Corporate Governance in India

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Manifest Pedagogy

Issues such as bank failures, NPA and Insolvency and Bankruptcy have been in news. UPSC may ask interdisciplinary questions relating aspects of financial reforms with a broader scope of their impact on the economic system and business ethics. Further issues like Satyam scam, global financial turmoil, too big to fail banks, etc. could be put into context.

Moreover one should be ready to face related questions such as the exit problem, *chakravyuha challenge*, *twin balance sheet syndrome* etc. One should be able to recall aspects of The Companies Act and role and development of institutions such as SEBI, ICAI etc.

In News

Crisis in NBFCs governance framework (Shadow Banks), IL&FS

Placing it in the syllabus

Paper 3:Financial and Banking sector reforms as part of LPG Reforms

Paper 4:Corporate Governance

Static Dimensions

1. What is Corporate Governance?
2. Companies Act, 2013
3. Role of SEBI
4. Need of Corporate Governance and Principles
5. Guidelines issued by ICAI

Current Dimensions

1. Issues of Corporate Governance in India
2. IL&FS Crises
3. Reforms
4. Data Protection and privacy

Content

Corporate Governance

- It is set of principles or guidelines on which a company is governed.
- It ensures that the corporate works in a way it supposed to work to achieve the desired goals.
- It makes the corporations accountable to each stakeholder including, directors, shareholders, employees, customers etc.

The term governance itself explains the meaning that it is an act of managing a corporate entity. The entity of a corporation is separate from its officials which makes corporate governance an important subject to study.

Corporate governance plays an important role to protect the rights of thousands of shareholders, who have ownership in the company but do not play an active role in governing day to day business activities.

Corporate governance is a part of Indian corporate sector since the beginning but corporate governance failure and fraud of Satyam Computer Services Limited increased the concerns about corporate governance in India.

The need for Corporate Governance in India

In the last decade, corporate fraud and governance failure is occurring frequently which is why we require good corporate governance in the country. India provides proper norms and laws aligned with international requirements to govern a corporate. Some of the important reasons are discussed below which raised the need for corporate governance in India.

- A corporate has a lot of shareholders with different attitudes towards corporate affairs, corporate governance protects the shareholder democracy by implementing it through its Code of Conduct.
- Large corporate investors are becoming a challenge to the management of the company because they are influencing the decision of the company. Corporate governance set the code to deal with such situations.
- Corporate governance is necessary to build public confidence in the corporation which was shaken due to numerous corporate fraud in recent years. It is important for reviving the confidence of investors.
- Society having greater expectations from corporate, they expect that corporates take care of the environment, pollution, quality of goods and services, sustainable development etc. code to conduct corporate is important to fulfil all these expectations. Takeovers of the corporate entity created lots of problems in the past. It affects the right of various stakeholders in the company. This factor also pushes the need of corporate governance in the country.
- Globalization made the communication and transport between countries easy and frequent, so many Indian companies are listed with international stock exchange which also triggers the need for corporate governance in India.
- The huge flow of international capital in Indian companies are also affecting the management of Indian Corporates which require a code of corporate conduct.

Principles of Corporate Governance

Corporate governance has evolved around certain key principles, which form the base of rules and guidelines set for the corporate.

- **Transparency:** Disclosure of the relevant information about corporate in timely and accurate manner is necessary. It helps stakeholder to know their rights and day to day activity of the corporate.
- **Accountability:** It ensures the liability of the person who takes decision for the interest of the others. Hence persons like managers, chairmen, directors and other officers should be accountable to other stakeholders of the corporate.
- **Independence:** Independence of top manager is important for smooth functioning of the corporate. Board of Director must work without the interference of any interested party in the corporate.

Corporate Governance Framework in India

The Indian framework on Corporate Governance has been vastly in sync with the international standards. Broadly, it can be described in the following:

- The **Companies Act, 2013** has provisions concerning Independent Directors, Board Constitution, General meetings, Board meetings, Board processes, Related Party Transactions, Audit Committees, etc.
- **SEBI (Securities and Exchange Board of India)** Guidelines ensure the protection of investors and have mandated the companies to adhere to the best practices mentioned in the guidelines.
- Accounting Standards issued by **the ICAI (Institute of Chartered Accountants of India)** wherein the ICAI is an autonomous body and issues accounting standards. The disclosure of financial statements is also made mandatory by the ICAI backed by the Companies Act 2013, Sec. 129.
- Standard Listing Agreement of **Stock Exchanges** applies to the companies whose shares are listed on various stock

exchanges.

- Secretarial Standards Issued by the **ICSI (Institute of Company Secretaries of India)** issues standards on ‘Meetings of the board of Directors’, General Meetings, etc. The companies Act 2013 empowers this autonomous body to provide standards which each and every company is required to adhere to so that they are not punished under the Companies Act itself.

Issues in Corporate Governance in India

Although there exist many issues in the field of Corporate Governance especially in India, an effort has been made to highlight only the major ones here:

- **Board performance**: The requirement of at least one woman director is necessary, and also the balance of executive and non-executive directors are not maintained. Evaluation is not performed from time to time and transparency is lost somewhere. The performance is not result oriented. These requirements are not always met with.
- **Independent Directors:** Independent directors are appointed for a reason which does not seem to be fulfilled in the current scenario. Even after SEBI guidelines being issued to the corporates, for the appointment of an audit committee or giving of a comprehensive definition of the independent directors, the actual situation appears to be worse.
- **Accountability to Stakeholders:** The accountability is not restricted to that of the shareholders or the company, it is for the society at large and also the environment. The directors are not to keep in mind their own interests but also the interests of the community.
- **Risk Management:** The risk management techniques are to be mandatorily be undertaken by the directors as per the Company Laws and they have to mention in their report to shareholders as well. This is not being done in the most

sincere manners required for the job.

- **Privacy and Data Protection:** This is an important governance issue. Cyber security has evolved to be the most important aspect of modern governance. Good governance can only be achieved once the directors and other leaders in the company are well known about the hazards in this field.
- **Corporate Social Responsibility (CSR):** Being among the few countries to legislate on CSR, it is mandatory for companies to invest minimum 2% of the profits in the last 3 years for CSR activities. Otherwise proper reasons should be mentioned in the reports in case of failure. The companies seem to be reluctant towards making such investments.

NBFC Crisis (IL&FS)

The infrastructure Leasing and Financial Services Limited, a systemically important non-banking financial company, has defaulted on its debt repayments. This has created turmoil in the NBFC sector and in the financial markets. Many analysts allege serious malpractices and fraud at IL&FS. Whatever the truth of these allegations, the fundamental problem at IL&FS was that of illiquidity arising from the use of short-term funds to finance infrastructure. The failure to address illiquidity early enough has pushed the company towards bankruptcy.

The essential lesson is that the conventional corporate governance regime is woefully inadequate to deal with financial institutions.

Even though the Reserve Bank of India has stipulated governance frameworks for banks and non-banking finance companies (NBFCs), they have been found wanting in situations such as IL&FS. This calls for governance in financial institutions to be viewed through a different lens altogether, and it is so for a number of reasons.

First, the traditional governance paradigm seeks to align the interests of the shareholders on the one hand and the management of a company on the other. In companies with concentrated shareholding, the alignment should extend to both controlling and minority shareholders. This framework falls flat in its application to financial institutions.

Often, the management's incentives are pegged to shareholder value rather than to creditor protection.

This has been evident from the global financial crisis when executive compensation skyrocketed in companies that collapsed, an accusation now levelled against the IL&FS management.

Second, the implications of a governance crisis in a systemically important financial institution can be catastrophic to the financial markets and the economy.

No longer is governance a private matter among the board, management and shareholders of the financial institution, but it has larger public repercussions.

For example, as in the case of IL&FS, an institution may take on short-term liabilities while in possession of long-term, often illiquid, assets that create a stark mismatch between assets and liabilities. If not addressed properly, this can leave a large number of creditors in the lurch and paralyse the financial system.

Third, managements of large ("too-big-to-fail") financial institutions suffer from moral hazard problems. They assume excessive risks with the understanding that the government will bail them to avoid the negative ramifications of failure of such a financial institution. The above factors present in financial institutions shed light on one aspect: excessive risk-taking.

Instead of curbing excessive risks, the shareholder-premised

corporate governance frameworks enables further risk-taking, and hence poses inadequacies.

Test Yourself: Mould your thoughts

What are Systematically Important Banks (SIBs)? Can NBFCs be regulated on similar lines of how SIBs are regulated? Discuss in light of recent events.