Ownership structure and corporate governance: the Indian scene

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Abstract

The rise of corporate governance is attributed to the Berne and means agency problem characterized by the separation of ownership and management, which results in a divergence of interests between the managers and shareholders. Separation of ownership and management and widely dispersed shareholding was thought to be the dominant characteristic of the corporations the world over. However, a number of studies during the 1990s and thereafter have shown thatseparation of interests and widely dispersed ownership is limited to a few developed economies particularly the USA and the UK and the dominant feature is concentrated ownership. India has taken large strides in corporate governance reforms:however,these reforms were mainly influenced by the reforms in USA and UK. The present article will analyze the effectiveness of these reforms at the theoretical level considering the peculiarities of Indian ownership.

Introduction

Corporate governance evolved in response to the corporate disasters that come to the fore from time to timeand agency theory predictions that there is a conflict of interest between the owners and managers and that ownership is so much dispersed that no shareholder is in a position to influence the decisions of the management.This separation of ownership and management creates an issue of trust (agency problem). According to[1] Jensen and Murphy (1990) If shareholders would have complete information regarding the CEO's activities and the firm's investment opportunities, they could design a contract specifying and enforcing the managerial action to be taken in each state of the world. But it is not so, the reigns of the firm remain in managers hands and shareholders have to trust the management that the company is being run in their best interests and in the best interests of other stakeholders as well. However, some high-profile business failures such as Enron, WorldCom, Satyam computers to name a few, and questionable business practices in many countries like the US, the UK including India have cast doubts on the honesty and integrity of business managers. Historian Alfred Chandler in 1977 once said that America had created a system of ‘managerial capitalism’ in which managers not the shareholders control the corporation. He had given the premonition of future debacle; the investors were going to face. These observations and failures have served as an impetus to the government's world over to take immediate regulatory measures to arrest this corporate indiscipline and corporate governance came into the forefront. Corporate Governance is about putting in place the structure, processes,and mechanisms by which business and affairs of the company or firm are directed and managed, in order to enhance long term shareholder value through accountability of managers and enhancing firm performance [2](Fan, P. S. 2004). After the UK government's publication of Cadbury report in 1992 and USA's Sarbanes-Oxley Act of 2002, there was a surge in corporate codes issued around the world and India is no exception.However, the relationship between corporate governance and firm performance is inconclusive for example [3]Jackling and Johl (2009),[4]Baysinger and Butler (1985)find a positive association between the number of independent directors and firm performance, [5]Hermalin,andWeisbach (1988), [6]Kouki&Guizani (2015) et al. argue that supervisory and monitoring role played by the outside directors are beneficial to the firm shareholders however,[7]Van Ness Paul Miesing.et al. (2010) found no such impact of independent directors on financial performance similarly,[8]Bhagat and black (2000) reported positive relationship between poor performance and subsequent increase in number of independent directors and showed no evidence that increased board independence leads to better financial performance. Thus, the debate remains inconclusive.the issue is complex and many explanations have been forwarded in literature whichincludes board members of one company are themselves the managers/executives of some other company and are so much involved in their own affairs, they won't mind giving a proper thought to the affairs of other companies or they are not involved in other company and are ready to give a considerable amount of time to the company they are on board so their difference in attitude towards a company make a difference in the performance of the companies . Similarly, interlocked boards where the executives of one company are on the board of a group company affect the firm performance differently if there are no such arrangements in group companies. According to[9] Byrd and Hickman (1992), highcaliber CEOs appoint independent directors to please shareholders that they are being actively monitored.

Concentrated ownership and corporate governance: India being a developing country is a mixed bag of insider-dominated concentrated ownership and dispersed ownership[10]J Sarkar (2010). Indian corporate world is facing the issues of corporate governance at two levels: the traditional agency problem of conflicting interests of management and shareholders, which is generally the characteristic feature of widely held companies whereby shareholders are so dispersed and ownership stake of each shareholder is small enough that individually they bother very less about monitoring and disciplining the management. This issue of corporate governance can best be addressed by concentrating the ownership of 10 to 20 percent in a few hands so that they have both the incentive and means to monitor and discipline the management. The second issue of corporate governance is the principal-principal conflict between block holders and minority shareholders where block holders try to exploit the minority shareholders through different means like related party transactions, cross-holdings, tunneling etc.A study by J. Sarkar (2010) for the sample of 2075 private sector listed Indian firms reveals that only a small portion of 7.2 percent firms are widely held and the remaining firms are dominated by insider control and concentrated ownership. Similarly, a study on ownership trends in India for the period from 2001-2011 by [11]Balasubramanian and Anand (2013) shows that controlling shareholders (promoters and institutional shareholders) have further entrenched themselves,especially in Nifty companies at the expense of non-institutional shareholders. In addition, the majority of the large Indian corporations have family control either in the form of executive positions or in the board. According to [12]Demsetz and Lehn (1985), systematic regulations provide subsidized monitoring and disciplining of the management which reduces the ownership concentration to a greater extent. Further, when the consumption goals of owners are better served through the firm than otherwise, they will strive to monitor the firm more closely.According to [13]Randall Morck (1988), there is a positive association between an increase in director ownership from 0 to 5 percent range and Tobin's Q. As the Managerial ownership increases, they have to pay a larger amount of deviation costs from value maximization and thus they are less likely to squander the corporate wealth ([14]Jensen and Meckling,1976). Furthermore, the free rider problem associated with the dispersed ownership can be arrested by a controlling shareholder. According to [15]R. La Porta et al (2000), legal environment shapes the private benefits of control and determines the equilibrium ownership structure. Countries with less developed institutions and weaker protection of shareholders are characterized by concentrated ownership and control. However, this is not always true, according to [16]Shleifer and Vishney (1997)Ownership concentration has become a common phenomenon rather than an exception. Business enterprises around the developing world are dominated either by family ownership or by the individual ownership except for a few developed countries like USA and UK where ownership is dispersed, even in these countries there is a moderate level of ownership concentration.

This agency issue of [17]Berne and means (1932) can thus be addressed by having a block holder who has the necessary resources and incentives to discipline and control the managerial opportunism. Furthermore, interest alignment by management ownership acts as a motivating factor for them to focus on value increasing activities and away from value-destroying activities. However, this does not preclude the opportunistic behavior of insiders in exploiting the minority shareholders.Controlling shareholders by a number of means like pyramidal structure, cross-holdings or dual-class voting shares as is evident in many east European countries, Asian countries raise their cash flow rights leverage[18]Lemmon and Lins (2003), thereby retain the control and reduce equity ownership. The less equity ownership controlling shareholder has, the greater the incentive to extract private benefits [19]Gilson (2005). For example, if A is a controlling shareholder of firm B and firm B has a15% stake in firm C and A owns 5% shares of firm C. A through cross-holdings controls firm C, although he owns only a small stake in firm C. by virtue of this control he can transfer, through related party transactions, the wealth of the firm belonging to minority shareholders to the firm where his cashflow rights are more as it is advantageous to him, this gives rise to tunneling. Using a sample of 800 firms from East Asian countries, Lemmon and Lins (2003) find evidence that during financial crises of 1997 firms where management and their families separated control and cash flow rights through pyramidal structures have cumulative stock returns lower by about 12 percentage points as compared to other firms. in the Indian context, Naresh Chandra committee on audit and governance observed that while a promoter who controls management and owns majority stake is not expected to act in a value-destroying manner, the promoter nevertheless acts in a way that deprives the minority shareholders their ownership rights without necessarily affecting the company profitability.

Governance reforms:

India made large strides since the initiative of CIIs voluntary code of corporate governance in bringing about radical changes in governance. After the CIIS code, many committees have been set up to look in to the issue of corporate governance either in response to changes in other parts of the world like USA and UK or in response to the contemporary political-economic pressures e.g. after independence India adopted the business house model of governance which was characterized by among other things, restrictions on the issue of securities, licensing, government intervention in corporate management, government regulated price and supply. Although these were aimed to promote the economic growth and employment creation through the support of both private and public sector undertakings, in reality, these reforms created systematic barriers to entry for small and medium undertakings, consequently, it resulted in the systematic weakening of competition and became fraught with rent-seeking political and bureaucratic elites [20]Reed (2002). Though it is not explicit that these reforms were demanded, it is well known economic bailout and assistance requires drastic economic changes-at the start of the 1990s.Indian economy was suffering from low foreign exchange reserves, high amount of fiscal deficit and widespread losses in public sector undertakings, these reforms had to be brought about earlier or later. The various committees that were set up from CIIs voluntary code through Birla, Naresh Chandra, Narayana Murthy committees' recommendations in one way or the other got motivation from UK and US code of governance and it can be seen that there are many provisions in clause 49 (Indian governance code) of listing agreement closely akin to Sarbanes Oxley act of USA and UK code of good governance. These reforms were mainly focused on independent board members, audit committees, related party transactions, shareholder rights etc. although the reforms, in theory, looked very promising and with good intentions, there were many critics of these reforms. Based on the interview of over170 business representatives according to [21]Banaji and Mody (2001) highlighted the issue that there is a consensus among these business leaders about the ineffectiveness of boards in Indian corporations and ambiguity in related party transactions within business groups despite the presence of a large number of non-executives. Similarly, according to Reed (2002) since 1995 Indianeconomy's recessionary trend has become a semi-permanent feature, companies were unable to maintain the rates of profits and transparency has become a victim- By using preferential share options, between 1992 and 1994 ten major firms have received INR 15 billion by abuse of this option.

Conclusion:

Good governance has become an important mechanism to channelize thefinancial resources from both domestic and international investors to the sectors where they will be put to optimum use and to avoid the corporate disasters that have widespread economic effects. However, the same size doesn't fit all, Indian corporate governance provisions are similar to Anglo-American governance provisions which have different legal setup, well developed financial institutions and atomistic ownership of companies in comparison to India's.thus, any reforms should take due consideration of country specificitieswithout blindly adopting one code or the other.

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