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Corporate governance in India

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corporate governance in india

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centre for financial research
Look deeper

Corporate Governance in India

December 8, 2007

Abstract

This study describes the Indian corporate governance system and examines how the system has both supported and held back India's ascent to the top ranks of the world's economies. While on paper the country's legal system provides some of the best investor protection in the world, enforcement is a major problem with slow, over-burdened courts and significant corruption. Ownership remains concentrated and family business groups continue to be the dominant business model. There is significant pyramiding and tunneling among Indian business groups and, notwithstanding copious reporting requirements, evidence of earnings management. However, corporate governance in India does not compare unfavorably with any of the other major emerging economies: Brazil, China and Russia. India ranks high on the ease of getting credit, and has a well-functioning banking sector with one of the lowest proportions of non-performing assets. The two main Stock Exchanges have among the highest number of trades in the world, and the relatively young *Securities and Exchanges Board of India* has a rigorous regulatory regime to ensure fairness, transparency and good practice. Most importantly, the corporate governance landscape in the country has been changing fast over the past decade, particularly with the enactment of Sarbanes-Oxley type measures and legal changes to improve the enforceability of creditor's rights. If this trend is maintained, India should have the quality of corporate governance necessary to sustain its impressive current growth rates.

Keywords: Corporate Governance, International Financial Markets, Government Policy and Regulation

JEL Classifications: G34, G15, G18

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Corporate Governance in India

Introduction

One of the major economic developments of this decade has been the recent take-off of India, with growth rates averaging in excess of 8% for the past four years, a stock market that has risen over three-fold in as many years and a steady inflow of foreign investment. In 2006, total equity issuance reached \$19.2 billion in India, up 22%, while merger and acquisition volume was a record \$27.8 billion, up 38%, driven by a 371% increase in outbound acquisition--exceeding for the first time inbound deal volumes. Debt issuance reached an all-time high of \$13.7 billion, up 28% from a year earlier. Indian companies were also among the world's most active issuers of depositary receipts in the first half of 2006, accounting for one in three new issues globally, according to the *Bank of New York*. And, in each of the years 2005 and 2006, the number of trades on the *National Stock Exchange of India*, one of the two major Indian Stock Exchanges, was third highest in the world, just behind NASDAQ and the *New York Stock Exchange*, and several times greater than the number of trades on the *London Stock Exchange* or *Euronext*.

The long-term sustainability of the India “success” story depends critically on the state of corporate governance in the country. The aim of this paper is to present an overview of India’s corporate governance system. The next section makes an assessment of the legal and institutional aspects of investor protection and corporate governance in India – both the letter of the law and the reality of its implementation. Section 3 briefly describes the historical evolution of corporate governance in India, while section 4 looks at changes in corporate governance since liberalization started in the early 1990’s, including developments affecting corporate governance of financial institutions. Section 5 reviews the recent literature on corporate governance in India. Section 6 summarizes and concludes.

2. The Institutional Environment in India – An Assessment

Business Laws and Regulations

The Indian legal system is built on English common law and, on paper, provides one of the highest levels of investor protection in the world. India has a shareholder rights index of 5 (out of a maximum possible of 6), the *highest* in the rankings presented by Rafael La Porta, Florencio Lòpez-de-Silanes, Andrei Shleifer, and Rob Vishny in their 1998 study¹, and is equal to those of the United States, United Kingdom, Canada, Hong Kong, Pakistan, and South Africa (all English-origin-law countries), and

¹ See Rafael La Porta, Florencio Lòpez-de-Silanes, Andrei Shleifer, and Rob Vishny, 1998, “Law and Finance,” *Journal of Political Economy* 106, pp. 1113-1150.

higher than all the other 42 countries in the study including countries like France, Germany, Japan, and Switzerland.

In terms of creditor rights, the Indian legal system also seems to provide excellent protection for lenders, according to the La Porta, et al (1998) metric. With no automatic stay on assets in the reorganization phase, the requirement that secured creditors are to be paid first, restrictions on going into reorganization, and the provision for replacing management in reorganization, India has a creditor rights index of 4 (the maximum possible), better than that of Australia, Canada, Ireland, New Zealand and the United States, not to mention civil law countries. *Doing Business 2008*, a World Bank publication, also gives India a relatively high score of 6 on creditors' rights, well ahead of the other major emerging economies, Brazil (2), China (3), and Russia (3), now popularly labeled as the BRIC countries.

However, the La Porta, et al (1998) enforcement variables, constructed using figures obtained from private country risk rating agencies, suggest that the *de facto* protection of investor's rights in India lags significantly behind the *de jure* protection. India has a score of 4.17 on the "Rule of Law" index, ranking 41st out of 49 countries studied. On the other hand, India gets a score of 8 out of 10 on the "efficiency of judicial system" variable, just behind the English-law average of 8.15 and better than the overall sample average of 7.67. India's accounting standards are also better than the sample average across all countries rated, but they lag behind each of the English-origin countries rated.

On the corruption dimension, India has been ranked 72nd out of 180 countries in the *Corruption Perception Index 2007*, published by *Transparency International*. This *Corruption Perceptions Index* is intended "as a composite index, a poll of polls, drawing on corruption-related data from expert and business surveys" carried out by 14 sources originated from 12 independent institutions on the "degree to which corruption is perceived to exist among public officials and politicians". It focuses on the public sector and on abuse of public office for private gain, e.g. bribery, kickbacks in procurement, embezzlement, and the strength of anti-corruption policies. India has a corruption perception index of 3.5 with a "confidence interval" of 3.3 to 3.7. Scores from 3 to 5 indicate that corruption is perceived to be a "serious challenge" while scores below 3 indicate "rampant corruption". Interestingly, Brazil and China have the same corruption perception index of 3.5, albeit with wider confidence intervals, while Russia has a much lower index of 2.3 (country rank 143). In comparison, the U.S. is ranked 20th with a index of 7.6.

Red tape and regulations are among the main deterrents for business and foreign investment in India, leading to its latest ranking of 120 out of 178 in the World Bank's *Doing Business 2008* publication², a little behind China ranked 83 and Russia ranked 106, but slightly ahead of Brazil ranked 122. India is ranked 111th out of 178 for the ease of starting a business, worse than Russia (ranked 50) but better than Brazil (ranked 122) and China (ranked 135). India's entrepreneurs must follow, on average, 13

² See World Bank, 2008. *Doing Business 2008*, World Bank and Oxford University Press, Washington DC.

procedures over 33 days, which is worse than the global average but compares favorably with the average of 13 procedures over 72 days for the other BRIC countries. Delays and costs of dealing with licenses in India are also far worse than the global average, with India ranked 134th out of 178, worse than Brazil ranked 107th but still much better than China ranked 175th and Russia ranked 177th. However, India scores well on getting credit. It is ranked 36th, significantly ahead of Brazil, China and Russia, each of whom are ranked 84th. India's creditors' rights score is particularly good, but there is no credit information available from public registries, and there is a serious paucity of credit information available from private bureaus (only 10.8%).

India is ranked 85th overall for the ease of employing workers, ahead of China ranked 86th, Russia ranked 101st and Brazil ranked 119th. Payroll and social security taxes are 17% of salary in India half the average of the other BRIC countries, but the costs of firing an employee are higher at 56 weeks salary relative to the BRIC average of 50 weeks salary. There is considerable variation in labor laws across Indian states, and Timothy Besley and Robin Burgess show that during the three and half decades before liberalization began in 1991, Indian states that followed more "pro-worker" policies experienced lower output, investment, employment and productivity in the registered or formal sector, as well as higher urban poverty and increased informal sector output.³

World Bank's *Doing Business 2008* publication gives India an investor protection score of 6, ahead of each of the other BRIC countries. An extremely important aspect of investor protection in any country is securities markets regulation. Using the framework of La Porta, et al (2006)--which focuses on disclosure and liability requirements as well as the quality of public enforcement of the regulations controlling securities markets--India scores an impressive 0.92 in the index of disclosure requirements, which is the third highest after the United States and Singapore.⁴ As for liability standards, India's score of 0.66 is again high, being the fifth highest, while the sample mean is only 0.47. In terms of the quality of public enforcement—or the nature and powers of the supervisory authority--the Securities and Exchanges Board of India (SEBI) earns a score of 0.67, significantly higher than the overall sample mean and the English-origin average of 0.52 and 0.62, respectively, and ranks 14th in the sample.

In comparing the regulatory powers and performance of the SEBI with those of *Securities and Exchanges Commission* in the U.S., Suchismita Bose concludes that while the scope of Indian securities laws are quite pervasive, there are significant problems in enforcing compliance, particularly in areas like

³ See Timothy Besley and Robin Burgess, 2004, "Can Labor Regulation Hinder Economic Performance? Evidence from India" *Quarterly Journal of Economics*, 119, pp. 91-134.

⁴ This index is described in Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 2006. "What Works in Securities Laws?" *Journal of Finance* 61, pp. 1-32.

price manipulation and insider trading.⁵ Between 1999 and 2004, Bose finds that the SEBI took action in only 481 cases as against 2,789 cases by the SEC, even though the latter regulates a significantly more mature market. SEBI took action against only 9% of the companies under its jurisdiction, while SEC's corresponding figure was 52%. The ratio of action taken to investigations made is also quite low for the SEBI, with 1 out of 24 cases of issue-related manipulation in 1996-97, and 7 out of 27 in the five-year period 1999-2004. As for appeals before higher authorities--the *Securities Appellate Tribunal* or the *Finance Ministry*--in 30% to 50% of cases, the decision goes against the SEBI. Though the SEBI has had some success prosecuting intermediaries, it has failed to convince the *Securities Appellate Tribunal* in its proceedings against corporate insiders and major market players. Thus, it appears that the quality of public enforcement of securities laws in India could potentially be significantly improved.

The institution of Debt Recovery Tribunals (DRTs) in the early 1990's and the passage of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act in 2002 were aimed at speeding up the judicial process. The SARFAESI Act paved the way for the establishment of Asset Reconstruction Companies that can take non-performing assets off the balance sheets of banks and recover them. Operations of these companies are restricted to asset reconstruction and securitization only. SARFAESI also allows banks and financial institutions to directly seize assets of a defaulting borrower that defaults and fails to respond within 60 days of a notice. Borrowers can appeal to a DRT only after the assets are seized and the Act allows the sale of seized assets. The SARFAESI Act itself, however, does not provide a final solution to debt recovery problems. With the borrower's right to approach the DRT, the DRAT (Debt Recovery Appellate Tribunal) and, in some cases, even a High Court, a case can easily be dragged out for three to four years, during which time the sale of the seized asset cannot take place. It is perhaps too soon to evaluate this Act's effects on reducing defaults generally, but public sector banks have had very notable success recovering their loans by seizing and selling assets since the Act came into existence. The recovery rates of bad debts has registered a sharp rise in 2005-06 and after, though it is difficult to attribute this to the new Act since the economy has also been booming significantly since then.

Yet another positive development in the area of disclosure has been the adoption of Accounting Standard (AS) 18 by the Institute of Chartered Accountants in India (ICAI) in 2001 which, among other things, makes reporting of related party transactions by Indian companies mandatory. Related parties include holding and subsidiary companies, key management personnel and their direct relatives, "parties with control" (which includes joint ventures and fellow subsidiaries), and other parties like promoters and employee trusts. Transactions that must be disclosed include purchase or sale of goods and assets,

⁵ See Suchismita Bose, 2005. "Securities Markets Regulation: Lessons from US and Indian Experience", *Money and Finance*, Jan-June, pp. 83-124.

borrowing, lending and leasing, hiring and agency arrangements, guarantee agreements, transfer of research and development and management contracts. Adoption of this standard is a major positive development on the Indian corporate governance landscape by bringing transparency to the dealings of Indian companies, particularly those of group-affiliates.

An area of the World Bank's *Ease of Doing Business Index* where India fares particularly badly is the ease of closing a business. India is ranked 137th out of 178, and has the dubious distinction of being among the countries where it takes the *longest time to go through bankruptcy in the world* (10 years on average). Consequently, recovery rates have also been very low, below 12%, as opposed to about 27% in the other BRIC countries. Nimrit Kang and Nitin Nayar point out that there is no single comprehensive and integrated policy on corporate bankruptcy in India along the lines of Chapter 11 or Chapter 7 of the U.S. bankruptcy code.⁶ Overlapping jurisdictions of the High Courts, the Company Law Board, the Board for Industrial and Financial Reconstruction (BIFR), and the Debt Recovery Tribunals all contribute to the costs and delays of bankruptcy. However, there has, once again, been a very positive recent positive development in the form of the *Companies (Second Amendment) Act of 2002* seeks to address these problems by establishing a *National Company Law Tribunal* and stipulating a time-bound rehabilitation or liquidation process of less than two years. This Act also brings other positive changes to the bankruptcy code.

Stock Exchanges in India

India currently has two major stock exchanges--the National Stock Exchange, established in 1994, and the Bombay Stock Exchange (BSE), the oldest stock exchange in Asia, established in 1875. Until 1992 the BSE was a monopoly, marked with inefficiencies, high costs of intermediation, and manipulative practices, so external market users often found themselves disadvantaged. The economic reforms of the early nineties created four new institutions: the Securities and Exchanges Board of India (SEBI), the National Stock Exchange, the National Securities Clearing Corporation, and the National Securities Depository. The National Stock Exchange (NSE) is a limited liability company owned by public sector financial institutions and now accounts for about two-thirds of the stock trading in India, as well as virtually all of its derivatives trading.

The National Securities Clearing Corporation is the legal counter-party to net obligations of each brokerage firm, and thereby eliminates counter-party risk and the possibility of payments crises. It follows a rigorous 'risk containment' framework involving collateral and intra-day monitoring. The NSCC, duly

⁶ See Nimrit Kang and Nitin Nayar, 2004, "The Evolution of Corporate Bankruptcy Law in India", *Money and Finance*, Oct 03 – Mar 04, pp. 37-58.

assisted by the National Securities Depository, has an excellent record of reliable settlement schedules since its inception in the mid-1990s.

The Securities and Exchanges Board of India has introduced a rigorous regulatory regime to ensure fairness, transparency and good practice. For example, for greater transparency, the SEBI has mandated disclosure of all transactions where the total quantity of shares is more than 0.5% of the equity of the company. Brokers must disclose to the Stock Exchange, immediately after trade execution, the name of the client and other trade details, and the Exchange must then disseminate this information to the general public on the same day. The new environment of improved transparency, fairness, and efficient regulation led BSE to also become a transparent electronic limit order book market in 1996, with an efficient trading system similar to the NSE. Equity and equity derivatives trading in India has skyrocketed to record levels over the last ten years.

Currently, about 5000 companies are listed and traded on NSE and/or BSE. While the dollar value of trading on the Indian stock exchanges is much lower than the dollar value of trading in Europe or the United States, it is important to note that the number of equity trades on BSE/NSE is about *ten* times greater than that of Euronext or the London Stock Exchange, and of the same order of magnitude as that of NASDAQ and the New York Stock Exchange. Similarly, the number of derivatives trades on NSE is several times greater than that of Euronext or London, and is comparable to US derivatives exchanges. Figure 2 provides a summary comparison in this regard. The number of trades is an important indicator of the extent of investor interest and participation in equities and equity trading, and provides important incentives for improving corporate governance practices in India.

Enforcing Corporate Governance Laws

Enforcement of corporate laws remains the soft underbelly of India's legal and corporate governance systems. The World Bank's 2004 *Reports on the Observance of Standards and Codes* (ROSC) finds that while India observes or largely observes most of the principles, it could do better in many areas, including the use of nominee directors, the enforcement of laws and regulations pertaining to stock listing on major exchanges, insider trading, and dealing with violations of the Companies Act.⁷ Some of these problems arise because of unsettled questions about jurisdictional issues and powers of the SEBI.

Indian Courts – an assessment

⁷ See World Bank, 2004. "Report on the Observance of Standards and Codes (ROSC), Corporate Governance Country Assessment: India, ROSC", World Bank-IMF, Washington DC.

In their analysis of “formalism” in the judicial process around the world, Simeon Djankov and his co-authors give India a score of 3.34 on their formalism index, higher than the English-origin average of 2.76 but slightly lower than the 3.53 average for all countries.⁸ Among the 42 English-origin countries in their sample, India has the 11th highest level of formalism and the 16th longest process for evicting a tenant (212 days) among English common law origin countries (average 199 days). For collection on a bounced check, however, India has the 16th *shortest* duration (106 days) among English common law origin countries (average 176 days). In both cases, India’s total process duration is significantly shorter than the overall mean duration for all the 109 countries considered (254 for eviction of a tenant and 234 for collecting on a bounced check, respectively). Thus, in spite of their formalism and their otherwise poor reputation on their speed, Indian courts seem to perform well (relatively speaking) on these two types of cases.

This assurance notwithstanding, contract enforcement through the court system remains a major problem in India. The *World Bank Doing Business 2008* publication ranks India virtually the worst in the world in this regard with a rank of 177 out of 178, on the basis of tracking the efficiency of the judicial system in resolving a commercial dispute, following the step-by-step evolution of a commercial sale dispute before local courts. The data are reportedly collected by them through study of the codes of civil procedure and other court regulations as well as surveys completed by local litigation lawyers. They estimate the time for contract enforcement as 1420 days! This is not surprising. Case arrears and decade-long legal battles are commonplace in India. In spite of having around 10,000 courts (not counting tribunals and special courts), India has a serious shortfall of judges. While the United States has 107 judges per million citizens, Canada over 75, Britain over 50 and Australia over 41, for India the figure is slightly over 10.⁹ In April 2003, for instance, the Supreme Court of India had almost 25,000 cases pending before it.¹⁰ Amab Hazra and Maja Micevska report that about 20 million cases are pending in lower courts and another 3.2 million cases are pending in High Courts.¹¹ A termination dispute contested until all appeals are exhausted can take up to 20 years for disposal, while writ petitions in High Courts can take between 8 and 20 years. About 63% of pending civil cases are more than a year old, and 31% are over three years old. Automatic appeals, extensive litigation by the government, underdeveloped alternative mechanisms of dispute resolution like arbitration, and the shortfall of judges all contribute to

⁸ See Djankov, Simeon, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 2003. “Courts,” *Quarterly Journal of Economics*, 118, pp. 453-517.

⁹ These data are from Bibek Debroy, 1999, “Some issues in law reform in India”, in Jean-Jacques Dethier ed. *Governance, decentralization, and reform in China, India, and Russia*, Boston: Kluwer Academic Publishers.

¹⁰ See Pravin Parekh, 2001. “Access to Justice” in Souvenir of All India Seminar on “Access to Justice”, UNDP, pp. 326-340. <http://www.undp.org.in/events/AISAJ/>.

¹¹ See Arnab K. Hazra and Maja Micevska, 2004. “The Problem Of Court Congestion: Evidence From Indian Lower Courts”, *Working Paper*, University of Bonn.

this unenviable state of delays in Indian courts. Since the same courts try both civil and criminal matters, and the latter gets priority, economic disputes suffer even greater delays.

The Small and Medium Enterprises (SME) sector in India

The small and medium-sized enterprises (SME) sector in India has played, and continues to play, an important role in India's growth story. As in many other countries, this sector consists largely of family enterprises in India.

Franklin Allen and his co-authors conduct surveys to measure how well the formal legal environment directly supports and regulates businesses, particularly these small and medium enterprises.¹² Their research indicates that small firms operate in a system governed almost completely with informal mechanisms based on trust, reciprocity and reputation, with little recourse to the legal system. The owners of these businesses also must deal with widespread corruption.

Over 80% of the firms surveyed needed a license to start a business, and for about half of them obtaining it was a difficult process. Government officials were most often the problem, which was usually solved through payment of bribes or by enlisting friends of government officials as negotiators. Clearly, networks and connections are crucially important to negotiating the government bureaucracy. As for conducting day-to-day business, legal concerns are far less important than the unwritten codes of the informal networks in which firms operate. In cases of default and breach of contract, the primary concern is loss of reputation, followed closely by loss of property, with the fear of legal consequences being the least important concern.

About half of the firms surveyed did *not* have a regular legal adviser, and less than half of those that did had lawyers in that capacity. For mediation in a business dispute or to enforce a contract, the first choice was "mutual friends or business partners." Only 20% of the respondents mentioned going to courts as the first option, indicating that the legal system, while not as effective as the informal mechanisms, is not altogether absent. The informal system, however, is far from perfect at resolving disputes and also has significant costs. About half of all respondents experienced a breach of contract or non-payment with a supplier or major customer in the past three years. Over a third of them renegotiated, while over 40% did nothing and continued doing business with the offending parties.

Franklin Allen and his co-authors also document serious credit constraints for firms in this sector, resulting in their ongoing reliance on informal finance. Relationship based systems, characteristic of Asian countries, are usually far more important for these companies rather than the explicit arm's length systems of governance and contracts observed in Western businesses. In general, the business

¹² See F. Allen, R. Chakrabarti, S. De, J. Qian and M. Qian, 2006, "Financing Firms in India", *Working paper*, The Wharton School.

environment of the SME sector is marked by strong informal mechanisms like family ties, reputation, and trust. Legal remedies, though present, are far less important than the rules of the informal networks.

Overall Ownership Patterns

Figures 3 and 4 provide a break-up of the shareholding and ownership of India's 500 largest companies that together account for over 90% of the market capitalization of the Bombay Stock Exchange. Figure 3 provides a break-up by number and Figure 4 by value. Family-run business groups clearly play a crucial role in the Indian corporate sector. About 60% of these companies (comprising about 65% of the total market capitalization of the Exchange), are part of these business groups. Recent studies have documented significant tunneling of funds among business groups.¹³ The actual ownership within these companies is far from being completely transparent with widespread pyramiding, cross-holding, and the use of non-public trusts and private companies for owning shares in group companies.

About 11% of companies comprising about 22% of the market capitalization are companies wholly or significantly owned by the Central (Federal) or State Governments; about 20% of companies comprising about 8% of the market capitalization are non-Group companies controlled by Indian promoters; and about 9% of companies comprising about 5% of the market capitalization are non-Group companies controlled by foreign promoters.

Even in 2002, the average shareholding of "promoters" in Indian companies was as high as 48.1%¹⁴. Figure 5 indicates the percentage shareholding of different groups of shareholders for the 500 largest Indian companies based again on data from *Prowess*. On average, promoters own about 53% of the shareholding of these firms. 7% of shareholding is with foreign promoters, and the rest are Indian, mainly corporate entities (19%) and the government (16%). Importantly, there is a sizeable non-promoter holding of foreign institutional investors (16%) and a 10% non-promoter holding of Indian institutional investors, i.e. banks, financial institutions, mutual funds and insurance companies.

Relatively few companies are widely held with no significant single-promoter control. Figure 6 provides a bird's eye view of the proportion of companies with different levels of promoters' shareholding. It does so separately for group companies, stand-alone companies and all companies taken together. Overall, less than 2% companies have a promoters' shareholding between zero to 5%, 4% companies between 5% to 15%, 6% companies between 15% to 25%, 42% companies between 25% to 50%, 38% companies between 50% to 75%, and 8% companies between 75% to 100% promoters' shareholding.

¹³ An example of this literature is M. Bertrand, P. Mehta, and S. Mullainathan. 2002. "Ferretting out Tunneling: An Application to Indian Business Groups." *Quarterly Journal of Economics* 117(1): 121–48.

¹⁴ See Petia Topalova, 2004. "Overview of the Indian Corporate Sector: 1989-2002." IMF Working Paper No. 04/64.

3. Corporate Governance in India – A Historical Background

The historical development of Indian corporate laws has been marked by many interesting contrasts. At independence, India inherited one of the world's poorest economies but one which had a factory sector accounting for a tenth of the national product. The country also inherited four functioning stock markets (predating the Tokyo Stock Exchange) with clearly defined rules governing listing, trading and settlements, a well-developed equity culture (if only among the urban rich), and a banking system replete with well-developed lending norms and recovery procedures.¹⁵ In terms of corporate laws and financial system, therefore, India emerged far better endowed than most other colonies. The 1956 Companies Act built on this foundation, as did other laws governing the functioning of joint-stock companies and protection of investors' rights.

Early corporate developments in India were marked by the managing agency system. This contributed to the birth of dispersed equity ownership but also gave rise to the practice of management enjoying control rights disproportionately greater than their stock ownership. The turn towards socialism in the decades after independence, marked by the 1951 *Industries (Development and Regulation) Act* and the 1956 *Industrial Policy Resolution*, put in place a regime and a culture of licensing, protection, and widespread red-tape that bred corruption and stilted the growth of the corporate sector. The situation worsened in subsequent decades and corruption, nepotism, and inefficiency became the hallmarks of the Indian corporate sector. Exorbitant tax rates encouraged creative accounting practices and gave firms incentives to develop complicated emolument structures with large "under-the-table" compensation at senior levels.

In the absence of a stock market capable of raising equity capital efficiently, three central (federal) government development finance institutions (the *Industrial Finance Corporation of India*, the *Industrial Development Bank of India* and the *Industrial Credit and Investment Corporation of India*), together with about thirty other state-government owned development finance institutions, became the main providers of long-term credit to companies. Along with the central government-owned and managed mutual fund, the *Unit Trust of India*, these institutions also held (and still hold) large blocks of shares in the companies to which they lent, and invariably had representations on their boards in the form of nominee directors, though they traditionally played very passive roles in the boardroom.

¹⁵ This section draws heavily from the history of Indian corporate governance in Omkar Goswami, 2002, "Corporate Governance in India," *Taking Action Against Corruption in Asia and the Pacific* (Manila: Asian Development Bank), Chapter 9.

The corporate bankruptcy and reorganization system also had serious problems. India's system has been driven by the 1985 *Sick Industrial Companies Act* (SICA), which considers a company "sick" only after its entire net worth has been eroded, and it has been referred to the *Board for Industrial and Financial Reconstruction* (BIFR). As soon as a company was registered with the BIFR, it won immediate protection from creditors' claims for at least four years. Between 1987 and 1992, the BIFR took well over two years, on average, just to reach a decision. Very few companies emerged successfully from the BIFR, and even for those that needed to be liquidated, the legal process took over 10 years on average, by which time the assets of the company were usually almost worthless. Protection of creditors' rights had therefore existed only on paper in India, and its bankruptcy process was featured among the worst in World Bank surveys on business climate. This could well explain why Indian banks have historically under-lent and invested primarily in government securities.

Though financial disclosure norms in India have traditionally been superior to most Asian countries, noncompliance with disclosure norms had been rampant and even the failure of auditors' reports to conform to the law attracted only nominal fines and little punitive action. The Institute of Chartered Accountants in India has rarely taken action against erring auditors.

While the *Companies Act* has always provided an excellent framework, and clear instructions for maintaining and updating share registers, in reality minority shareholders had often suffered from irregularities in share transfers and registrations. Sometimes non-voting preferential shares had been used by promoters to channel funds and expropriate minority shareholders. There were cases in which the rights of minority shareholders had been compromised by management's private deals in the relatively infrequent event of corporate takeovers. Company Boards had often been largely ineffective in their monitoring role, and their independence had been perceived as highly questionable.

For most of the post-Independence era the Indian equity markets were not liquid or sophisticated enough to exert effective control over the companies. Listing requirements of exchanges enforced some transparency, but non-compliance was neither rare nor punished. All in all, therefore, minority shareholders and creditors in India had remained effectively unprotected despite the laws on the books.

However, this relatively dismal environment started changing rapidly after the monumental economic reforms and the major liberalization programs initiated by the Indian government in the early nineties.

4. Recent Developments in Corporate Governance in India

Liberalization of the Indian economy began in 1991. Since then, we have witnessed wide-ranging changes in both laws and regulations, and a major positive transformation of the corporate sector and the

corporate governance landscape. Perhaps the single most important development in the field of corporate governance and investor protection in India has been the establishment of the *Securities and Exchange Board of India* in 1992 and its gradual and growing empowerment since then. Established primarily to regulate and monitor stock trading, it has played a crucial role in establishing the basic minimum ground rules of corporate conduct in the country. Concerns about corporate governance in India were, however, largely triggered by a spate of crises in the early 1990's—particularly the Harshad Mehta stock market scam of 1992--followed by incidents of companies allotting preferential shares to their promoters at deeply discounted prices, as well as those of companies simply disappearing with investors' money.¹⁶

These concerns about corporate governance stemming from the corporate scandals, coupled with a perceived need of opening up the corporate sector to the forces of competition and globalization, gave rise to several investigations into ways to fix the corporate governance situation in India. One of the first such endeavors was the *Confederation of Indian Industry Code for Desirable Corporate Governance*, developed by a committee chaired by Rahul Bajaj, a leading industrial magnate. The committee was formed in 1996 and submitted its code in April 1998. Later the SEBI constituted two committees to look into the issue of corporate governance--the first chaired by Kumar Mangalam Birla, another leading industrial magnate, and the second by Narayana Murthy, one of the major architects of the Indian IT outsourcing success story¹⁷. The first Committee submitted its report in early 2000, and the second three years later. These two committees have been instrumental in bringing about far reaching changes in corporate governance in India through the formulation of Clause 49 of Listing Agreements (described below).

Concurrent with these initiatives by the SEBI, the *Department of Company Affairs* and the *Ministry of Finance* of the *Government of India* also began contemplating improvements in corporate governance. These efforts included the establishment of a study group to operationalize the *Birla Committee* recommendations in 2000, the *Naresh Chandra Committee on Corporate Audit and Governance* in 2002, and the *Expert Committee on Corporate Law (J.J. Irani Committee)* in late 2004. All of these efforts were aimed at reforming the existing *Companies Act* of 1956 that still forms the backbone of corporate law in India.

Clause 49 of the Listing Agreements

¹⁶ See Omkar Goswami, 2002, "Corporate Governance in India," *Taking Action Against Corruption in Asia and the Pacific* (Manila: Asian Development Bank), Chapter 9.

¹⁷ Importantly, Narayan Murthy has been the Chair of *Infosys*, a company that built its success on a widely held ownership structure rather than the traditional family-controlled Indian model; and he has led key corporate governance initiatives in India.

The SEBI implemented the recommendations of the *Birla Committee* through the enactment of Clause 49 of the Listing Agreements. Clause 49 may well be viewed as a milestone in the evolution of corporate governance practices in India. It is similar in spirit and in scope to the *Sarbanes-Oxley* measures in the United States. The requirements of Clause 49 were applied in the first instance to the companies in the BSE 200 and S&P C&X NIFTY stock indices, and all newly listed companies, on March 31, 2001. These rules were applied to companies with a paid up capital of INR 100 million (\approx \$2.5 million) or with a net worth of INR 250 million (\approx \$6.3 million) at any time in the past five years on March 31, 2002, and to other listed companies with a paid up capital of over INR 30 million (\approx \$0.75 million) on March 31, 2003. The *Narayana Murthy Committee* worked on further refining the rules, and Clause 49 was amended accordingly in 2004.

The key mandatory features of Clause 49 regulations deal with the following: (i) composition of the board of directors; (ii) the composition and functioning of the audit committee; (iii) governance and disclosures regarding subsidiary companies; (iv) disclosures by the company; (v) CEO/CFO certification of financial results; (vi) reporting on corporate governance as part of the annual report; and (vii) certification of compliance of a company with the provisions of Clause 49.

The composition and proper functioning of the board of directors emerges as the key area of focus for Clause 49. It stipulates that non-executive members should comprise at least half of a board of directors. It defines an “independent” director and requires that independent directors comprise at least half of a board of directors if the chairperson is an executive director and at least a third if the chairperson is a non-executive director. It also lays down rules regarding compensation of board members, sets caps on committee memberships and chairmanships, lays down the minimum number and frequency of board meetings, and mandates certain disclosures for board members.

Clause 49 pays special attention to the composition and functioning of the audit committee, requiring at least three members on it, with an independent chair and with two-thirds made up of independent directors--and having at least one “financially literate” person serving. The Clause spells out the role and powers of the audit committee and stipulates minimum number and frequency of and the quorum at the committee meetings.

With regard to “material” non-listed subsidiary companies (those with turnover/net worth exceeding 20% of a holding company’s turnover/net worth), Clause 49 stipulates that at least one independent director of the holding company must serve on the board of the subsidiary. The audit committee of the holding company should review the subsidiary’s financial statements, particularly its investment plans. The minutes of the subsidiary’s board meetings should be presented at the board meeting of the holding company, and the board members of the latter should be made aware of all

“significant” (likely to exceed in value 10% of total revenues/expenses/assets/liabilities of the subsidiary) transactions entered into by the subsidiary.

The areas where Clause 49 stipulates specific corporate disclosures are: (i) related party transactions; (ii) accounting treatment; (iii) risk management procedures; (iv) proceeds from various kinds of share issues; (v) remuneration of directors; (vi) a Management Discussion and Analysis section in the annual report discussing general business conditions and outlook; and (vii) background and committee memberships of new directors as well as presentations to analysts. In addition, a board committee with a non-executive chair is required to address shareholder/investor grievances. Finally, it is mandated that the process of share transfer (that had been a long-standing problem in India) be expedited by delegating authority to an officer or committee or to the registrar and share transfer agents.

The CEO and CFO or their equivalents need to sign off on the company’s financial statements and disclosures and accept responsibility for establishing and maintaining effective internal control systems. The company is also required to provide a separate section of corporate governance in its annual report, with a detailed compliance report on corporate governance. It is also required to submit a quarterly compliance report to the stock exchange where it is listed. Finally, it needs to get its compliance with the mandatory specifications of Clause 49 certified by auditors or by practicing company secretaries. In addition to these mandatory requirements, Clause 49 also mentions non-mandatory requirements concerning the facilities for a non-executive chairman, the remuneration committee, half-yearly reporting of financial performance to shareholders, moving towards unqualified financial statements, training and performance evaluation of board members, and perhaps most notably a clear “whistle blower” policy.

By and large, the provisions of Clause 49 closely mirror those of the Sarbanes-Oxley measures in the United States. In some areas, like certification compliance, the Indian requirements are even stricter. There are, however, areas of uniqueness as well. The distinction drawn between boards headed by executive and non-executive chairmen and the lower required share of independent directors is special to India—and is also somewhat intriguing, given the prevalence of family-run business groups.

The market reaction to the corporate governance improvements sought by Clause 49 seems to have been quite positive, somewhat in contrast to the mixed response to Sarbanes-Oxley’s adoption. Tarun Khanna and Yishay Yafeh use an event-study approach to measure the stock price impact of the adoption of Clause 49 by Indian firms.¹⁸ Focusing on the May 7, 1999 announcement by SEBI about the formation of the *Kumar Mangalam Birla Committee*, when an earlier application to large companies was expected, they report that large firms that adopted these measures first witnessed a 4% (7%) positive price-jump in a two-day (five-day) event-window beginning with the announcement day compared to

¹⁸ See Tarun Khanna and Yishay Yafeh, 2005, *Business Groups in Emerging Markets: Paragons or Parasites?*, *Finance Working Paper N° 92/2005*, European Corporate Governance Institute.

smaller firms that were required to implement the reforms at the same time (RAJESH, THIS IS NOT CLEAR).

Corporate Governance of Banks

The reforms adopted since 1991 have marked a shift from hands-on government control to market forces as the dominant instrument of corporate governance in Indian banks.¹⁹ Competition has been encouraged with the issuance of licenses to new private banks and by giving more power and flexibility to bank managers, both in directing credit and in setting prices. The *Reserve Bank of India* (RBI), India's central bank, has moved to a model of governance by "prudential norms" rather from that of direct interference, even allowing debate about the appropriateness of specific regulations among banks. Along with these changes, market institutions have been strengthened by government actions attempting to infuse greater transparency and liquidity into markets for government securities and other asset markets.

This market orientation of governance in banking has been accompanied by stronger disclosure norms and greater stress on periodic RBI surveillance. From 1994, the *Board for Financial Supervision* (BFS) inspects and monitors banks using the "CAMELS" (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and controls) approach. Audit committees in banks have been stipulated since 1995. Greater independence of public sector banks has also been a key feature of the reforms. Nominee directors from government and the RBI are being gradually phased out, with a stress on boards being elected rather than "appointed from above." There is increasing emphasis on greater professional representation on bank boards, with the expectation that the boards will have the authority and competence to properly manage the banks within broad prudential norms set by the RBI. Rules like non-lending to companies that have one or more of a bank's directors on their boards are being softened or removed altogether, thus allowing for "related party" transactions for banks. The need for professional advice in the election of executive directors is increasingly being realized.

As for the old private banks, concentrated ownership remains a widespread characteristic, limiting the possibilities for professional excellence and opening the possibility of misdirecting credit. Corporate governance in co-operative banks and non-bank financial companies perhaps needs the greatest attention from regulators. Rural co-operative banks are frequently run by politically powerful families as their personal fiefdoms, with little professional involvement and considerable channeling of credit to family businesses. It is generally believed that the "new" private banks (those established after the reforms process started in the 90's) have better and more professional corporate governance systems in

¹⁹ Reddy summarizes the reforms-era policies for corporate governance in Indian banks. See Y.V. Reddy, 2002. "Public Sector Banks and the Governance Challenge - The Indian Experience," *BIS Review* 25/2002, Bank for International Settlements, Basle.

place.²⁰ In recent years, the collapse of the private Global Trust Bank and its subsequent acquisition by a public sector bank has, however, strengthened beliefs that the government will ultimately bail out failing banks.

It is noteworthy that India has one of the best banking sectors in Asia in terms of the ratio of non-performing assets. The India NPL ratios of around 4% of total banking assets are far below those of China (or Japan) and most other Asian and emerging markets.

Public Sector Governance in India

Public sector Enterprises (PSEs) have played a major role in India's mixed economy and industrialization program. The *Industrial Policy Resolution* of 1956 reserved the "commanding heights" of the economy for the public sector, and during the second half of the twentieth century the number of central (federal) PSEs in India climbed steadily, from 5 to 242. In addition, there are also many more smaller PSEs promoted and owned by different state governments. Between 1996-97 and 2005-06 PSEs registered a 70% increase in investments to over US\$87 billion. Over the same period their return on investment improved from barely 13% to over 18%. The public sector still accounts for over 11% of India's GDP, over 27% of industrial output and over a third of central government receipts. They account for over 20% of the market capitalization of firms listed on the Bombay Stock Exchange, and five of the six Indian *Fortune 500* firms are Central PSEs.

Though the cumulative profits of the PSEs have risen over time their performance has always been a concern, with close of half of the PSEs incurring losses. As these enterprises came under the purview of the government, they have often been subjected to political interference and governance by rigid bureaucratic norms rather than on the basis of performance and profitability. A break with this tradition happened in 1987 with the adoption of a *Memorandum of Understanding* (MoU) between the enterprises and the government that gave greater functional autonomy to the PSEs, with a stipulation of targets against which the government would hold its performance. MoUs specified various targets with different weights, with the most important being gross profit margin and net profit as a proportion of capital employed (30% each).

By the end of 2000, 107 PSEs had signed MoUs with the government. With the adoption of MoUs, PSEs have increasingly gained operational autonomy and moved to a "board managed corporation" model rather than reporting to government ministry officials directly. In 1997, nine large and profitable central PSEs, now referred to as the "*Navratnas*" (Nine jewels), were granted even greater autonomy than others, including the right to form joint ventures and engage in mergers and acquisitions.

²⁰ See Rajesh Chakrabarti, 2006. *The Financial Sector in India – Emerging Issues*, (with a Foreword by Richard Roll), Oxford University Press, New Delhi, India.

97 other profitable PSEs gained the status of “mini-Ratnas” and with it greater autonomy than before. In general, the PSEs are gradually being separated from direct government control, with the more profitable ones gaining autonomy faster. Another major step in the administration of PSEs has been the constitution of the *Board for Reconstruction of PSEs* (BRPSE) in 2004, which now acts as the agency in charge of reconstruction (or liquidation) of PSEs in financial distress. All of these are extremely positive developments from a corporate governance perspective.

Partial privatization (or “disinvestment” as it is called in India) of PSEs emerged as a policy objective in 1991, with the initiation of economic reforms. Disinvestment has followed a rocky path in India, with unions and leftist political parties attempting to block almost every disinvestment effort. Nevertheless, 42 Central PSEs had been partially privatized by the end of March 2005. In addition, 16 “strategic sales” with transfer of control took place between 1999-2000 and 2004-05. After 2004, however, the disinvestment process effectively stalled because the national elections of May 2004 yielded a coalition government which had left and communist parties as vital members, even though it was headed by the Congress party, and even though the newly elected Prime Minister, Dr. Manmohan Singh, was the principal architect of India’s economic reforms of the early nineties while serving as the Finance Minister in the then government in power.

5. Recent findings about corporate governance in India

Of late, a burgeoning empirical literature has begun to document important features of corporate governance in India. We summarize some of the major findings in this section, beginning with research examining corporate board composition.

Jayati Sarkar and Subrata Sarkar show that corporate boards of large companies in India in 2003 were slightly smaller than those in the United States (in 1991), with 9.46 members on average in India compared to 11.45 in America.²¹ While the percentage of inside directors was roughly comparable (25.38% compared to 26% in the U.S.), Indian boards had relatively fewer independent directors, (just over 54% compared to 60% in the U.S.) and relatively more affiliated outside directors (over 20% versus 14% in the U.S.). 41% of Indian companies had a promoter on the board, and in over 30% of cases a promoter served as an Executive Director. There is evidence that larger boards lead to poorer performance (market-based as well as in accounting terms), both in India and in the United States.²²

²¹ See Jayati Sarkar and Subrata Sarkar, 2000. Large shareholder activism in developing countries: Evidence from India, *International Review of Finance*, 1, pp. 161-94.

²² See Saibal Ghosh, 2006, Do board characteristics affect firm performance? Firm level evidence from India, *Applied Economic Letters* 13, pp. 435-443.

The median director in large Indian companies held 4.28 directorships in 2003, and this number is considerably (and statistically significantly) higher for directors in group-affiliated companies (4.85 versus 3.09 for non-affiliated companies).²³ The figures were similar for inside directors, being 4.34, 4.95 and 3.06 for large companies, group affiliates, and non-affiliated companies, respectively. As for independent directors, however, the median number of positions held was 4.59, with no major differences between group and stand-alone companies. Interestingly, independent directors with multiple directorships are associated with higher firm value in India while busier inside directors are correlated negatively with firm performance. Busier independent directors are also more conscientious in terms of attending board meetings than their counterparts with fewer positions. As for inside directors, it seems that the pressure of serving on multiple boards (due largely to the prevalence of family owned business groups) does take a toll on the directors' performance.

However, busy independent directors also appear to be correlated with a greater degree of earnings management as measured by discretionary accruals.²⁴ Multiple positions and non-attendance of board meetings by independent directors seem to be associated with higher discretionary accruals in firms. After controlling for these characteristics of independent directors, board independence (measured by the proportion of independent directors) does not seem to affect the degree of earnings management. However, CEO-duality, where the top executive also chairs the Board, and the presence of controlling shareholders as inside directors, are related, perhaps unsurprisingly, to greater earnings management.

Shareholding patterns in India reveal a marked level of concentration in the hands of the promoters. In 2002-03, for instance, Jayati Sarkar and Subrata Sankar find that promoters held 47.74% of the shares in a sample of almost 2500 listed manufacturing companies, and held 50.78% of the shares of group companies and 45.94% of stand-alone firms.²⁵ In comparison, the Indian public's share amounted to 34.60%, 28% and 38.51%, respectively. As for the impact of concentrated shareholding on firm performance, an earlier study by these same authors finds that in the mid-90's (1995-96) holdings above 25% by directors and their relatives was associated with higher valuation of companies while there was no clear effect below that threshold.²⁶ More recently, based on 2001 data that distinguishes between "controlling" insiders and non-controlling groups, Ekta Selarka reports a U-shaped relationship between

²³ See Jayati Sarkar and Subrata Sarkar, 2003. Liberalization, Corporate Ownership and Performance: The Indian Experience (with Subrata Sarkar), in *Corporate Capitalism in South Asia* edited by Ananya Mukherjee-Reed, International Political Economy Series (ed by Timothy M. Shaw), Macmillan Press, UK

²⁴ See Sarkar Jayati, Subrata Sarkar and Kaustav Sen, 2006 Board of Directors and Opportunistic Earnings Management: Evidence from India, *Working Paper*, Indira Gandhi Institute of Development Research, Mumbai, India.

²⁵ See Jayati Sarkar and Subrata Sarkar, 2005a, "Multiple Board Appointments and Firm Performance in Emerging Economies: Evidence from India," *Working Paper 2005-001*, Indira Gandhi Institute of Development Research, Mumbai, India.

²⁶ See Jayati Sarkar and Subrata Sarkar, 2000. Large Shareholder Activism in Developing Countries: Evidence from India," *International Review of Finance*, 1, pp. 161-94.

insider ownership (with insiders being defined as promoters and “persons acting in concert with promoters”) and firm value, with the point of inflection lying at a much higher level, between 45% and 63%.²⁷

Institutional investors--comprising government sponsored mutual funds and insurance companies, banks and development financial institutions (DFIs) that are also long-term creditors, and foreign institutional investors--hold over 22% shares of the average large company in India, of which the share of mutual funds, banks and DFIs, insurance companies, and foreign institutional investors are about 5%, 1.5%, 3% and 11%, respectively. Analyzing cross-sectional data from the mid-1990's, Jayati Sarkar and Subrata Sarkar find that company value actually declines with a rise in the holding of mutual funds and insurance companies between zero and a 25% holding, after which there is no clear effect.²⁸ On the other hand, for DFIs' holdings, there is no clear effect on valuation below 25%, but a significant positive effect above 25%, suggesting better monitoring takes place when the stakes are higher.

Executive compensation in India, which was freed from the strict regulation by the Companies Act in 1994, is another area of corporate governance that has received attention among researchers. Managerial compensation in India often has two components--salary and performance-based commission—as well as retirement and other benefits and perquisites. Based on an analysis of unbalanced panel data for roughly 300 firms each year, Sonja Fagernäs reports that the average total compensation (salary plus commission) of Indian CEOs has risen almost three-fold between 1998 and 2004 (from INR 2.1 million (\approx USD 52,500) to INR 6.4 million (\approx USD 160,000) in real terms.²⁹ During this period, the proportion of profit-based commission has risen steadily, from 13.4% to 25.6%, and the proportion of CEOs with commission as part of their pay package has risen from 34% to 51%. CEO pay has thus clearly become more performance based over the past decade. There is also some evidence that this increasing performance-pay linkage is associated with the introduction of the corporate governance code or Clause 49. Meanwhile, executive compensation as a fraction of profits has also almost doubled from 0.55% to 1.06%. Fagernäs also finds that CEOs related to the founding family or directors are paid more than other CEOs. In a firm fixed effects model, she finds being related to the founding family can raise CEO pay by as much as 30% while being related to a director can cause an increase of about 10%. There is some evidence that the presence of directors from lending institutions lowers pay while the share of non-executive directors on the board connects pay more closely to performance.

²⁷ See Ekta Selarka, 2005, “Ownership Concentration And Firm Value -- A Study From The Indian Corporate Sector”, *Emerging Markets Finance And Trade* 41, pp. 83–108.

²⁸ See Jayati Sarkar and Subrata Sarkar, 2000. Large Shareholder Activism in Developing Countries: Evidence from India,” *International Review of Finance*, 1, pp. 161-94.

²⁹ See Sonja Fagernas, 2007, “How do Family Ties, Boards and Regulation Affect Pay at the Top? Evidence for Indian CEOs?” *Working Paper*, University of Cambridge.

A recent study finds that, during 1997-2002, the average (of a sample of 462 manufacturing firms) *board* compensation in India has been around INR 5.3 million (\approx USD 132,500), with wide variation across firm size.³⁰ The average board compensation is INR 7.6 million (\approx USD 190,000) for large firms and INR 2.5 million (\approx USD 62,500) for small firms. The board compensation also appears to be higher, on average, at INR 6.9 million (\approx USD 172,500) if the CEO is related to the founding family. Both Board and CEO compensation depend on current performance, and CEO pay depends on past-year performance as well. Diversified companies also pay their boards more.

Given that almost two-thirds of the top 500 Indian companies are group-affiliated, issues relating to corporate governance in business groups are naturally very important. Tunneling, or “the transfer of assets and profits out of firms for the benefit of those who control them” is a major concern in business groups with pyramidal ownership structure and inter-firm cash flows.³¹ Marianne Bertrand and her co-authors estimate that an industry shock leads to a 30% lower earnings increase for business group firms compared to stand-alone firms in the same industry.³² They find that firms farther down the pyramidal structure are less affected by industry-specific shocks than those nearer the top, suggesting that positive shocks in the former are siphoned off to the latter, benefiting the controlling shareholders but hurting the minority shareholders. However, Bernard Black and Vikramaditya Khanna question how this logic would make them less sensitive to negative shocks.³³ There is also some evidence that firms associated with business groups have superior performance than stand-alone firms.³⁴

More recently Raja Kali and Jayati Sarkar argue that diversified business groups help increase the opacity of within-group fund flows driving a wider wedge between control and cash flow rights. A greater degree of diversification also aids tunneling.³⁵ Using data for Indian firms in 385 business groups in 2002-03 and 384 groups in 2003-04, Kali and Sarkar find that firms with greater ownership opacity and a lower wedge between cash flow rights and control than those in a group’s core activity are likely to be located farther away from the core activity. This incentive for tunneling explains, according to them, the persistence of value destroying groups in India and occasional heavy investment by Indian groups in businesses with low contribution to group profitability.

³⁰ See A. Ghosh, 2006, “Determination of Executive Compensation in an Emerging Economy: Evidence from India”, *Emerging Markets Finance and Trade* 42, pp. 66-90.

³¹ See S. Johnson, R. LaPorta, F. Lopez-de-Silanes, and A. Shleifer, 2000, “Tunneling,” *American Economic Review* 90, pp. 22-27.

³² See M. Bertrand, P. Mehta, and S. Mullainathan. 2002. “Ferretting out Tunneling: An Application to Indian Business Groups,” *Quarterly Journal of Economics* 117, pp. 121–48.

³³ See Bernard Black and Vikramaditya Khanna, forthcoming 2007, “Can Corporate Governance Reforms Increase Firms’ Market Values?: Evidence From India,” *Journal of Empirical Legal Studies*.

³⁴ See Tarun Khanna and Krishna Palepu, 2000, “Emerging Market Business Groups, Foreign Investors and Corporate Governance,” in Randall Morck, ed. *Concentrated Ownership*, NBER, University of Chicago Press.

³⁵ See Raja Kali and Jayati Sarkar, 2007, “Diversification and Tunneling: Evidence from Indian Business Groups,” *Working Paper*, Indira Gandhi Institute of Development Studies.

Using a sample of over 600 of the 1000 largest (by revenues) Indian firms in 2004, Jayashree Saha finds that, after controlling for other corporate governance characteristics, firm performance is negatively associated with the extent of related party transactions for group firms but positively so for stand-alone companies. This further strengthens the circumstantial evidence of tunneling and its adverse effects.³⁶ The same study also reveals that, using a sample of over 5000 firms for the period 2003-2005, most related party transactions in India occur between the firm and “parties with control,” as opposed to management personnel as in the United States. Also, group companies consistently report higher levels of related party transactions than stand-alone companies.

Two cross-country studies published in 2003 have put India among the worst nations in terms of earnings opacity and management.³⁷ Indian accounting standards provide considerable flexibility to firms in their financial reporting and differ from the *International Accounting Standards* (IAS) in several ways that can often make interpreting Indian financial statements relatively challenging. In a 2007 study of Kee-Hong Bae and co-authors, India continues to be below the median within their 49 country sample in terms of the number of deviations from *International Accounting Standards*.³⁸

The nature of corporate governance can affect the capital structure of a company. In the presence of well functioning financial institutions, debt can be a disciplining mechanism in the hands of shareholders or an expropriating mechanism in the hands of controlling insiders. Studying the relationship between leverage and Tobin’s Q in 1996, 2000, and 2003, Jayati Sarkar and Subrata Sarkar conclude that the disciplinary effect has been more marked in recent years as institutions have adopted a significantly greater market orientation.³⁹ They also find limited evidence of the use of debt as an expropriating mechanism in group companies.

The market for corporate control was relatively limited in India until the mid-1990’s, when the average number of mergers per year leapt from 30 between 1973-74 and 1987-88, and 63 between 1987-88 and 1994-95, to 171 between 1994-95 and 2002-03.⁴⁰ Merger activity appears to occur in waves and is split roughly evenly between inter-industry and intra-industry mergers. The share of group-affiliated mergers has increased significantly in the post 1994-95 period.

³⁶ See Jayashree Saha, 2006, “A Study of Related Party Transactions in Indian Corporate Sector,” Draft Ph.D. dissertation, IGIDR.

³⁷ See U. Bhattacharya, H. Daouk, and M. Welker, 2003, “The World Price of Earnings Opacity,” *Accounting Review* 78, pp. 641-678 and C. Leuz, D. Nanda, and P. Wysocki, 2003. “Earnings Management and Investor Protection: An International Comparison,” *Journal of Financial Economics* 69, pp. 505-527.

³⁸ See Kee-Hong Bae, H. Tan and M. Welker, 2007, “International GAAP Differences: The Impact on Foreign Analysts”, *Working Paper*, Queen’s University, Canada

³⁹ See Jayati Sarkar and Subrata Sarkar, 2005, “Corporate Governance, Enforcement and the Role of Non-Profit Organizations,” *Background Paper for IFMR Conference on Corporate Governance*, IFMR, Chennai, India.

⁴⁰ See Manish Agarwal and Aditya Bhattacharya, 2006, “Mergers in India – a Response to Regulatory Shocks,” *Emerging Markets Finance and Trade* 42, pp. 46-65.

With regard to public sector governance, Nandini Gupta finds that even when control stays in government hands, partial privatization has a positive impact on profitability, productivity, and investment of the PSEs concerned.⁴¹ She argues that the monitoring role of the markets has been responsible for this. However, S. Sangeetha argues that it may be difficult to disentangle the effect of partial privatizations from the effect of the application of MoUs to these cases before the partial privatizations. She finds that the application of MoUs or performance contracts had a positive impact on the profitability and the operational performance of PSEs.⁴²

6. Conclusions

This article outlines the salient features of the Indian corporate governance system. While on paper the Indian legal system provides one of the highest levels of investor protection in the world, the reality is different with slow, over-burdened courts and significant corruption. Much of the country's extensive small and medium enterprises (SME) sector displays relationship-based informal control and governance mechanisms, inhibiting financing and keeping the cost of capital at levels higher than necessary, even though India ranks high on the ease of getting credit, and has a well-functioning banking sector with one of the lowest proportions of non-performing assets.

Even among large companies, shareholdings remain relatively concentrated with "promoters" and family business groups continuing to dominate the corporate sector. There is significant pyramiding and tunneling among Indian business groups and, notwithstanding copious reporting requirements, evidence of earnings management. This is not surprising: concentrated ownership and family control are important in countries where enforceable legal protection of minority property rights is relatively weak. Family-controlled businesses provide an organizational form that reduces transaction costs and asymmetric information problems under these conditions.

Most of the corporate governance problems noted here, far from being unique to India, are in fact commonplace in Asia, and are present in many other economies as well. In particular, corporate governance in India does not compare unfavorably with any of the other major emerging economies: Brazil, China and Russia.

Despite the above corporate governance shortcomings, the Indian economy and its financial markets have started attaining impressive growth rates in recent years, and display an exceptionally high level of optimism. The reason is that India is now clearly and strongly committed to sustaining and rapidly furthering the major economic reforms and the liberalization started in the early nineties.

⁴¹ See Nandini Gupta, 2005, "Partial privatization and Firm performance," *Journal of Finance* 60, pp. 987-1015.

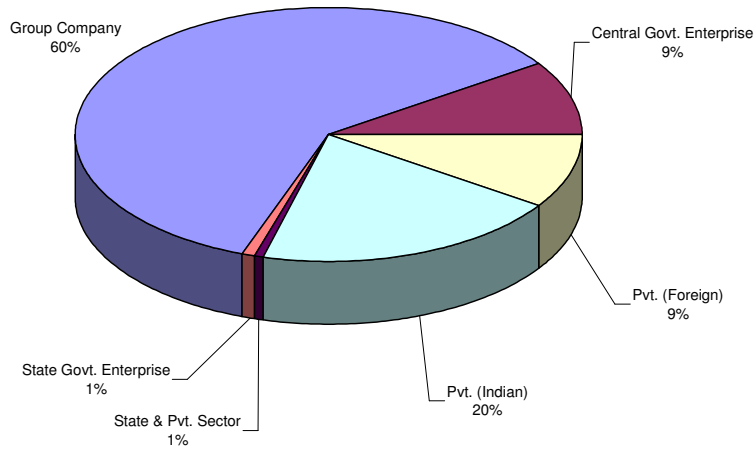
⁴² See S. Sangeetha, 2006, Empirical Essays on Enterprise and Ownership Reforms in Public Sector Enterprises - Evidence from India," Draft Ph.D. dissertation, IGIDR

Specifically, the *Securities and Exchanges Board of India* established as a part of these reforms, has a rigorous regulatory regime to ensure fairness, transparency and good practice, and the *National Stock Exchange of India*, also established as part of the reforms, functions efficiently and transparently to now trade among the highest number of trades in the world, just behind NASDAQ and NYSE. The traditional *Bombay Stock Exchange* has also reformed effectively. Most importantly, the corporate governance landscape in the country has been changing very fast over the past decade, particularly with the enactment of Sarbanes-Oxley type measures in Clause 49 of the listing agreements, and legal changes to improve the enforceability of creditor's rights. We are also seeing the rise of companies like INFOSYS that are free from the influence of a dominant family or group, and make the individual shareholder their central governance focus. There is a strong momentum for continuing reforms, and the monumental changes that have already taken place pave the way for more changes to come. All these positive developments should arguably help Indian industry ensure that their financial gains reach their investors fairly and transparently, and enable it to sustain its new-found prosperity and growth.

Figure 1: Distribution of 500 largest Indian companies among different ownership categories

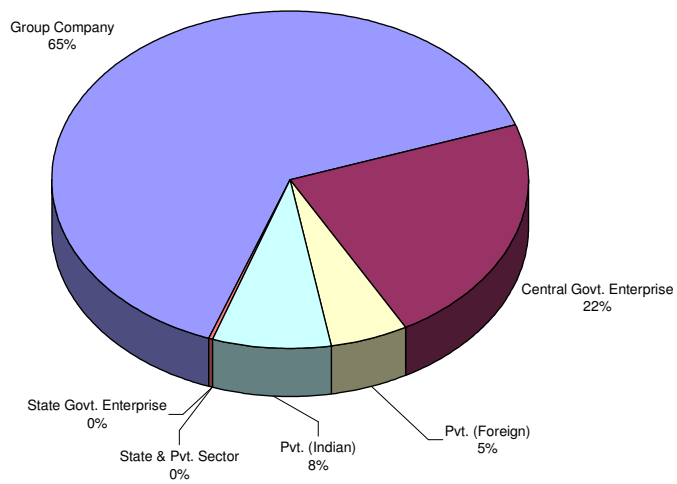
Panel A: Count

Break-down (number) of 500 largest Indian corporations



Panel B: Market Capitalization

Breakdown (Market Cap) of 500 largest Indian companies



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