Executive Summary

Corporate governance mechanisms differ as between countries. The governance mechanism of each country is shaped by its political, economic and social history as also by its legal framework. Despite the differences in shareholder philosophies across countries, good governance mechanisms need to be encouraged among all corporate and non-corporate entities. While multilateral organisations like the World Bank and the Asian Development Bank have evinced keen interest in the subject of corporate governance an effective lead has been given by the OECD in evolving a set of cogent principles of corporate governance which are internationally recognised to serve as good benchmarks. There have also been some welcome initiatives by the stock exchanges in the UK and the US in prescribing good governance practices to their listed companies. These initiatives have been especially in the area of audit committee of the board and appointment of truly independent directors to tone up the quality of board deliberations and performance. The Advisory Group on Corporate Governance has attempted to compare the status of corporate governance in India vis-à-vis the internationally recognised best standards and has suggested a course of action to improve corporate governance standards in India.

Globally, the process of convergence in corporate governance is gathering momentum due to growing international integration of financial and product markets. Foreign investors and creditors are more comfortable in dealing with economic entities that adopt transparent and globally acceptable accounting and governance standards. Companies that embrace high disclosure and governance standards invariably command better premium in the market and are thus able to raise capital at lower costs.

The predominant form of corporate governance in India is much closer to the East Asian ‘insider’ model where the promoters dominate governance in every possible way. Indian corporates, which reflect the pure ‘outsider’ model with widely dispersed shareholdings and professional management control, are relatively small in number. A distinguishing feature of the Indian Diaspora is the implicit acceptance that corporate entities belong to the ‘founding families’ though they are not necessarily considered to be their private properties. Even today, the concept of industrial house popularised some time ago by the Dutt Committee and the MRTP Act continues to be the commonly accepted reference points in most of the discussions on ownership patterns of industrial/business units.

Strengthen Companies Act

As is generally the case in most of the well governed economies, in India too a detailed statutory framework of corporate governance has been defined primarily by the Companies Act. Most of the important requirements set out by the OECD principles in regard to good corporate governance are very well defined in the Companies Act in India. These provisions have been further supplemented by SEBI recently which has directed all the stock exchanges to amend their listing agreement to incorporate new clauses to make it binding on the listed companies to improve their governance practices. However, the main instrumentality, viz. the listing agreement, through which SEBI seeks to ensure implementation of its measures is a weak instrument, as its penal provisions are not hurting enough. Secondly, several regional stock exchanges where a large number of companies are listed lack effective organisations and skills to monitor effective compliance with corporate governance requirements as stipulated by SEBI. Moreover, a vast majority of companies which are not listed on any of the stock exchanges will remain outside the purview of SEBI's measures. It is therefore desirable that the Companies Act needs to be amended suitably for enforcing good governance practices in India.

Most of the important rights of shareholders like right to ownership and conveyance of transfer, obtaining relevant information regularly, elect members of the board, etc. are reasonably well covered by the Companies Act. However, the rights of shareholders of banks and public sector undertakings stand considerably abridged. The quality of disclosures by most of the Indian companies in regard to several key areas is rather poor. There is scanty disclosure regarding structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their known equity ownership. Similarly, disclosures regarding intra-group company dealings, division-wise accounts, consolidated accounts, etc. are all rather very poor. Companies need to share their business goals and plans with the shareholders adequately. The risk factors and off-balance sheet items affecting company's future performance should all be disclosed to the shareholders. In short the quality of financial reporting adopted by the companies in India needs to be substantially improved.

Role of Independent Directors

India has adopted a unitary board structure. For unitary board structure to function efficiently there should be a strong representation of non-executive independent directors who are capable of taking independent stand and are not cowed down by the full time directors or the promoters of the company. The board should be able to perform its task of monitoring performance of the full time directors satisfactorily. It should ensure that returns to the shareholders on their investments are maximised while not making any compromises with the provisions of law and the rightful interests of all the stakeholders. Since most of the Indian companies belong to the 'insider' model, the most important reform that should be quickly brought about is to make boards more professional and truly autonomous. They need to be restructured in such a way that majority of the directors are truly independent. An independent director is one who does not have any family relationship with any of the executive directors/promoters, does not have currently or during the last five years any material financial dealings with the company and is/was not, during the last five years, an employee of the company or other companies that have/had material financial dealings with the company.

It should be made mandatory that 50% or more of the board members are really independent (not merely non-executive) and are under no obligations whatsoever either of the executive directors or the promoters. Unless there is a clear and unambiguous definition as to who really is an independent director, the term is likely to be misinterpreted conveniently by the promoter groups. The independent directors would be in a position to play their fiduciary role more effectively especially if they possess experience and expertise in the areas related to the activities of the company. In some ways, the independent directors may be considered as the trustees for protecting interests of the common shareholders and the stakeholders. In view of the complexity of the tasks of governance, the boards of companies should appoint at least four committees of independent directors for monitoring and direction of the affairs of the company, viz. audit committee, remuneration committee, appointment committee, and investment committee. While remuneration committee is expected to play a key role in the determination of compensation package of executive directors and senior employees, the appointment committee should be the focal point in the induction of new and independent directors in the place of retiring directors. The appointment committee has a crucial role to play in ensuring that the boards do not continue to be the cosy places towing the lines of promoters.

Public Sectors Units & Banks

Given the important place occupied by the public sector entities in the fields of industry and financial sector, any steps to improve corporate governance in the Indian economy would remain incomplete and half-hearted unless public sector units are also covered in this exercise. Multiple layering of 'principal-agent' chains in the case of government owned entities has important consequences for the corporate governance mechanisms that will be adopted in them. Often the accountability chain is very weak in public sector units. The first important step to improve governance mechanism in these units is to transfer the actual governance functions from the concerned administrative ministries to the boards and also strengthen them by streamlining the appointment process of directors. The process of selecting directors should be made highly credible by entrusting the task to a specially constituted body of eminent experts with an independent and high status like the Union Public Service Commission.

The role and relationship of the administrative ministries should be limited to issuing of written guidelines/directives to units under their jurisdiction in so far as these instructions are expected to reflect the will of the ultimate owners viz. the voters as perceived by the concerned ministries. It is necessary that the rights of common shareholders should be recognised in the corporate governance mechanisms adopted by all the public sector entities. They should also adopt the system of setting up of the three important board committees viz. the audit committee, remuneration committee, appointment committee, and investment committee. While the body of the eminent experts prepares a panel of names, the appointment committees of the public sector entities should recommend to their boards the persons from such panels that could be considered for induction on their boards.

Both government and RBI need to bring about significant changes in the corporate governance mechanism adopted by banks and other financial intermediaries. As a matter of principle, RBI should not appoint its nominees on the boards of banks to avoid conflict of interests. Although it is not feasible to have a free market for take-overs in respect banks there is a strong case for recognising the rights of the shareholders, especially of public sector banks and financial institutions. Today the common shareholders are denied such basic rights as adopting annual accounts or approving dividends. They cannot also influence composition of the boards in any way. As per the Bank Nationalisation Act, the general superintendence, direction, and management of the PSBs vest with their boards. At the same time, the Act also empowers government to issue directions/guidelines in matters of policy involving public interest. Over the years, however, the nature of government directions has often exceeded the 'matters involving public interest' and includes the whole gamut of administrative and corporate activities of the PSBs.

As a part of strengthening the functioning of their boards, banks should appoint a risk management committee of the board in addition to the three other board committees viz. audit, remuneration and appointment committees. Since banks and institutions are highly leveraged entities their failure would pose large risks to the entire economic system. Their corporate governance mechanisms should, therefore, be relatively much tighter.

Current governance practices adopted by the PSBs have created an inequality among different types of directors. Special status amounting to veto powers given to government directors, is not in the interest good corporate governance. Banks should have clear strategies for guiding their operations and establishing accountability for executing them. Banks should maintain high degree of transparency in regard to disclosure of information.