Finance Corporation of India (IFCI), the Industrial Development Bank of India (IDBI) and the Industrial Credit and Investment Corporation of India (ICICI). In addition, state governments set up their State Financial Corporations. From their inception up to the early 1990s, the *raison d'être* of these public sector DFIs was to foster industrialisation by advancing long term loans at low, often subsidised, real interest rates for setting up plant and machinery.

There is nothing wrong with a fiscally surplus government pushing subsidised long term funds for creating competitive industrial capacities. South Korea’s huge industrial base is a testimony to the efficacy of such a policy. However, when careful project appraisal is abandoned for loan pushing — DFIs were judged on the amount of loans sanctioned and disbursed, and not by their asset quality — and when this occurs in a tightly controlled, rigidly licensed, highly protected, import substituting milieu, it invariably results in crony capitalism, rent seeking, setting up of inefficient capacities and corporate misgovernance with public funds. This is precisely what occurred in India in the 1970s and 1980s.

There are two strands to the corporate misgovernance story *a la* DFIs. The first has to do with excess leveraging, and the second with the role of DFIs as shareholders. By the early 1980s, many term loans for industrial projects were sanctioned with a long term debt-to-equity ratio that exceeded 2.5:1, and a total debt-to-equity ratio that went over 4:1. This kind of gearing allowed the ‘promoters’ to start projects with a relatively low equity base. In fact, their equity contribution was lower still. During the industrial expansion of the 1970s and 1980s, average share ownership of the controlling groups declined to 15%. In other words, it was possible to embark on a Rs.500 million project with only Rs.100 million of equity, of which a mere Rs.15 million came from the promoters and sufficed for control.

To understand the extent of leveraging, one needs to take a cursory look at corporate data for the financial year ended 31 March 1991 — just before the beginning of economic reforms. In that year, 528 listed manufacturing and non-banking services companies posted sales in excess of Rs.500 million. Some 65% of their total capital employed of Rs.1,145 billion (or \$64 billion at the prevailing exchange rate) was accounted for by borrowed funds. Almost 20% of borrowings was supplied by the three all-India DFIs. The mean gearing (ra-

tio of total borrowing to net worth) was 1.25, the median was 1.44 and a third of the sample were leveraged in excess of 2.50. [Unless stated otherwise, data are computed from *Prowess*].

The stage was thus set for moral hazard of limited liability. Given subsidised loan funds and various tax incentives to set up industries, most promoters recovered their relatively meagre equity within a year or two of operation, if not earlier. Thereafter, in good states, DFIs could count on their loans being repaid. In bad states, debt took a hit while equity had already recouped its outlay. The nexus between business groups and politicians ensured that debts would be invariably rescheduled in the event of systematic default — in the name of ‘rehabilitating’ financially ‘sick’ industrial companies. Played out in the backdrop of inefficient implementation of bankruptcy laws, this created widespread corporate misgovernance, the least of which was major diversion of DFI funds for other ventures.

The other aspect of poor governance had much to do with the shareholding of government owned financial institutions. Even today, nine years after the advent of economic liberalisation, a substantial proportion of the equity of India’s private sector companies is held by the DFIs, the nationalised insurance companies, and the government owned mutual fund, the Unit Trust of India, or UTI.

Chart A: Government owned financial institutions are still large shareholders

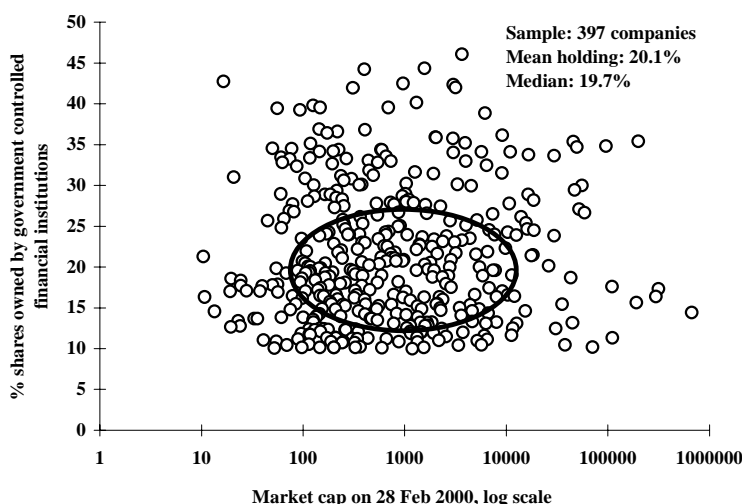


Chart A plots a scatter of India’s top 397 listed companies, ranked according to market cap. The mean shareholding of state-owned financial institutions is 20.1%; the median is 19.6%. This kind of indirect state ownership of equity also fostered poor corporate governance through inefficient monitoring. The institutional shareholders insisted on nominating their directors on corporate boards. Given their shareholdings, nobody could argue with that. However, at best, most of these nominee directors were incompetent; at worst, they were instructed to support the incumbent management irrespective of performance. Such significant errors of omission cannot be fully explained by the nexus between industrialists, bureaucrats and politicians. Much of it has to do state ownership of these financial institutions, where nobody was rewarded for profit-making or punished for adverse wealth and income consequences of inaction. Thus, the institutional share-owners, who could have played an important governance role, chose not to do so. Soon, promoters knew that they had the support of anything between a fifth and a third of the voting stock. Not surprisingly, their control rights vastly exceeded their cash flow rights.

In theory, the three all-India DFIs were very well placed to play the role of corporate governance watchdogs in the 1970s and 1980s. They were like the large German *hausbanks* — being major lenders as well as substantial shareholders. If the DFIs had done their job well, they could have simultaneously reduced the agency costs associated with debt and equity. But they didn't. On the equity side, the failure had to do with distorted incentives of government ownership and management of the DFIs, and the state–business nexus that induced nominee directors to invariably vote with the promoters. On the debt side, it had much to do with inadequate income recognition and provisioning norms, as well as poor processes for bankruptcy and debt recovery.¹¹

Thus, by the time India embarked on economic liberalisation, the waters had got very muddied. On the one hand, the country had an equity base which was substantially greater than most developing countries; had laws that regulated companies and protected the rights of shareholders; and had a very large and active industrial sector ranging from complex petrochemicals to simple toy manufacturing. On the other, a combination of licensing, protection, quotas, high gearing and poor board-level accountability had created an environment that didn't punish poor corporate governance. How have reforms changed this picture? And to what extent?

2 Structure of the Corporate India — A Description

Before describing India's corporate sector at the end of the 20th. century, it is useful to emphasise the great churning that has been unleashed by less than a decade of economic liberalisation. Nothing highlights this more than two simple comparisons — the fall from grace of yesterday's corporate giants, and the rise of the new kids on the block.

Consider the top 100 companies ranked according to market capitalisation as on 1 April 1991. How have these been treated by the market nine years after liberalisation? Very poorly, as the following statistics indicate:

- Between *rank* of the top 10 companies on 1 April 1991 fell by an average of 28 points as on 28 February 2000.
- The rank of the top 25 companies fell by an average of 47 points.
- The rank of the top 50 companies fell by an average of 58 points.
- For the top 100, the average fall in rank was 77 points.

Simply put, in relative terms, yesterday's giants have been dwarfed by the forces of change.¹² What about the new kings of the bourse? When did these firms come into being? That data is even more revealing, and shows how economic liberalisation, competitiveness and dismantling of controls have reduced entry barriers, and permitted new entrepreneurs to race to the top of the market capitalisation table.

¹¹ Right up to the late 1980s, banks and DFIs were allowed to book interest income on an accrual basis irrespective of actual payment, and rare was the case when a loan asset was properly written down. Thus, most accounts were never non-performing. Not surprisingly, all banks and FIs made 'profits'. India took 1993-96 to gradually introduce proper income recognition, asset classification and provisioning according to the Basle standards. When it did, the profits of most banks and financial institutions nosedived, and the government had to spend in excess of \$5 billion to recapitalise impaired banks. Bankruptcy is discussed in section 4. For non-performing loan assets and problems in the banking system, see CII, *Report on Non-Performing Assets in the Indian Financial System: An Agenda for Change* (December 1999).

¹² Indeed, some of these companies have even eroded their absolute value of market cap — despite a 420% growth in market capitalisation for this sample of 100 companies.

- Seven of the top 10 companies ranked by market cap as on 28 February 2000 either did not exist or were not listed on any stock exchange.¹³
- Twenty-eight of the top 50 companies were in identical circumstances.
- While information technology stocks rule the roost, other industries are represented as well (see Table 3).

The dominant characteristic of today's top 50 companies is the preponderance of first generation enterprise or professionally run businesses. In 1991, 22 out of the top 50 companies were controlled by family groups that held their sway during the licence-control regime. By February 2000, the roles were reversed: 35 were professionally managed, of which 14 were first generation businesses; only 4 out of the 50 were run by older business families. This change has augured well for corporate governance. The new breed of managers are not wedded to the mechanics of capture of the *dirigiste* regime of the past. Instead, they believe in professionalism and the credo of running business transparently to increase corporate value. Thus, the need for good corporate governance is being appreciated as a sound business strategy, and as an important facilitator to tap domestic as well as international capital.

Now for a brief description of India's corporate sector. It consists of closely held (private limited) as well as publicly held (public limited) companies.¹⁴ Among the latter are those which are listed in one or more stock exchanges. Table 1 gives the data for 1997-99.

Table 1: Basic statistics of India's corporate sector, 1997-99

	1997	Share	1998	Share	1999	Share
Number of companies						
Closely held (Private limited)	386841	86%	415954	86%	440997	86%
Widely held (Public limited including listed)	64109	14%	68546	14%	71064	14%
All companies	450950	100%	484500	100%	512061	100%
Paid-up capital (Rs. billion)						
Closely held (Private limited)	588	32%	718	34%	790	34%
Widely held (Public limited including listed)	1257	68%	1409	66%	1503	66%
All companies	1845	100%	2127	100%	2293	100%
Government companies						
Number of companies	1220	0.30%	1223	0.30%	1240	0.24%
Paid-up capital (Rs. billion)	797	43%	824	39%	890	39%

Source: Ministry of Law and Justice, Department of Company Affairs, Government of India

As expected, the number of closely held companies vastly outnumber the publicly held ones, and constitute the bulk of small scale enterprises. However, it the public limited companies including the listed ones which account for almost two-thirds of the book-value of equity. The other point worth noting from Table 1 is the size of the government corporate sector: while it accounts for a mere 0.24% of the number of companies, it speaks for 39% of corporate India's paid-up capital.

A little over 10,000 listed firms form a sub-set of public limited companies. While there are 23 registered stock exchanges in India, many are moribund — and exist only because the law insists that any listed company must at least register with the stock exchange that is lo-

¹³ Among these are Infosys (ranked third with a market cap of almost \$14 billion and the first company to be listed on Nasdaq), Zee Telefilms (ranked fourth with a market value of \$13 billion), and Reliance Petroleum (which is putting up Asia's largest refinery in Jamnagar in Gujarat, and has a market cap in excess of \$7 billion).

¹⁴ There is no category called listed company in The Companies Act, 1956. That is defined in the Securities Contract (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992.

cated nearest to the company's registered address.¹⁵ Only two stock exchanges matter in terms of size, efficiency and liquidity. These are the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE), which came into being in the late 1980s. It is fair to say that any company worth its reputation in corporate India is listed in either BSE or NSE, or both.

At the end of February 2000, the market capitalisation of companies listed on the BSE or stood at Rs.10.3 trillion, or US \$236 billion. Thus, the market capitalisation of India's listed companies accounts for almost 53% of the country's GDP. Moreover, the present level of market cap ranks India as the seventh in Asia-Pacific league table. Table 2 gives the comparative market capitalisation rankings.

Table 2: Market capitalisation of Asia-Pacific stock exchanges, August 1999 (\$ bn)

Stock Exchanges	Market cap
Tokyo	3710
Hong Kong	552
Sydney	398
Taipei	355
China	338
Seoul	256
Bombay (BSE)	236
Singapore	194
Kuala Lumpur	184
Bangkok	46
Jakarta	27
Manila	21
Karachi	10

Source: *Asia Week*, 10 March 2000 and BSE

A remarkable feature of listed Indian companies is the relative size of the SOEs. For example, the BSE lists only 73 government companies — which accounts for less than 2% of the listing. Yet, these stocks account for almost 15% of market capitalisation. Quite simply, the representative listed SOE is larger than its private sector counterpart. This has policy implications for corporate governance, which are discussed in section 7.

As mentioned earlier, while information technology stocks are at the top of the table, very many industries have their place in the sun among listed companies. Table 3 gives a list of sectors that account of 1% or more of BSE's market capitalisation.

Table 3: An illustrative list of sectors represented in stock exchanges

Sectors	Share
Computer software	17.76%
Computer hardware	17.47%
Diversified	11.06%
Refinery	5.58%
Banks and DFIs	4.53%
Drugs & pharmaceuticals	4.44%
Telecommunication services	3.99%
Trading	2.46%
Crude oil & natural gas	2.33%
Commercial vehicles, cars, two and three wheelers	1.99%
Tobacco products	1.96%

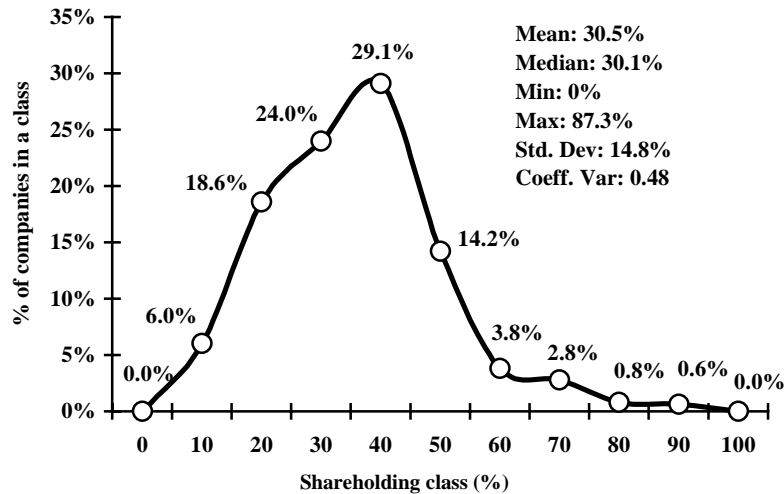
¹⁵ In fact, many of these 'regional' stock exchanges see no active trade whatsoever, and survive only on the basis of the annual listing fees of the companies located in its region.

Sectors	Share
Communication equipment	1.36%
Cement	1.13%
Finished steel	1.13%
Aluminium and aluminium products	1.03%
Cosmetics & toiletries	1.00%
Electricity generation	1.00%

Source: CMIE, *Prowess*

How wide and deep are the two main stock markets? Not enough by the standards of most developed countries. Public shareholding ought to cover shares owned by individual investors, mutual funds, insurance companies and DFIs. In India, it would be wrong to consider this aggregate as a measure of freely traded shares. DFIs and, to a lesser extent, the nationalised insurance companies hardly trade in the market. Hence, a more realistic concept of ‘freely tradeable shares’ should be limited to the holdings of individual investors and the mutual funds. This share varies considerably across listed companies, as Chart B shows.

Chart B: Frequency distribution of freely tradeable shareholdings



Thus, something like 30% of the shares of a ‘typical’ listed company can be theoretically treated as freely tradable. The average trading volume is far less. For liquid, pivotal stocks, anything no more than 20% of the freely tradable shares are actually traded on active days. Simply put, while the market cap of Indian companies is very impressive — especially given India’s per capita income of \$410 — the actual market for trading tends to be thin even in active exchanges like the BSE and the NSE. That explains the relatively high volatility of share prices, especially narrow based share indices such the BSE Sensitivity Index (or Sensex) or the NSE-50 (popularly called Nifty).

Before moving on to the next section, it is necessary to briefly describe the laws that govern corporations in India. If an entity is incorporated as a company — which accounts for the vast majority of corporate India — it is primarily governed by the provisions of the **Companies Act, 1956**. Based largely on its British counterpart, many sections of the Com-

panies Act have been amended from time to time.¹⁶ The Act has 685 sections organised in 13 parts, plus 14 schedules. Table 4 describes the more substantive parts of Act.

Table 4: Abridged subject content of the Companies Act, 1956

Parts	Description
Part I	Preliminaries, including definitions, and administration of the Company Law Board (CLB), a quasi-judicial body that has the powers to hear cases dealing with provisions of the Act. The CLB's decisions can be appealed to at the High Courts and, thereafter, the Supreme Court.
Part II	Rules and procedures regarding the incorporation of a company — memorandum and articles of association, definition of a 'member' and the membership of companies, registration.
Part III	Prospectus and allotment of ordinary and preference shares and debentures
Part IV	Kinds of share capital (ordinary and preference), numbering and certificate of shares, transfer of shares and debentures and reduction in share capital.
Part V	Registration of various types of charges
Part VI	Management and administration of a company: registered office, register of shareholders and debenture-holders, annual returns, frequency and conduct of shareholders' meetings and proceedings, managerial remuneration, the nature and payment of dividend, maintenance of accounts, statutory audit, the board of directors, disqualification of directors, meetings of the board, register of directors and their shareholdings, remuneration of directors, role of the Company Secretary, prevention of mismanagement and oppression of minority shareholders' rights, provident funds, and the power of investigation by the government, including powers of the CLB.
Part VII	Winding up, or liquidation of companies
Schedules	The important ones: the minimum that needs to be given in the memorandum and articles of association, who constitute relatives, the form of the annual report including balance sheet and profit and loss account along with its schedules, and rates of permissible depreciation.

Three other pieces of legislation are also very important from the point of view of corporate governance. These are:

- **Securities Contracts (Regulation) Act, 1956.** It covers all types of tradable government paper, shares, stocks, bonds, debentures and any other form of marketable securities issued by companies, including the “rights and interest in securities” — thus effectively allowing for options. The SCRA defines the parameters of conduct of stock exchanges as well as its powers.
- **Securities and Exchange Board of India (SEBI) Act, 1992.** This established the independent capital market regulatory authority, SEBI, with the objective to protect the interests of investors in securities and to promote and regulate the securities markets.
- **Sick Industrial Companies (Special Provisions) Act, 1985.** This Act, popularly known as SICA, lays down the framework for bankruptcy restructuring of financially distressed companies. SICA will be critiqued in section 4.

To conclude this section:

- India has a sizeable corporate sector registered as closely- or widely-held companies under the Companies Act.
- Although widely held firms speak for only 14% of the number of registered companies, these account for 66% of corporate India's book value of paid-up capital.

¹⁶ In fact, there have been so many disjointed amendments that the Act has now become unwieldy and, in many instances, unrepresentative of the times.

- The government sector plays a significant part among the widely held (though not necessarily listed) public limited companies. While government companies constitute only 0.3% of the number of companies, these account for 39% of paid-up capital.
- There are over 10,000 listed companies, the more reputable of which are listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). As of February 2000, the market cap of the BSE stood at \$236 billion — making it the seventh largest exchange in Asia-Pacific, and accounting for 53% of India's GDP.
- Private sector listed companies account for almost 80% of BSE's market cap; the remaining 20% is made up of listed government companies.
- Listed companies represent all possible commercial activity, covering every major branch of manufacturing and services.
- As in most stock exchanges, a large number of companies constitute a very small proportion of the market cap, while relatively few make up for the bulk. For instance, the top 10% of private sector companies (450 firms) account for over 96% of private sector's market cap.
- Freely tradable shares account for roughly 30% of the equity of listed companies. However, even on very active days, no more than 20% of this stock is traded — and that estimate is on the high side. Thus, despite the size of corporate India's market cap, trading volumes are quite thin. That has implications for the future of takeovers through open offers.

3 Two Types of Agency Cost

In corporate governance literature, the discussion of agency costs has mostly focused on efficiency. That's not surprising given the disproportionate role which US corporations have played to empirically validate agency costs arguments. Following Jensen and Meckling (1976), and a series of Michael Jensen's articles [Jensen (1986, 1988, 1989, 1993)], there is a widespread view that the dominant aspect of poor corporate governance is erosion of corporate value due to dispersed shareholding and the separation of ownership from control.¹⁷

The model is as follows. Modern US (and British) corporations are characterised by almost complete separation of ownership and control. Managers of vast corporations ran their empires with very little or no shareholding. Therefore, they had no incentive to align their managerial behaviour and decisions in line with those desired by the shareholders. Until the mid-1980s, this was facilitated by widely dispersed share ownership, and the absence of powerful pension and mutual funds which could have used their relatively concentrated stockholdings to demand greater shareholder value. According to Jensen and his followers, this was the prime cause for the spate of junk-bond financed takeovers and leveraged buy-outs from the mid-1970s to the mid-1980s.

Jensen's description fits US corporations of the 1970s and early 1980s like a glove. But here lies the rub. Intense Japanese competition after second oil price shock, the warning bells pealed by leveraged buy-outs during 1975-85, and the rapidly increasing power of large pen-

¹⁷ Well before Jensen, Adam Smith had highlighted the efficiency aspect of agency costs. Speaking of managers of joint-stock companies, Smith wrote, "The directors [managers] of such companies, however, being managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnership frequently watch over their own... Negligence and profusion, therefore, must always prevail more or less in the management of the affairs of such a company." Adam Smith, *An Inquiry into The Nature and Causes of The Wealth of Nations*, 31

sion funds like CalPERS and TIAA-CREF have changed the Jensenian model of corporate America. More important, the Jensen description doesn't seem to fit the story of corporate control in most parts of Asia.

There are three dominant themes that characterise corporate ownership and control in most parts of Asia. First, relative to their size, most Asian companies have low equity. This has been traditionally facilitated by highly geared, credit- and term lending driven growth. Second, given the low equity base, promoters have found it relatively cheap to own majority shares. This is true for many companies in Hong Kong, Indonesia, Malaysia, Philippines, Thailand and China. In many instances, the entrepreneur and his family own up to 75% of the equity, which thwarts all possibilities of equity-triggered takeovers. Third, as in the case of Korea and Japan, equity ownership is invariably camouflaged through complex corporate cross-holdings.

None of this conforms to the model of the modern US corporation — with its large equity base, dispersed shareholding and profound separation of ownership from management. However, that doesn't reduce the importance of agency costs. Unlike Jensen's model, these did not affect corporate efficiency as much as minority shareholder rights. A promoter who controls management and directly or beneficially owns over 75% of a company's equity is not expected to perform in a value-destroying manner like many US corporate managers and boards did up to the mid-1980s. However, he can do a large number of things that deprive minority shareholders of their *de jure* ownership rights, without adversely affecting pre- or post-tax profits. These involve fixing the election of board members, packing boards with crony directors, ensuring that key shareholder resolutions are vaguely worded and inadequately discussed at shareholders' meetings, fobbing off minority shareholder complaints, issuing preferential equity allotments to the promoters and their allies at discounts, transferring shares through private bought-out deals at prices well below those prevailing in the secondary markets, and the like.

In most parts of Asia, such acts did not necessarily destroy corporate value, and until the Asian crash of 1997-98 most listed companies of South-east Asia enjoyed consistently good valuations. Much of that may be because of thin and inefficient capital markets, greedy investors, and corporate governance structures that placed no value on proper financial and non-financial disclosures. Thus, from the late 1980s right up to the crash, poorly governed Asian companies did very well for themselves. They earned large profits, bagged greater and greater debt, grew in scale and scope and, most important, managed to maintain high valuations. The tycoon were honoured citizens who were admired for creating national wealth — not reviled as inefficient perquisite-grabbing managers and directors of the Jensenian corporations of the US in the mid-1980s.

It will take considerably more research before anyone can definitively apportion agency cost effects between efficiency and expropriation for the Asian corporations. However, the point to recognise is that poor corporate governance is not only about destroying shareholder value through managerial inefficiency arising out of the disjunction between share ownership and corporate control. Efficiently run firms that consistently outperform the market and earn returns that exceed the opportunity cost of capital can have poor corporate governance. And this can manifest itself in a steady expropriation of minority shareholder rights. Indeed, the attitude of minority shareholders in most parts of Asia has facilitated this

process. For most part, they have questioned corporate policies of their companies, and felt satisfied by their dividends and capital appreciation.¹⁸

Until the mid-1990s, India had the worst of both types of agency costs. Dysfunctional economic and trade policies combined with low equity ownership to allow companies to thrive in uncompetitive ways — which began to have their denouement when the economy started opening up to international competition. There was a major erosion of corporate value, measured in terms of economic value added (EVA), which is difference between the return on capital employed and the opportunity cost of capital. A CII study shows that, during the four-year period between 1995 and 1998, the top 363 listed Indian companies ranked by sales lost EVA to the tune of Rs.564 billion (\$13 billion), which amounted to almost 6% of the aggregate value of sales.¹⁹

Added to this value destruction was the expropriation of minority shareholder rights. In part, this was facilitated by the nominee directors of banks, financial institutions and DFIs who invariably voted with management. But laws did their bit as well. Until seven years ago, there were provisions in the Companies Act which put restrictions on acquisition and transfer of shares. Section 108B stated that if the government was satisfied that any share transfer might result in a change in the board of directors, and if it considered this “prejudicial to the interest of the company or to the public interest”, it could prevent such a transfer. Section 108D allowed government to restrict share transfer if it could lead to a change in the controlling interest that might be prejudicial to the company or public interest.²⁰

Thankfully, these provisions are things of the past and, as we shall see in the next section, there is now a transparent legal framework for facilitating the market for equity-driven corporate control. Besides, the introduction of paperless trading through dematerialisation of shares has drastically reduced transactions costs and allowed minority shareholders to enter and exit at will. Moreover, the market has begun to severely punish under-performing companies as well as those that have disregarded minority shareholder interests. For instance, the CII study mentioned above shows that, in the last four years, markets have consistently punished poorly governed under-performers and rewarded the more transparent firms.

4 The Rights of Debt and Equity

Curiously, while the market for corporate control has greatly improved on the equity side with a well-defined takeover code, the debt side remains as bad as it was in the licence-control days. It is hardly coincidental that countries with ineffective bankruptcy laws and

¹⁸ An example suffices to emphasise the difference in attitudes of small shareholders in the US and Great Britain and most parts of Asia. Until a couple of years ago, most individual Indian shareholders (who in the aggregate often hold more equity than mutual funds) were happy when their companies incessantly increased free reserves. It was considered a sign of good management and financial prudence — where the company put back a large chunk of its post-tax profits for future investments or for a rainy day. Such managerial behaviour will not be tolerated by shareholders in the US or Britain.

¹⁹ Omkar Goswami, M. Karthikeyan and G. Srivastava, ‘Are Indian Companies Losing Shareholder Value?’, CII Corporate Research Series, 1(1), 1999. It is, however, difficult to ascertain how much of this value destruction was due to poor corporate governance, and how much due to these companies’ inertia and historical inability to deal with increasing competition.

²⁰ These provisions were tested in 1983, when Swraj Paul, a British citizen of Indian origin, launched a takeover bid for two major companies, Escorts and DCM. In both companies, the promoters controlled corporate affairs despite owning less than 5% of the equity. Paul might have succeeded in getting on to their boards, if not wresting control, had not the government used these provisions to prevent the share transfers.

procedures also have widespread corporate misgovernance. Poor protection of creditors' rights gives enormous — and ultimately deleterious — discretionary space to inefficient management. It allows companies to reallocate funds to highly risky investments (since management fears neither attachment nor bankruptcy); it needlessly raises the cost of credit; it debases the disciplining role of debt; and it eventually ruins the health of a country's financial sector. Unfortunately, India has very poor bankruptcy reorganisation laws and procedures, and the liquidation procedures are worse still.

Bankruptcy restructuring

Bankruptcy reorganisation of large industrial companies is governed by Sick Industrial Companies (Special Provisions) Act, 1985 or SICA, and the process is directed and supervised by the Board for Financial and Industrial Reconstruction (BIFR). A quick look at the law and BIFR will demonstrate the flaws of poorly designed and inadequately implemented bankruptcy procedures.

There are five fundamental flaws with the SICA-BIFR process. These are:

- a) **Late detection.** The law defines financial distress as erosion of net worth. This is much worse than bankruptcy — which is basically debt default. When a company loses so much as to erode its net worth, the probability of a successful turnaround becomes very low. Not surprisingly, between July 1987 and November 1998, only 11% of the 1954 cases that BIFR has considered 'maintainable' are no longer sick. A losing record of 89% reflects both late detection and time consuming procedures.
- b) **Cumbersome and time consuming procedures.** Between 1987 and 1992 the mean delay in arriving at a decision in BIFR was 851 days. That was bad enough. It has worsened since then. Between January 1997 and March 1998, the mean delay for cases that were sanctioned restructuring schemes was almost double at 1664 days; while those that were recommended liquidation took 1468 days. Such delays are caused by tedious quasi-judicial procedures where cases continue to go through multiple loops before a final decision is taken. These delays, of course, confer additional bargaining power to the management of the bankrupt company at the expense of secured and senior creditors.
- c) **Indefinite stay on all claims of creditors.** From the time the company is registered and until the case is disposed, BIFR will not allow creditors to exercise any claims. All reasonable restructuring processes confer time-bound stays. This is based on the assumption that the value of the whole is greater than the sum of its parts, and that a company must get some breathing space to reorganise itself and offer a viable restructuring plan. In BIFR, however, delays exceed four years. That makes the legal stay a key strategic device for the promoters of debtor firms. All they need to do is to get the case registered, and then secure protection from creditors' claims for four years or more.
- d) **Debtor in possession.** Neither SICA nor BIFR recognises that incumbent management always has great informational advantage compared to outside creditors. Therefore, a procedure that allows existing management to control and run a bankrupt company during the period when it is being reorganised invariably results in secured creditors having to take big hits on their exposures at the expense of shareholders and management. Studies by the *Committee on Industrial Sickness and Corporate Restructuring* (Goswami Committee, July 1993), Anant, Datta Chaudhuri, Gangopadhyay and Goswami (1994), Anant and Goswami (1995) and Goswami (1996) clearly show that secured creditors of BIFR companies had to make large write-offs on their exposure, while management and shareholders did not.

- e) *Violation of absolute priority rule.* This rule says that in any bankruptcy restructuring or liquidation process, senior creditors have to be settled in full before junior creditors are entertained at all. BIFR procedures violate this principal by often rewarding incumbent management and old shareholders (despite net worth being negative) at the expense of fully secured creditors.

It is not difficult to design a far better bankruptcy reorganisation system. The key features of an expeditious, market-driven and incentive compatible procedure must incorporate the following features.

- The definition of bankruptcy should be altered to debt default. That will detect financial distress much earlier than net worth erosion and, all other things being equal, increase the probability of a successful turnaround.
- Up to a point, bankruptcy restructuring should be voluntary for the company. The onus must be on the company to convince its secured and senior creditors with a satisfactory rescheduling and cash flow plan. This should be outside BIFR.
- Only if negotiations break down between the company and senior creditors should the case be taken to BIFR, which can give an extra time-bound chance to renegotiate. If that does not succeed, BIFR must appoint an independent administrator with the mandate to advertise for the sale of the company. During the advertising and sale period, BIFR should impose a strictly time bound stay on creditors' claims on the company's assets. In the meanwhile, an independent financial professional can determine the liquidation value of the company. That will serve as the confidential reserve price.
- The sealed bid offers must be submitted within the given time period. During this period, subject to a confidentiality bond, all prospective bidders should be permitted to conduct due diligence. Existing promoter(s) can also bid.
- The bids should be in two parts: (a) the post-restructuring profit and loss account, balance sheet and cash flow projections, and (b) the financial bid, which can be in cash or in recognised securities.
- Secured and senior creditors should vote within their class on (a). Those bids that secure the assent of 75% of secured and senior credit should be short-listed. The best financial bid of the shortlist is the winning bid.
- If the winning bid happens to be less than the liquidation value, then the company should go for liquidation. If it is greater than the liquidation value but less than the secured debt, then the proceeds should be pro-rated across secured creditors (including wage dues), with unsecured creditors getting nothing. If the bid is high enough to meet the outstanding of unsecured creditors, then all claimants get their dues. And if it was higher still, then old equity obtains the residual value.

In this scheme of things BIFR will act like a facilitator, instead of behaving like a court. All cases are designed to get cleared within a specified time period, and in a market-driven manner. Such a scheme was laid down in the Sick Industrial Companies Bill, 1997. Unfortunately, the political instability has kept the bill in limbo.

Bankruptcy liquidation or winding up

If bankruptcy restructuring under BIFR is tedious, liquidation under the Companies Act is virtually impossible. Major delays in High Courts to wind-up companies that are beyond redemption have been proven by evidence. Table 5 below gives the data as of 1992-93 for 1,859 companies which were under winding up in courts.

Table 5: Delays in Winding Up in Courts

0-10 yrs	10-20 yrs	20-30 yrs	30-40 yrs	40-50 yrs	>50 yrs
774 (41%)	506 (27%)	346 (19%)	186 (10%)	44 (2%)	3 (1%)

Note: () indicates % of total. **Source:** Ajeet N. Mathur, 'Industrial restructuring and the National Renewal Fund', ADB, 1993.

These delays reflect two factors of the law and legal administration:

- lack of appreciation that it is of prime importance to preserve the value of the assets of a company that is being wound up – which is best achieved by ensuring that these assets are quickly re-allocated to productive use by more efficient entrepreneurs;
- failure to realise that the parties worst affected by delays in winding up are workers and secured creditors.

An attempt to reform the laws governing liquidation was made in 1996-97 by the Working Group on the Companies Act. While drafting the Companies Bill (which still awaits introduction in the Lok Sabha, or the Lower House), the Group recognised the international trend in corporate bankruptcy: sell assets as quickly as possible; adjudicate and distribute later. It recommended an entirely new and time-bound approach to winding up, whose key features are:

- Encouraging voluntary winding-up, which is generally a more cost and time efficient manner of liquidation.
- Distinctly separating the two aspects of liquidation: (i) first, asset sale and (ii) then, distribution of the proceeds.
- Clarity in winding-up order — which should coherently describe the steps that have to be taken along with time frames for each action.
- Clear enunciation of the manner in which the Act would catalyze rapid, transparent, market-determined sale of assets.
- Well-defined and non-subjective norms to ascertain whether a company's assets should be sold in totality as a going concern, or in parts as individual asset sale.
- Permitting professionals such as chartered accountants, lawyers or company secretaries to be empanelled by the High Court as Company Liquidators.

At present, however, the proposed reform of SICA and winding-up remain in the realms of wishful thinking. These bills have yet to be read in the Rajya Sabha (Upper House), leave alone being introduced in the more important Lok Sabha.

By law, creditors have prior claims over shareholders. When their contractual obligations are not adhered to, creditors can do one of three things — demand bankruptcy reorganisation under SICA/BIFR or file for winding up of the company, or apply for receivership. As we have seen, BIFR leaves much to be desired, and filing for winding up is losing proposition. These are hardly credible threats. The speed with which creditors can obtain a receivership decree varies according to High Courts. It is quite efficient in Mumbai, extremely inefficient bordering on impossible in Calcutta, and somewhere in between in other High Courts.

Since 1993, banks and DFIs have recourse to a third alternative — that of filing for recovery of dues at the Debt Recovery Tribunals (DRTs). These quasi-judicial bodies were set up in response to inordinate delays in the standard judicial system. However, the last six years have shown that the DRTs are riddled with their own problems. For one, many of

them have not yet been set up because of either administrative delays in finding an appropriate presiding officer, or because injunctions have been filed against the appointment of such officers. For another, the DRTs have also got clogged up, and they have no infrastructural support to decongest their traffic.

On balance, creditors have very little protection in reality. A consequence of this is extreme risk aversion, especially in a new milieu where public sector bank managers have to stop pushing loans and focus on their bottom-line. As a result, banks are in a peculiar situation. On the one hand, they are flush with depositors' funds. On the other, they avoid lending to anyone other than blue chip companies. The remainder they invest in treasury bills — which are risk free, don't impair capital adequacy, give a return that is at least 300 basis points above the average deposit rate and, most important, require no effort at project appraisal. This pervasive debasing of debt is choking off funds to small and medium enterprises and — unless rectified by better implementation of creditors' rights — will have serious negative implications for the future structure and sustainability of industrial growth.

Market for equity-driven takeovers

Thankfully, the equity side of the market for corporate control has been reformed in substantive ways. Credit for this goes entirely to the capital market regulatory body, the Securities and Exchange Board of India or SEBI, which came into being under the Securities and Exchange Board of India (SEBI) Act, 1992.²¹

Until February 1997, companies could structure quietly negotiated takeover deals, which more often than not, left minority shareholders in the lurch. This changed with the SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 1997, which is popularly known as the Takeover Code. The major provisions are:

- **Disclosure.** Any person or body corporate whose shareholding crosses the 5% threshold has to publicly disclose this to the relevant stock exchange and to SEBI.
- **Trigger.** SEBI initially specified a 10% trigger. If an acquirer's shareholding crossed 10%, he (person or body corporate) had to make an open offer for at least an extra 20% of the shares. In other words, for market purchases, a slow rise in shareholding from 9.9% to say 11.9% is no longer permissible. If the acquirer crosses the 10% threshold, he must purchase at least 30%. Given the structure of share ownership in corporate India, SEBI believes — and rightly so — that 30% generally suffices to give controlling interest. Recently, the trigger has been raised from 10% to 15%.
- **Minimum offer price.** Any such public offer must carry a minimum price which is the average of the market price for the last six months.
- **Creeping acquisition.** Existing management is allowed to consolidate its holdings through the secondary market so long as such acquisition does not annually exceed 2% of the shares. This has been subsequently raised to 5%. The creeping acquisition provision is

²¹ The Board consists of a chairman and five other members, two of whom are from the central government and one from the central bank, the Reserve Bank of India (RBI). Among other things, SEBI is empowered to (i) regulate stock exchanges and any other securities markets, (ii) register and regulate brokers and sub-brokers, share transfer agents, bankers and registrars to an issue, underwriters, domestic and foreign portfolio managers, investors in securities, independent financial advisers, trustees of trust deeds, mutual funds and venture capital funds, credit rating agencies, depositories and custodians of securities, and self-regulatory securities market organisations, (iii) prohibit fraudulent and unfair trading practices, including insider trading; (iv) regulate public offers for the takeover of companies; and obtain information from all securities market institutions and intermediaries and conduct inspections, inquiries and audits.

aimed to allow management to gradually consolidate its ownership without detriment to minority shareholders.

- **Escrow.** To ensure that the takeover bids are serious, there has to be an escrow account to which the acquirer has to deposit 25% of the value of his total bid. He loses this in the event of his winning the bid but renegeing on timely payment.

The SEBI regulation has had two beneficial effects. First, it has created a transparent market for takeovers. Second, by legislating in favour of open offers, it has ensured that minority shareholders will have the right to obtain a market driven price in any takeover. Moreover, while friendly takeovers are still the norm, hostile takeovers have begun. And the SEBI Takeover Code has been already tested in at least half-a-dozen hostile bids, and has come out more robust than before.

5 Quality and Quantity of Disclosures

This section deals with financial and non-financial disclosures mandated by law, and their strengths and weaknesses. All companies have to prepare statutorily audited annual accounts which are first submitted to the board of approval, then sent to all shareholders, and finally lodged with the Registrar of Companies. Listed companies have three other requirements. First, the annual accounts have to be submitted to every stock exchange where the companies are listed. Second, they have to prepare abridged unaudited financial summaries for every quarter. Third, in addition to all the disclosure requirements mandated under the Companies Act for public limited companies, listed firms have to submit a cash flow statement.

In theory, the most substantive financial disclosures of companies are to be found in their annual reports — particularly the balance sheet, profit and loss account and their relevant schedules. All these sheets have to give the data for the current and the previous financial year. The gist of such disclosures and their critique is discussed here.

Balance Sheet

SOURCES OF FUNDS

Capital. This gives the share capital of the company, backed up by a schedule that gives details of the number of equity shares authorised, issued and paid-up. Taken together, these are sufficiently transparent.

Reserves and surplus. The summarised version is supported by a detailed schedule that classifies the reserves under various heads. The mandated items are (i) capital reserve, (ii) share premium reserve, (iii) debenture redemption reserve (iv) investment allowance reserve, (v) general reserves less the debit balance in the profit and loss account, and (vi) the surplus, i.e. balance in profit and loss account after providing for dividends, bonus or reserves. Again, this is up to international standards.

Secured loans. The accompanying schedule gives full line-by-line disclosure of debentures. The data on loans and advances from term lending institutions and banks is also quite detailed, and includes the description and extent of charge on each loan, with separate disclosure on foreign currency loans. In some cases, the problems lie with loans and advances from subsidiaries. Unfortunately, Indian accounting standards do not follow the

principles of consolidation.²² As a result, companies can, and do, under- or overstate such transactions for strategic purposes.

Unsecured loans. All heads of unsecured loans have to be listed.

APPLICATION OF FUNDS

Fixed assets. Although the listing of fixed assets in the schedule is quite exhaustive, it suffers from two types of problems. First, gross block is valued at historical cost. A more realistic approach will be to value all the elements at either market prices or replacement cost. Second, the depreciation schedule used in annual accounts have no bearing with that which is permitted for computing the corporate income tax liability. This is a historical anomaly which could be rectified by allowing for deferred tax liability.

Investments. These are split between long and short term, with the latter covering a period of a year or less. Investments in quoted securities have to be marked to market, while those in unquoted instruments are evaluated at cost. While the disclosures look tight on paper, this is the area of maximal opaqueness. Again, the reasons have to do with the lack of consolidation. This is what often occurs, especially in companies that care little for corporate governance and shareholder value. Suppose a listed company A has 20 closely held subsidiary investment companies. Quite often the management will siphon off investors' funds from A to the subsidiaries. Since the latter are private limited entities, it becomes very difficult for investors to track the second round of transactions, leave aside the third and fourth. Within a space of weeks, massive sums of money can be taken out as investments of a listed company — only to be parked in the subsidiaries, and then further muddied through complex inter-corporate transactions. For a few years, these 'investments' will be reflected as such in the accounts of A. Thereafter, these will be gradually 'written down' on the premise that the investments are souring. In the meanwhile, the funds will have effectively disappeared. The best solution is to mandate consolidation according to US-GAAP or Internationally Accepted Accounting Standards (IAAS), and insist of full disclosure of all related party transactions. Until these two changes are brought about, there will always be unscrupulous management intentionally misallocating investors' funds. In fact, according to bankers, the single largest reason for corporate financial distress in India is diversion of funds. Investment in subsidiary companies is a great vehicle for such siphoning.

Loans, advances and deposits. In the absence of consolidation, entries on this account can also be used to misallocate corporate funds. It is only a matter of eventually writing down the loans and advances as doubtful or bad.

Inventories are normally well captured, especially for medium and large scale manufacturing companies. Smaller companies tend to play around a bit with work-in-progress, but that is quite minor.

Sundry debtors can occasionally be used to artificially push up sales in the profit and loss account. It works as follows. Companies book extra sales in the last month or two before the end of the financial year, knowing that the revenue is not intended to be received by the year end. The top line on the profit and loss account gets inflated and, all else being equal, the bottom line as well. Fully anticipated unpaid dues get booked as receivable under sundry debtors. Sometimes this gets a bit more sinister. Output is siphoned out to a host of subsidi-

²² It is a different matter that some of the outward oriented, better governed companies are giving separate financial disclosures involving consolidation and related party transactions according to US-GAAP.

ary or ‘front’ dealer companies through dummy sales. No payment is intended to take place. The amount languishes receivable for a few years and is then written down — first as doubtful, and then as bad debt.

Cash and bank balances. Usually reflects the true picture.

Profit and loss account

By and large, the disclosures required in the profit and loss account are quite exhaustive and up to international standards. The Companies Act requires detailed schedules for:

- ‘other income’, i.e. income other than what the company earned from its sale of goods and services,
- expenditure on raw materials and intermediate goods,
- wages and employee costs,
- ‘other expenses’, which includes consumables, energy charges, repairs and maintenance, rents, rates and local taxes, advertising and selling costs, R&D expenses, travelling expenses, directors’ fees and commissions, and other heads,
- inventories, including work-in-progress and finished goods
- interest, which includes interest on fixed term loans and debentures and on other loans, less interest received.

There are two areas for fiddling the books. The first relates to manufacturing expenses, which can be inflated up to a point. Beyond that it requires collusion with the government’s sales tax and excise duty officials. The second has to do with selling, distribution, administration and other expenses. However, the scope for mis-reporting on these two heads is far less than for investments and loans on the balance sheet. And, by and large, most of the records in the profit and loss account tend to reflect the true and fair picture of a company.

Cash flow statement

Listed companies have to submit a three-part cash flow statement consisting of cash flows from (i) operating activities, (ii) investing activities, and (iii) financing activities. This statement is quite detailed and any reasonably well equipped financial analyst should be able to arrive at a company’s free cash flows for a given year.

As far as incorporated companies go, the quality of financial disclosure in the annual accounts is determined by three agencies: (i) The Department of Company Affairs, which administers the Companies Act, (ii) SEBI, which mandates special disclosure requirements for listed companies, and (iii) the Institute of Chartered Accountants of India (ICAI) — the body which lays down the parameters of Indian accounting standards.

While these standards are better than what prevails in most of Asia, including Korea and Japan, they are behind the norms laid down by US-GAAP. The critical differences between Indian accounting standards and US-GAAP are given in Table 6. Of these, the three most serious lacunae are the absence of consolidation, lack of segment reporting, and low standards of disclosure of related party transactions.

Table 6: Some Differences Between US-GAAP and Indian Accounting Standards

US GAAP	India
Consolidation of accounts is compulsory, with line-by-line aggregation for subsidiaries and equity pro-rated adding-up for associate companies.	Consolidation is neither statutory, nor is it at all popular. As on date, no more than half a dozen Indian companies have voluntarily chosen to fully adopt consolidation according to either US-GAAP or IAAS.
All assets and liabilities, including physical assets, are recorded at market value, wherever possible.	Assets and liabilities are recorded at historical value, except for quoted securities.
Depreciation is charged according to fair value or salvage value as calculated by management.	Depreciation is charged according to rates specified in the Companies Act. These rates are rigid and often anachronistic. More seriously, there are two sets of depreciation rates — one for computing profits in the profit and loss account (as per the Companies Act), and another for income tax purposes (as per the Income Tax Act, 1961). Anomalies between the two are embedded in the provision for income tax. These differences frequently induce management to adopt the lowest possible rates for the profit and loss account (thus showing large profits before tax), and the highest ones for income tax calculations. Consequently, good analysts never look at PBT. Instead they examine trends in PBDIT, PBDT and PAT.
Segment reporting is compulsory.	Although manufacturing companies are supposed to give some details about category-wise production, capacity utilisation and sales, such data is quite fragmentary. It is fair to say that there is no real segment reporting that is worth the name.
Accounting for deferred tax liability is compulsory.	Not accounted for at all.
Contingent liabilities are exhaustively specified.	One of the poorest aspects of Indian accounting is the cavalier attitude that many auditors take in disclosing details of contingent liabilities either in the 'Notes on accounts' or in their qualifications.
Detailed discussion on risk management is expected to form an integral part of the section on management discussion and analysis (MD&A).	For one, very few companies publish annual reports having a detailed MD&A chapter. The preferred substitute is a blandly disclosed Directors' Report which, more often than not, doesn't go beyond the minimum that is needed by the statutes. There is hardly any discussion on risk, barring one or two cursory paragraphs on Y2K.
Related party disclosure is very elaborate.	Companies Act requires a small element of related party disclosures — which must be kept separately in a register. However, this is nowhere near as elaborate and informative as US-GAAP.
All foreign currency losses have to be provided for in the year of occurrence.	Foreign currency losses can be amortised over a period of time.

While the Companies Act specifies punishments for non-compliance of financial disclosures, these are light. In most instances, the maximal penalty is either imprisonment for six months, or a fine of no more than Rs.2000 (\$48), or both. In practice, there has hardly been any instance of imprisonment. For instance, if a company does not comply with proper audit practices or does not make available the necessary financial documents for audit, the penalty is a fine that does not exceed Rs.500 (\$12). If the auditor's signed reports are not in

conformity with the law, the maximum penalty is Rs.1000 (\$24). In practice, the Indian system is quite lax. Huge judicial delays further diminish the minimal deterrence that such penalties are supposed to inflict. Moreover, some ethically questionable acts are considered par for the course. To give an example, certain auditing firms are known to cast benevolent eyes towards contingent liabilities, and ensure that the notes on account — while on the right side of the law — are sufficiently benign to give comfort to management. Such acts are routinely overlooked. And, while the ICAI prescribes detailed standards for external auditors, rare are the instances when it has taken any serious action against its members.

If anything, stock markets are doing their own enforcement. Increasingly, companies are enjoying premia for good corporate disclosures, and these have increased the demand for hiring the services of internationally respected and independent audit firms. Indian companies are increasingly finding the need for a reputed auditor for seeking foreign capital. This might clean up the system faster than enforcement that is mandated by law.

Credit rating

Since the early 1990s, the law prescribes that companies have to be rated by approved credit rating agencies before issuing any commercial paper, bonds and debentures. At present there are five rating agencies, of which four — CRISIL, CARE, ICRA and Duff and Phelps — are well established. Each of these agencies have a set of ratings from very safe to poorer than junk bond status. The rating has to be made public, and must be accompanied by the rating agencies' perceptions of risk factors that can affect payment of interest and repayment of the principal. Company management also exercises its right to comment on these risk factors.

In the past there has been a tendency to do 'rating shopping' — namely, to approach more than one rating agency and then publish the one which is most beneficial to the company. Section 8 highlights the code of best practices suggested by the Confederation of Indian Industry (CII). At this juncture, it is important to note that the CII code has commented on this practice, and recommended that:

“If any company goes to more than one credit rating agency, then it must divulge in the prospectus and issue document the rating of all the agencies that did such an exercise. It is not enough to blandly state the ratings. These must be given in a tabular format that shows where the company stands relative to higher and lower ranking. It makes considerable difference to an investor to know whether the rating agency or agencies placed the company in the top slots, or in the middle, or in the bottom.”
[CII, *Desirable Corporate Governance: A Code*, April 1998, Recommendation 15, pp.9-10]

Historically, three of the credit rating agencies — CRISIL, ICRA and CARE — were set up with shareholdings from the three all-India DFIs, namely ICICI, IDBI and IFCI. Recently, SEBI has insisted that these agencies will not be allowed to rate any of their shareholding companies or their subsidiaries.

Share ownership

As mentioned earlier, the Companies Act requires all companies to maintain a register of 'members' or shareholders, which has to be updated each time share transfers take place. In any given year, there are two dates for book closure (typically covering two weeks prior to the date of the AGM) for final updating of the register for payment of dividends. Although the register is legally public domain information, and a list of shareholders have to be sent to the Registrar of Companies, in practice it is not as public as made out to be, especially for closely held, unlisted companies.

It is easier to access shareholding information for listed companies—at least in terms of broad aggregates. Stock exchange listing agreements require shares to be declared in the basis of individual promoters, DFIs, foreign institutional investors, mutual funds, foreign holdings, other corporate bodies, top 50 shareholders, and other shareholders. While better than unlisted companies, this classification often fails to give a fully transparent picture of share control —thanks to the prevalence of fairly complex cross-holdings across most family or group controlled conglomerates.

Traditional family dominated business groups — which constitute a sizeable chunk of listed companies — have tended to protect their interest through complex cross-holdings. Contrary to popular opinion, the main objective of this practice was not so much to thwart takeover bids, but to avoid steep wealth and inheritance taxes that characterised pre-1991 India. Abolition of both these taxes as well as the tax on individuals for dividend income, and a reduction of personal income tax rates to a little over 30%, has led to many business groups slowly unwinding their cross-holdings. Even so, at this point, it would be quite difficult to use the stock exchange ownership classification to construct a share-ownership matrix like the ones required under Form 10-K of the US Securities and Exchange Commission (SEC).

The process of moving towards cleaner and more transparent share ownership is also driven by an increasingly active stock market. Foreign institutional investors, who now account for anywhere between 24% and 30% of the equity of highly traded companies, avoid companies with complex cross-holdings. Desire to raise market capitalisation and access international capital are finally doing the right things for the pattern of equity-holdings.

There is another factor that has diminished the importance of cross-holdings: the meteoric rise of new, technologically oriented companies such as information technology and drugs and pharmaceuticals. Today, two internationally recognised IT companies share the pride of place among the top-five in market cap (Wipro and Infosys). Eight drug companies feature in the top-25. These firms are run along highly professional lines; their management is outward oriented and attuned to best principles of disclosures and corporate governance.

Consider the case of Infosys. The company discloses its accounts in keeping with GAAP requirements of India, US and six other countries. It follows the CII code and the Cadbury committee recommendations on corporate governance, has a highly acclaimed and independent board with Audit, Remuneration and Nomination Committees. From 1996 onwards — three years before it issued an ADR and got listed on NASDAQ — Infosys has been making full-fledged disclosures under section 10-K of the SEC. Its annual reports contain an exhaustive management discussion and analysis as well as other financial disclosures that go beyond best international practices. Other highly acclaimed companies in terms of disclosure include NIIT, Bajaj Auto, Hindalco, Nicholas Piramal, Wipro, BSES, Housing Development Finance Corporation and Dr. Reddy's Laboratory. All of them have voluntarily gone well beyond the mandated disclosures of the Companies Act, and have done so in their self-interest. They have also been amply rewarded by the market for their transparency.

Disclosures about directors

The Companies Act is fairly exhaustive in its requirements about disclosing details of directors, senior management, and selling agents. Registers are required to be maintained that disclose material transactions of directors *vis-à-vis* the company, and whether they are related to each other. Annual reports of companies have to furnish details about the remuneration to the directors as a whole, including salaries, commissions, and directors' fees. However,

many of these disclosure are not detailed enough — for example that of directors' remuneration is given in the aggregate. Many others are made only at the time of appointment, and are not required on an annual basis. And other still, while technically in the public domain, are not made fully public in the sense of being disclosed in the annual report. The CII code has suggested major changes, and companies that abide by the code now make such disclosures in their annual reports (see section 8).

Related party transactions and other disclosures

As mentioned, perhaps the greatest drawback of financial disclosures in India is the absence of detailed reporting on related party transactions. At the level of the balance sheet, there is no requirement to report which investments and loans made by the corporation are to subsidiaries and associated companies. And while the Companies Act insists upon maintaining registers on sole selling agents and the company's business relationships with the directors, no such disclosure is separately made in the annual report. In this context, the *Working Group on the Companies Act* made certain important recommendations which are listed below.

- Comprehensive report on the relatives of directors — either as employees or board members — should be a part of the Directors' Report of all public limited companies.
- The fact a company has to maintain a register which discloses interests of directors in any contract or arrangement, and that it is open for inspection by any shareholder should be explicitly stated in the notice of the AGM of all public limited companies.
- Details of loans to directors should be disclosed as an annex to the Directors' Report in addition to being a part of the schedules of the financial statements. Moreover, such loans should be available only to executive directors.
- A tabular form containing details of each director's remuneration and commission should form a part of the Directors' Report, in addition to the usual practice of having it is a note to the profit and loss account.
- All listed public limited company must give segment information as a part of the Directors' Report in the Annual Report. This should encompass (i) the share in total turnover, (ii) review of operations during the year in question, (iii) market conditions, and (iv) future prospects. In the first instance, the cut-off was recommended at 10% of total turnover. The practice of segment reporting is rare.
- If a company has raised funds from the public by issuing shares, debentures or other securities, it must give a separate statement showing the end-use of such funds, namely: how much was raised versus the stated and actual project cost; how much has been utilised in the project up to the end of the financial year; and how the residual funds are invested. This disclosure should be in the balance sheet, as a separate note forming a part of accounts.
- In addition to the present level of disclosure on foreign exchange earnings and outflow, there should also be a note containing separate data on of foreign currency transactions that are germane in today's context: (i) foreign holding in the share capital of the company, and (ii) loans, debentures, or other securities raised by the company in foreign exchange.
- Differences in assets and liabilities between the end of the financial year and the date on which the board approves the balance sheet and profit and loss account must not be limited only to the Directors' Report. These should be clearly stated under the relevant sub-heads, and presented as a note forming a part of the accounts.

Insider trading

Clause (g) of sub-section (2) of section 11 of the SEBI Act, 1992, clearly states that one of the functions of the capital market regulator is “prohibiting insider trading in securities”. The law also defines insider trading quite explicitly:

“Insider trading takes place when insiders or other persons who, by virtue of their position in office or otherwise, have access to unpublished price sensitive information relating to the affairs of a company and deal in the securities of such company or cause the trading of securities while in possession of such information or communicate such information to others who use it in connection with the purchase or sale of securities.”

As in most countries, the problem with insider trading lies in implementation. The example of SEC shows that, even with sophisticated detection devices, it is very difficult to pin-point insider trades. In the US, less than 1% of the trades that are initially identified as potential cases of insider trading are actually investigated; lesser still are charged and convicted. In India there are three sets of problems. The first, despite the BSE and NSE having full-fledged screen based trading, it is still difficult to flag a trade as a possible case of insider trading. Second, given the number of brokers and middle-men who operate in the market, it is possible for a person who has insider information to create enough fire-walls between himself and the traders — which militates against identifying the real insiders. Third, and most important, SEBI does not have judicial powers like courts. It can conduct an investigation, prepare a report and even suggest a penalty; but it cannot inflict that penalty. The act of implementing the punishment vests upon courts. Given the judicial delays in India, such penalties don't account for much.

Despite SEBI's handicap, it has initiated several cases of insider trading. Most of them have been directed to relatively small players. There has been one exception: two years ago, India's largest market cap company was subjected to a pre-merger insider trading investigation. Although SEBI declared it to be a case of insider trading, the matter was overturned by the Appellate Authority.

Financial disclosures of banks and DFIs

Although Indian banks and DFIs disclose more than their counterparts in East and South-east Asia and, indeed, Switzerland, these fall short of what is desirable. In particular, neither banks nor DFIs need to disclose the structure and extent of their asset-liability mismatch — something that says a great deal about their future financial health. Moreover, while they follow the Basle standards for recognition of non-performing assets, this does not take into account some of the institutional realities of India. To give an example, a case that is referred to BIFR should not be expected to be resolved in anything less than four years. Therefore, prudential accounting should treat that loan as bad, and write it off the books — to be added back as profits if and when something is recovered. Similarly, any case going for winding-up under court should be written off. More often than not, such practices are followed in the breach.

In this context, ICICI has taken a lead. Driven by the objective of becoming India's first truly universal bank, ICICI has decided to tap the US capital market via an American Depository Receipt that is scheduled to be launched in late September 1999. In order to access the US market, ICICI has voluntarily re-cast its accounts for the year ended 31 March 1999 in terms of US-GAAP. The exercise has eroded ICICI's bottom-line by a third. But it has also created investor confidence — arising from the comfort that a large DFI is not afraid of

using the toughest accounting standards. Not surprisingly, ICICI's recent domestic IPO (concluded on 13 September 1999) was over-subscribed by 80%.²³

To summarise:

- Unlike most countries in East and South-east Asia, India has a strong body of corporate law that requires fairly exhaustive disclosure of financial data. By and large, the annual accounts of the larger listed companies give a 'true and fair' picture.
- There are, however, certain lacunae. Despite a mass of details required in the annual report, Indian companies still don't need to disclose related party transactions and consolidate the accounts of subsidiaries and associate companies. Moreover, while most of the disclosures regarding directors are required to be maintained in registers, these are not as much in the public domain as printed and widely circulated annual reports.

Nevertheless, there is a discernible trend towards increased disclosures in line with best international practices. This trend is voluntary and is being driven by the desire of professionally managed companies to access international capital markets.

6 Board of Directors

Perhaps the greatest drawback of corporate governance in India is the lack of independent directors on the vast majority of boards. This is not for the want of supply. With a population of a billion people, India has more than enough professionals to man corporate boards. It is entirely a reflection of the lack of demand — of a pervasive attitude that boards are empty legal constructs meant for justifying the perpetuation of existing management. This section gives a short resume of the legal requirements and then goes on to a longer description of the facts on the ground.

Corporate law clearly stipulates the requirement of a board of directors and that all directors are fiduciaries of the shareholders. The Companies Act emphasises the fiduciary aspect in several ways:

- Directors are elected by shareholders, and can be removed by them.
- Directors are accountable to shareholders, and an expression of this is to be found in the Directors' Report to the shareholders, which is mandated for every company.
- The remuneration of directors have to disclosed in the annual report, and their relationships and material interests with the company have to be disclosed in separate registers that are available to all shareholders.

Despite all legal trappings of being fiduciaries, most boards do not satisfy any of the conditions that accompany the principle of independent oversight. Listed below are the conspicuous absences.

- a) First, while there is a distinction between 'whole time' directors and other non-executive board members, there is no legal definition of independence.²⁴ A sample of the board

²³ On 28 March 2000, ICICI Bank, a subsidiary of ICICI, also got listed on the NYSE, and thus conformed to all SEC disclosure standards.

²⁴ Recently, SEBI has mandated such a definition, which is discussed in section 8. Until then, a few companies defined an independent director one who is (i) not a formal executive and has no professional relationship with the company, (ii) not a large customer and/or vendor to the company, (iii) not a close relative of the promoter and/or any executive directors, (iv) not holding a significant stake, and (v) not a nominee of any large shareholder/creditor.

composition of the top 100 companies would reveal that truly independent directors hardly account for more than a fifth of the board.

- b) Second, in most companies, non-executive directors do not constitute even a third of the board. More often than not, the non-executives are family members, recently retired CEOs and company managers, representatives from the firm that offers legal advice, and disinterested nominees of DFIs, LIC, GIC and UTI.
- c) Third, quite often the agenda papers for the board meeting arrive just a day or two before the date of the meeting. Sometimes these are given to the directors the night before when they check in to their hotel. Moreover, there are two types of agenda papers. The first is the ‘thin agenda’ which contains very little prior information of what is to be discussed by the board. The second is the ‘thick’ agenda. This is the preserve of government companies. Such agendas run to several hundred pages — most of which concern irrelevant items that should never have been brought to the board in the first place. Rarely does one come across the ‘right sized’ agenda, which concisely outlines the issues to be discussed, their importance, and the tasks before the board for that meeting. Companies presenting thin agendas either have nothing worthwhile to discuss in the board, or table extremely important issues under ‘Any Other Item’ — which are then expected to be discussed and ratified with no prior reading or preparation. Those with thick agendas often slip in key board resolutions towards the end — on the assumption that the non-executive directors would be too exhausted going through reams of inane matter.
- d) Fourth, except for a couple of dozen companies, board meetings last less than half a day. They begin at about 10.30 a.m. and close at 1.30 p.m. — in time for a leisurely lunch.
- e) Fifth, until very recently, there was no law or regulation, either under the Companies Act or via listing agreements, that requires boards to have Audit, Remuneration or Nomination Committees.²⁵ The fact that roughly two dozen large companies had one or more such board-level committees reflected their desire to follow international corporate governance standards.
- f) Sixth, more often than not, management shares very little substantive information with outside directors. Indeed, outside directors are generally so chosen as to not bother too much about such information.
- g) Seventh, while the bulk of non-executive directors play a passive role, perhaps the most non-performing and dysfunctional ones are the employees of public sector banks, DFIs, LIC, GIC and UTI. To begin with, most of these ‘nominee directors’ fail to understand that they are fiduciaries of the company where they have been elected to the board. Instead, their major interest — if any at all — is directed to protecting the exposure of their parent company. Moreover, in the majority of cases, they bring with them little specialised knowledge of any aspect of a corporation and, hence, contribute very little to the deliberation. Worse still, they sometimes demand special treatment — which is acquiesced to, given that they control credit and/or a large equity stake. The sad aspect of institutional nominee directors is that while they are, in theory, well placed to exercise effective oversight, they hardly ever discharge this role in practice. Since the management recognises them as necessary evil, they are borne with patience but little else.

²⁵ This has changed with the recent SEBI Corporate Governance Code, which is discussed in section 8.

h) Eighth, all of this reflects a basic malaise of India's corporate sector — most companies are driven by their management and not by their boards.

How can one make the boards of Indian companies more active and aligned to the interests of maximising shareholder value? Despite SEBI's recent initiatives (see section 8), this cannot be mandated with any degree of success. A couple of things, however, are possible to create the right kind of milieu. The first is a positive, and has to do with remuneration of directors. At present, the vast majority of directors get paid a sitting fee, which has been recently increased by the government to a ceiling of Rs.5,000 per meeting (or \$115). This is hardly a compensation for properly exercising fiduciary responsibilities. To align directors towards short- and long-run maximisation of corporate value, companies must begin to offer a combination of commissions on net profits and stock options.

The second suggestion is in the nature of a stick. Listed companies should be mandated to disclose in their annual reports the attendance record of the directors. Moreover, shareholders should not generally elect directors who have less than 50% attendance record (either physically present or participating in a board meeting through tele- or video-conferencing). No doubt, attendance does not substitute performance. But publishing the attendance record would certainly dissuade directors from missing one board meeting after the other.

Having severely critiqued the *de facto* board structure in India, it is also necessary to state that there are major changes occurring in the boards of the top 20 or 30 private sector companies. Most of them have a majority of non-executive directors (if not genuinely independent ones). Most have at least an Audit Committee comprising of a minimum of three independent directors; some even have Remuneration and Nomination Committees. To attract good talent, these companies pay commission to directors over and above the token sitting fees; a few are contemplating stock options. All of them send the right kind of agenda papers well in advance of the board meetings; and the meetings themselves stretch over a full day. In some instances, key board meetings — such as the one which approves the annual accounts or fixes the operating budgets for the following year — can continue over two days, with various functional heads being invited to make detailed presentations about their departments.

7 State Owned Enterprises

Given the size of state owned enterprises (SOEs) among listed companies — which account for 20% of market capitalisation — it necessary to touch upon their governance structures. These are companies which can be best described by a phrase: “Agents without principals”. Shareholders (or principals) of private sector companies are direct beneficiaries of profitable performance. Therefore, in theory, they have an incentive to monitor management so that it maximises corporate value. In contrast, most government companies, especially the unlisted ones, do not have a substantial body of informed private shareholders whose income depends upon the performance of these companies.

If anything, the major shareholder of SOEs has distinctly different objectives. Commercial viability, profitability, quality, cost minimisation, optimal investment decisions and corporate value creation rarely figure among the concerns of a typical member of Parliament or a minister. Next in the hierarchy of shareholders' representatives comes the civil servants. By their very training, bureaucrats specialise in slavishly adhering to laid-down procedures, irrespective of their relevance. This training creates an inconsistency between the

organisational forms of governments and those of modern financial and industrial entities: *governments and their agents are process oriented, whereas firms have to result oriented.* The mismatch gets exacerbated by a civil servant's aversion to risk taking. Thus, when a civil servant serves on the board of an SOE, he typically tows the ministry's line, ensures that the SOE follows 'proper' procedures, and avoids any risky decision that may have harmful consequences for his ministry.

Given the non-commercial objectives of the principal, most chief executives of SOEs quickly adopt the line of least resistance, develop the 'don't rock the boat' syndrome and avoid changes that may alienate any powerful element among the shifting and fuzzy coalition of interests. Thus, important organisational changes are not made, erring staff remain undisciplined, loss-making plants are neither downsized nor closed, wages are not linked to productivity, and redundant workers are not retrenched.

Above all this sits Article 12 of the Constitution of India, which defines 'the State' as "the Government and Parliament of India and the Government and Legislature of each of the States and all local or other authorities within the territory of India or under the control of the Government of India". Since most SOEs have more than 50% government ownership, they fall under the ambit of 'the State'. This has affected SOEs in several adverse ways.

- All SOEs are expected to achieve a wide variety of non-commercial objectives which are imposed by the ministries and the Parliament.
- One of the most difficult one to maintain is employment reservation. Every SOE must adhere to the affirmative action norms, and ensure that the share of employment under reserved categories (scheduled castes, scheduled tribes, other backward castes, physically handicapped persons, and ex-military or dependants of those killed in military or para-military action) is identical to the central government ministries. Employment reservation is monitored at five levels: by the administrative ministries, the Department of Public Enterprises under the Ministry of Industry, the Departments of Personnel and Training under the Ministry of Labour, the Parliamentary Committee on the Welfare of Scheduled Castes and Scheduled Tribes, and the National Commission for the Scheduled Castes and Scheduled Tribes. The chief executive of an SOE has to ensure that the reserved quota is maintained not just on incremental employment, but increasingly on the average – and deviations, particularly in the higher paid categories, invite immediate Parliamentary questions and show-cause notices.²⁶
- The annual audit by the Comptroller and Accountant General (CAG) in addition to the audit by the statutory auditor. The area where CAG audits inflict the greatest *ex ante* damage is in purchases and tenders. SOE managers and board members invariably veer towards selecting the lowest bid, even when they know that the quality is poorer. Innumerable CAG allegations of financial impropriety adduced only on the basis of rejecting the lowest bid have taught SOE executives and directors that propriety dominates profitability.

²⁶ Presently, for all state agencies the minimal reservation quotas are 15% for Scheduled Castes, 7.5% for Scheduled Tribes, and 27% for Other Backward Classes – making it 49.5% of total employment. For the relatively lower paid, lower skill jobs, there is an additional quota of 3% for the physically disabled, and 14.5% to 24.5% for ex-military and dependants of those killed in military or para-military action. These quotas are particularly restrictive in selecting people for technically specialised jobs.

- Constraints on appointment of senior management personnel, which can only be done through the Public Enterprise Selection Board (PESB) and, thereafter, clearance from the Department of Personnel, the Home Ministry, and, in many instances, by the Office of the Prime Minister. This has led to delays, non-appointment of CEOs and executive directors and excessive emphasis on seniority. In such a milieu, biding time dominates corporate accomplishment. A study sponsored by the Standing Committee on Public Enterprises (SCOPE) in 1992 found that only 64 companies of a sample of 101 central SOEs had full-time chairmen or executive chairman-cum-managing directors; and the post of 30 chief executives and 66 executive directors were lying vacant [Kaw (1994), 360]. The study also found that only 13% of the chief executives and 5% of the functional directors remained in employment for the full five-year contract period; they reached the mandatory retirement age in an average of 18 months. Matters have not improved since.
- Since SOEs are parts of ‘the State’, they are subject to writ petitions to the Supreme Court under Articles 32, and High Courts under Article 226 of the Constitution.
- Again by virtue of being considered as servants of ‘the State’, managers as well as directors of SOEs are, in principle, subject to criminal investigation by the Chief Vigilance Commissioner and the Central Bureau of Investigation.
- State status limits managers from downsizing plants, retrenching or re-deploying employees.
- Finally, the directors of SOEs have little autonomy in finalising investment decisions.

What do SOE managers have to say about these restrictions? A SCOPE survey published in January 1997 emphasises their frustrations in no uncertain terms, as can be seen in Table 7.

Table 7: The SCOPE Sample Survey — Responses of Senior SOE Managers

Issues	Percentage of respondents
Accountability	
Oppose Interference from political quarters	62
Oppose Interference from bureaucracy	75
Oppose multiple reporting	65
Oppose multiple accountability (Ministries, vigilance, Parliament)	82
Bureaucrat Directors	
Oppose increase in number of government officers as directors	82
Restructuring	
Favour financial restructuring	77
Favour business restructuring	74
Favour privatisation	71

Note: 114 senior executives from 83 SOEs responded to the questionnaire. **Source:** SCOPE, *Opinion Survey of Public Sector Chief Executives: Executive Summary*, January 1997.

In the final analysis, there can be no real solution to SOEs without systematic and transparent privatisation. This has been recognised by the present government and clearly enunciated in its policies. However, progress has been poor — partly because of resistance from entrenched, rent-seeking bureaucracy, and partly due to the lack of sufficient —political will. In the meanwhile, even the better run SOEs are suffering on two counts. First, there has been a major fall in corporate value, measured in terms of EVA. For the four year period between 1995 and 1998, a sample of 109 SOEs in the aggregate lost EVA worth Rs.9.1 bil-

lion, which amounted to almost 9% of their capital employed.²⁷ Second, there has been a far more important loss — that of skilled and trained managers leaving for the private sector. Unless these companies get privatised, and managers realise that they will be rewarded for performance and risk-taking, this exodus will continue. And with it, the deterioration of SOEs will exacerbate.

8 Winds of Change — Recent Corporate Governance Initiatives

There have been two major corporate governance initiative launched in India since the mid-1990s. The first has been by , the Confederation of Indian Industry (CII), which is India's largest industry and business association. The second is by the SEBI.

The CII Code

More than a year before the onset of the Asian crisis, CII set up a committee to examine corporate governance issues, and recommend a voluntary code of best practices. The committee was driven by the conviction that good corporate governance was essential for Indian companies to access domestic as well as global capital at competitive rates. The first draft of the code was prepared by April 1997, and the final document (*Desirable Corporate Governance: A Code*), was publicly released in April 1998. The code focuses on listed companies. Given below are excerpts that highlight the rationale of the exercise, and summarise the key recommendations.

“First, there is no unique structure of corporate governance ... Thus, one cannot design a code of corporate governance for Indian companies by mechanically importing one form or another. Second, Indian companies, banks and financial institutions (FIs) can no longer afford to ignore better corporate practices. As India gets integrated in the world market, Indian as well as international investors will demand greater disclosure, more transparent explanation for major decisions and better shareholder value. Third, corporate governance goes far beyond company law.”

“The objective of good corporate governance [is] maximising long-term shareholder value. Since shareholders are residual claimants, this objective follows from a premise that, in well performing capital and financial markets, whatever maximises shareholder value must necessarily maximise corporate prosperity, and best satisfy the claims of creditors, employees, shareholders and the State.”

BOARD OF DIRECTORS

- “The key to good corporate governance is a well functioning, informed board of directors. The board should have a core group of excellent, professionally acclaimed non-executive directors.”
- “The full board should meet a minimum of six times a year, preferably at an interval of two months.”
- “Any listed company with a turnover of Rs.1 billion and above should have professionally competent, independent, non-executive directors, who should constitute at least 30% of the board if the Chairman of the company is a non-executive director, or at least 50% of the board if the Chairman and Managing Director is the same person.”
- “No single person should hold directorships in more than 10 listed companies.”
- “To secure better effort from non-executive directors, companies should:
 - Pay a commission over and above the sitting fees for the use of the professional inputs.
 - Consider offering stock options, so as to relate rewards to performance.”
- “While re-appointing members of the board, companies should give the attendance record of the concerned directors. If a director has not been present for 50% or more meetings, then this should be explicitly stated in the resolution that is put to vote. As a general practice, one should not re-appoint any director who has not had the time to attend even one half of the meetings.”
- “Key information that must be reported to, and placed before, the board must contain:
 - Annual operating plans and budgets, together with up-dated long term plans.
 - Capital budgets, manpower and overhead budgets.

²⁷ Bhandari and Goswami (2000), Chapter 3.

- ❑ Quarterly results for the company as a whole and its operating divisions or business segments.
- ❑ Internal audit reports, including cases of theft and dishonesty of a material nature.
- ❑ Show cause, demand and prosecution notices received from revenue authorities which are considered to be materially important. (Material nature if any exposure that exceeds 1 percent of the company's net worth).
- ❑ Fatal or serious accidents, dangerous occurrences, and any effluent or pollution problems.
- ❑ Default in payment of interest or non-payment of the principal on any public deposit, and/or to any secured creditor or financial institution.
- ❑ Defaults such as non-payment of inter-corporate deposits by or to the company, or materially substantial non-payment for goods sold by the company.
- ❑ Any issue which involves possible public or product liability claims of a substantial nature, including any judgement or order which may have either passed strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company.
- ❑ Details of any joint venture or collaboration agreement.
- ❑ Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
- ❑ Recruitment and remuneration of senior officers just below the board level, including appointment or removal of the Chief Financial Officer and the Company Secretary.
- ❑ Labour problems and their proposed solutions.
- ❑ Quarterly details of foreign exchange exposure and the steps taken by management to limit the risks of adverse exchange rate movement, if material.”
- ❑ “Listed companies with either a turnover of over Rs.1 billion or a paid-up capital of Rs.200 million should set up Audit Committees within two years. Audit Committees should consist of at least three members, all drawn from a company's non-executive directors, who should have adequate knowledge of finance, accounts and basic elements of company law. Audit Committees should assist the board in fulfilling its functions relating to corporate accounting and reporting practices, financial and accounting controls, and financial statements and proposals that accompany the public issue of any security and thus provide effective supervision of the financial reporting process. They should periodically interact with the statutory auditors and the internal auditors to ascertain the quality and veracity of the company's accounts as well as the capability of the auditors themselves.”

DESIRABLE DISCLOSURE

- ❑ “Listed companies should give data on: high and low monthly averages of share prices in a major stock exchange where the company is listed; greater detail on business segments, up to 10% of turnover, giving share in sales revenue, review of operations, analysis of markets and future prospects. “
- ❑ “Major Indian stock exchanges should gradually insist upon a corporate governance compliance certificate, signed by the CEO and the CFO.”
- ❑ “If any company goes to more than one credit rating agency, then it must divulge in the prospectus and issue document the rating of all the agencies that did such an exercise. These must be given in a tabular format that shows where the company stands relative to higher and lower ranking.”
- ❑ “Companies which are making foreign debt issues cannot have two sets of disclosure norms: an exhaustive one for the foreigners, and a relatively minuscule one for Indian investors.”
- ❑ “Companies that default 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.”

The CII code is voluntary. Since 1998, CII has been trying induce companies to disclose much greater information about their boards. Consequently, annual reports of companies that abide by the code contain a chapter on corporate governance which discloses:

- *The composition of the board:* executive, non-executive and independent directors. An independent director is (i) not a formal executive and has no professional relationship with the company, (ii) not a large customer and/or vendor to the company, (iii) not a close relative of the promoter and/or any executive directors, (iv) not holding a significant stake, and (v) not a nominee of any large shareholder/creditor.
- *The number of outside directorships held.*
- *Family relationship with other directors.*
- *Business relationship with the company, other than being a director.*

- *Loans and advances taken from the company.*
- *Remuneration* — consisting of salaries and perquisites, sitting fees, commission and stock options, if any.
- *Attendance of directors at board meetings*, including those of special committees of the board. These have to be tabulated as number of meetings held versus those attended.

In addition, companies are encouraged to disclose

- *details about their monthly high and low share prices in various stock exchanges, and compare these with the market indices;*
- *data on the distribution of shares across various types of shareholders and according to size classes;*
- *classes of complaints received from shareholders regarding share transfers, and how these have been addressed;*
- *economic value added (EVA), return on capital employed (ROCE) and return on net worth (RONW);*
- *details on risk factors, especially foreign exchange and derivative risks;*
- *details on contingent liabilities;*
- *data on outstanding warrants and their effect on dilution of equity, when converted;*
- *segment-wise information, wherever appropriate, in a chapter on management discussion and analysis.*

The efforts have started to bear fruit. For the financial year ended 31 March 1999, 23 large listed companies accounting for 19% of India's market cap have fully or partly adopted the CII disclosure norms. Indeed, companies such as Infosys, have long overshot such norms. A more subtle, yet pronounced, effect of the CII initiative is a distinct trend among larger listed companies to look positively towards corporate governance, and to stop discounting it as 'the flavour of the month'.

SEBI's Corporate Governance Initiative

The other major — and mandatory — corporate governance initiative has been taken by SEBI. In early 1999, it set up a committee under Kumar Mangalam Birla. By early 2000, the SEBI board had accepted and ratified key recommendations of this committee and informed all stock exchanges accordingly. SEBI's key recommendations are mandatory. These apply to listed companies and are to be enforced at the level of stock exchanges through listing agreements. The main recommendations are:

- Independent directors are defined as those who, apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgement of the board may affect their independence of judgement.
- Not less than 50% of the board should comprise of non-executive directors. The number of independent directors would depend on the nature of the chairman of the board. In case a company has a non-executive chairman, at least one-third of board should comprise of independent directors and in case a company has an executive chairman, at least half of board should be independent.
- Every listed company must, according to their size and a three year time-table, set up a qualified and independent audit committee at its board level. The audit committee should have minimum three members, all being non executive directors, with the majority being independent, and with at least one director having financial and accounting knowledge; the chairman of the committee should be an independent director, who

should be present at Annual General Meeting to answer shareholder queries; the Company Secretary should act as the secretary to the committee. To begin with the audit committee should meet at least thrice a year. One meeting must be held before finalisation of annual accounts and one necessarily every six months. The audit committee should have powers to (i) investigate any activity within its terms of reference, (ii) seek information from any employee, (iii) obtain outside legal or other professional advice, and (iv) secure attendance of outsiders with relevant expertise, if necessary.

- Among other things, the audit committee should (i) oversee a company's financial reporting process and quality of disclosure of financial information, (ii) recommend the appointment and removal of external auditor, (iii) review with management, external and internal auditors the adequacy of internal audit function and the annual financial statements before submission to the board, including financial risks and risk management policies.
- The board of directors should decide the remuneration of non-executive directors.
- The following disclosures should be made in the section on corporate governance of the annual report: (i) all elements of remuneration package of all the directors i.e. salary, benefits, bonuses, stock options, pension etc. (ii) details of fixed component and performance linked incentives, along with the performance criteria, (iii) service contracts, notice period, severance fees, and (iv) stock option details, and whether issued at a discount as well as the period over which accrued and over which exercisable.
- Board meetings should be held at least four times in a year, with a maximum time gap of four months between any two meetings.
This is a mandatory recommendation.
- To ensure that directors give due importance and commitment to their fiduciary responsibilities, no director should be a member in more than 10 board-level committees or act as chairman of more than five committees across all companies in which he is a director.
- In every company's annual report, there should be a detailed chapter on Management Discussion and Analysis. This should include discussion on industry structure and developments, opportunities and threats, segment-wise or product-wise performance, outlook, risks and concerns, internal control systems and their adequacy, relating financial performance with operational performance, and issues relating to human resource development.
- For appointment or re-appointment of a director, shareholders must be provided with the following information: (i) a brief resume of the director, (ii) nature of his expertise in specific functional areas, and (iii) companies in which he holds directorships.
- Information like quarterly results, presentation made by companies to analysts should be put on the company's web-site and sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.
- A board committee under the chairmanship of a non-executive director should be formed to specifically look into the redressing of shareholder complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc.
- There should be a separate section on corporate governance in the annual reports of companies. Non-compliance of any mandatory recommendation with their reasons should be specifically highlighted. This will enable the shareholders and the securities market to assess for themselves the standards of corporate governance followed by a company.

SEBI has set a timetable for ushering in mandated corporate governance. The recommendations must be followed at the time of listing for all companies that are listing for the first time. For already listed companies, the larger ones that fall under Group A of the BSE or in the S&P CNX 50 index (the Nifty), will need to adhere to the guidelines no later than 31 March 2001. That would cover more than 80% of market cap. For the rest, the guidelines will come into being either by 31 March 2002 or a year later, depending upon the size of share capital and/or net worth.

While most of SEBI's recommendations follow from the CII code, there is no question that the regulator's mandate has much more teeth. CII's code is, by its very nature, voluntary. In contrast, the substantive aspects of the SEBI code are mandatory. And there is a need to put in place certain mandated aspects of corporate governance.

There are, however, a couple of questions. The first relates to policing and punishment. SEBI envisages that all these corporate governance norms will be enforced through listing agreements between companies and the stock exchanges. A little reflection suggests that for companies with very little floating stock — which account for more than 85% of the listed companies — de-listing because of non-compliance is hardly a credible threat. SEBI can, of course, counter that by stating that it is first focusing on the big fish, namely the Group A and S&P CNX 50 companies. Here, the reputation effect of de-listing can induce compliance and, hence, better corporate governance.

The second issue is more problematic, and it has to do with form versus substance. There is a fear that by legally mandating several aspects of corporate governance, SEBI might unintentionally encourage the practice of companies ticking checklists, instead of focusing on the spirit of good governance. The fear is not unfounded. Take, for instance, the case of Korea. After the crash of 1998, a part of the IMF bailout package was that a fourth of the board of every listed Korean company must consist of independent directors. They do, but the directors are hardly independent by any stretch of imagination. For most part, they are retired executives of the *chaebols*, friends of business groups and politicians that have supported the business in the past. And, in any event, they don't do what was intended — namely, to speak for shareholders and ensure that management does what is necessary to maximise long term shareholder value.

This raises a question of how to trace the line that divides voluntary from mandatory. In an ideal world with efficient capital markets, such a question need not arise — because the markets would recognise which companies are well governed and which are not, and reward and punish accordingly. Unfortunately, ideal capital markets exist only in theory. The reality is quite different. Markets are often thin and shallow and operate on the basis of ebbs and flows of pivotal stocks; informational requirements are lax; and regulatory and policing devices leave much to be desired.

Thus, what is needed is a small corpus of legally mandated rules, buttressed by a much larger body of self-regulation and voluntary compliance. This will surely happen in India. When all listed companies are forced to follow the SEBI guidelines, the better ones will voluntarily raise the bar so as to be measured according to best international practices. That will happen because of the desire of the high performers to be separated from the chaff — and to emphasise this separation in order to attract international funds.

9 Conclusion

Although corporate governance has been slow in making its mark in India, the next few years will see a flurry of activity. This will be driven by several factors.

First, and most important, is the force of competition. With the dismantling of licenses and controls, reduction of import tariffs and quotas, virtual elimination of public sector reservations, and a much more liberalised regime for foreign direct and portfolio investments, Indian companies have faced more competition in the second half of the 1990s than they did since independence. Competition has forced companies to drastically restructure their ways of doing business. Underutilised assets are being sold, capital is being utilised like never before, and companies are focusing on the top and bottom line with a hitherto unknown degree of intensity. Moreover, while there have been losers in liberalisation, competition has led to greater overall profits. Thus, the aggregate financial impact of competition has been positive — the more so for those who went through the pains of restructuring in the relatively early days of liberalisation. And there is every indication that while many companies will fall by the wayside, many more will earn greater profits than before.

Second, as referred to earlier, there has been a great churning taking place in corporate India. Many companies and business groups that were on the top of the pecking order in 1991 have been relegated to the bottom. Simultaneously, new aggressive companies have clawed their way to the top. By and large, these are firms managed by relatively young, modern, outward-oriented professionals who place a great deal of value on corporate governance and transparency — if not for themselves, then as instruments for facilitating access to international and domestic capital. Therefore, they are more than willing to have professional boards and voluntarily follow disclosure standards that measure up to the best in the world.

Third, there has been a phenomenal growth in market capitalisation. Consider a common sample of 1,322 companies that were listed in 1991. Their market capitalisation on 1 April 1991 was Rs.678 billion (or \$38 at the prevailing exchange rate). On 28 February 2000, their market cap stood at Rs.5.52 trillion (or \$127 billion). For all companies taken together, the market cap on 28 February 2000 was Rs.10.3 trillion (or \$236 billion). This growth has triggered a fundamental change in mindset from the earlier one of appropriating larger slices of a small pie, to doing all that is needed to let the pie grow, even if it involves dilution in share ownership. Creating a distributing wealth has become a more popular maxim than ever before — the more so when the maxim is seen to be validated by growing market cap.

Fourth, one cannot exaggerate the impact of well focused, well researched foreign portfolio investors. In December 1993, the cumulative net foreign portfolio investment was \$827 million. In December 1999, it stood at \$10.2 billion. These investors have steadily raised their demands for better corporate governance, more transparency and greater disclosure. And given their clout in the secondary market — they account for over 15% of the average daily volume of trade — foreign portfolio investors have voted with their feet. Over the last two years, they have systematically increased their exposure in well governed firms at the expense of poorly run ones.

Fifth, the pressure on corporate governance will intensify with the entry of foreign pension funds. Indian equity offers very attractive dollar-denominated rates of return on capital, which is bound to make funds like CalPERS, Hermes or TIAA-CREF begin to invest in Indian stocks. These funds hold on to their investments much longer than mutual funds; and their fund managers will be looking even more closely at corporate governance before mak-

ing their investments. Indeed, it is fair to predict that in the next five years, the biggest pension funds will invest in India, and some of them will, like CalPERS, put Indian companies on their corporate governance watch.

Sixth, India has a strong financial press, which will get stronger with the years. In the last five years, the press and financial analysts have induced a level of disclosure that was inconceivable a decade ago. This will increase and force companies to become more transparent—not just in their financial statements but also in matters relating to internal governance.

Seventh, despite serious lacunae in Indian bankruptcy provisions, neither banks nor DFIs will continue to support management irrespective of performance. Already, the more aggressive and market oriented DFIs have started converting some of their outstanding debt to equity, and setting up mergers and acquisition subsidiaries to sell their shares in underperforming companies to more dynamic entrepreneurs and managerial groups. This will intensify over time, especially with the advent of universal banking.

Penultimately, Indian corporations have appreciated the fact that good corporate governance and internationally accepted standards of accounting and disclosure can help them to access the US capital markets. Until 1998, this premise existed only in theory. It changed with Infosys making its highly successful Nasdaq issue in March 1998. This was followed three more US depository issues — ICICI (which is listed on NYSE), Satyam Infoways (Nasdaq), and ICICI Bank (NYSE). At this point, there at least ten companies gearing up to issue US depository receipts in 2000, and all of them will get listed either of NYSE and Nasdaq. Twenty more are preparing for 2001. This trend has had two major beneficial effects. First, it has shown that good governance pays off in spades, and allows companies to access the world's largest capital market. Second, it has demonstrated that good corporate governance and disclosures are not difficult to implement — and that Indian companies can do all that is needed to satisfy US investors and the SEC. The message is now clear: it makes good business sense to be a transparent, well governed company incorporating internally acceptable accounting standards.

Finally, in a couple of years India will move to full capital account convertibility. When that happens, an Indian investor will seriously consider whether to put his funds in an Indian company or to place it with a foreign mutual or pension fund. That kind of freedom will be the ultimate weapon in favour of good corporate governance. Thankfully for India, the companies that matter, have already seen the writing on the wall. Thus, it may not be wrong to predict that, by the end of 2005, India might have the largest concentration of well governed companies in South and South-east Asia.