CHAPTER IV

CORPORATE GOVERNANCE

The concept of corporate governance has been increasingly demanding our attention and has moved centre stage in the wake of corporate failures and widespread dissatisfaction with the way many corporates function, thus becoming a widely discussed topic across the globe recently.

Corporate governance is now recognized as a paradigm for improving competitiveness and enhancing efficiency and thus improving investors' confidence and accessing capital, both domestic as well as foreign. As a result, corporate governance has become a dynamic concept and not a static one.

Banks form a crucial link in a country's financial system because of which it is universally a regulated industry and their wellbeing is imperative for the economy. Corporate governance is however conceptually different for banks. The business model of financial intermediaries especially of banks envisages dealing in the financial resources of others and most of their liabilities constitute debt which is in the form of deposits.

Banks are different from other corporate in important respects, and that makes corporate governance of banks not only different but also more critical. Banks are interconnected in diverse, complex and often opaque ways underscoring their “contagion” potential. If a corporate fails, the fallout can be restricted to the stakeholders. If a bank fails, the impact can spread rapidly through to other banks with potentially serious consequences for the entire financial system and the macro economy.
It would, however, be erroneous to conclude that regulatory oversight is a substitute to corporate governance. There exists complementarity between regulation and corporate governance in banking.

This chapter discusses the corporate governance theories, models and mechanism in banks, its necessity in the banking sector, the history of corporate governance in the world as well as India, best practices of corporate banking incorporated in India and measures taken to implement them and the recent developments in this area in the banking sector. Finally we design conceptual model for measuring corporate governance in Indian banking system.

**Corporate Governance Definitions and Approaches**

The term “corporate governance” has a clear origin from a Greek word, “kyberman” meaning to steer, guide or govern. From a Greek word, it moved over to Latin, where it was known as “gubernare” and the French version of “gouverner”. In order to understand corporate governance, it is important to highlight its definition. Even though, there is no single accepted definition of corporate governance. It is difficult to define the concept of corporate governance in a universally acceptable way because definitions vary from country to country. Moreover, countries differ from each other in terms of culture, legal systems and historical developments. This explains why there is a wide range of definitions of the concept of corporate governance. It can be defined as a set of processes and structures for controlling and directing an organization. It constitutes a set of rules, which governs the relationships between management, shareholders and stakeholders. Each firm has numerous stakeholders whose different interests

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must be taken care of. This is why corporate governance has also been referred to as a collective group of people united as one body with the power and authority to direct, control and rule an organization.\(^3\)

The Australian Standard (2003) defines corporate governance as the process by which organizations are directed, controlled and held to account. This implies that corporate governance encompasses the authority, accountability, stewardship, leadership, direction and control exercised in the process of managing organizations.\(^4\) Since this definition recognizes the need for checks and balances in the process of managing organizations, it can be considered to be more comprehensive.\(^5\)

Moreover, it is similar to the definitions provided by the Audit Commission (2009)\(^6\) and CIPFA/SOLACE (Chartered Institute of Public Finance and Accountancy and the Society of Local Authority Chief Executives 2007) which emphasize the core aspects of accountability and control in the governance of organizations.\(^7\)

According to Turnbull (1997) Corporate Governance influences all activities of firms that produce goods or provide services.\(^8\) Colley et al. (2004)

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opine that corporate governance is the act or process of governing while Cadbury (2000) defines corporate governance in terms of the systems by which firms are directed and controlled.

It could also mean the process of decision-making and the process by which decisions may be implemented. Henceforth, corporate governance has much a different meaning to different organizations. Corporate Governance could be defined as ways of bringing the interests of investors and managers into line and ensuring that firms are run for the benefit of investors. It is concerned with the relationship between the internal governance mechanisms of corporations and society’s conception of the scope of corporate accountability. Corporate governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company. Corporate Governance consists of procedures and processes according to which an organization is directed and controlled. The Corporate Governance structure specifies the distribution of rights and responsibilities among the different participants in the organization such as the board, managers, shareholders and other stakeholders and lays down the rules


and procedures for decision-making. Corporate Governance is about promoting corporate fairness, transparency and accountability. With the emergence of globalization, there is greater de-territorialization and less of governmental control, which results in a greater need for accountability. Corporate governance is defined as "the structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation's primary objective." It is one of the key elements in improving economic efficiency and investors' confidence in the market. The corporate governance structure of a firm is expected to motivate managers towards improving their business through supervision of their performance and ensuring their accountability to shareholders. Thus, the OECD (2004) advocates that companies should continuously pursue good corporate governance practices in order to use resources more efficiently and thereby achieve high growth. International guidelines on corporate governance prescribe the application of governance principles and practices as a whole. It is important to study the governance system of a firm as a whole instead of focusing only on a particular aspect of corporate governance. These dimensions can be: 1) board structure and independence; 2) board procedure and effectiveness; 3) directors' remuneration; 4) audit committee procedure; 5) disclosure and transparency; 6) disclosure reliability; 7) shareholders' rights; and, 8) related party transactions.

Corporate Governance is a relatively recent. Over the past decade, the concept has evolved to address the rise of Corporate Social Responsibility (CSR) and the more active participation of both shareholders and stakeholders in corporate decision making. Two categories prevail. The first focuses on behavioral patterns—the actual behavior of corporations, as measured by performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. The second concerns itself with the normative framework—the rules under which firms operate, with the rules coming from such sources as the legal system, financial markets, and factor (labor) markets. Both definitions include CSR and sustainability concepts. For studies of single countries or firms within a country, the first type of definition is the more logical choice. It considers such matters as how boards of directors operate the role of executive compensation in determining firm performance, the relationship between labor policies and firm performance, and the roles of multiple shareholders and stakeholders. For comparative studies, the second type is more relevant. It investigates how differences in the normative framework affect the behavioral patterns of firms, investors, and others. In a comparative review, the question arises: how broadly should we define the framework for corporate governance? Under a narrow definition, the focus would be only on those capital markets rules governing equity investments in publicly listed firms. This would include listing requirements, insider dealing arrangements, disclosure and accounting rules, CSR practices, and protections of minority shareholder rights. Under a definition more specific to the provision of finance, the focus would be on how outside investors protect themselves against expropriation by the insiders. This would include minority rights protections and the strength of creditor rights, as reflected in collateral and bankruptcy laws and their enforcement. It could also

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include such issues as requirements on the composition and rights of executive directors and the ability to pursue class-action suits. This definition is close to the one advanced by economists Shleifer and Vishny (1997):20 “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” This definition can be expanded to define corporate governance as being concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders.

A somewhat broader definition would characterize corporate governance as a set of mechanisms through which firms operate when ownership is separated from management. This is close to the definition used by Sir Adrian Cadbury, head of the Committee on the Financial Aspects of Corporate Governance in the United Kingdom: “Corporate governance is the system by which companies are directed and controlled”.21 An even broader definition of a governance system is “the complex set of constraints that shape the ex post bargaining over the quasi rents generated by the firm”.22 This definition focuses on the division of claims and can be somewhat expanded to define corporate governance as the complex set of constraints that determine the quasi-rents (profits) generated by the firm in the course of relationships with stakeholders and shape the ex-post bargaining over them. This definition refers to both the determination of the value added by firms and the allocation of it among stakeholders that have relationships with the firm. It can be read to refer to a set of rules and institutions. Corresponding to this broad definition, the objective of a good corporate governance framework would

be to maximize firms’ contributions to the overall economy—including all stakeholders. Under this definition, corporate governance would include the relationship between shareholders, creditors, and corporations; between financial markets, institutions, and corporations; and between employees and corporations. Corporate governance would also encompass the issue of corporate social responsibility, including such aspects as the firm’s dealings affecting culture and the environment and the sustainability of firms’ operations. Looking over the past decade, we see increased emphasis on CSR, as reflected in investor codes, companies’ best practices, company laws, and securities regulatory frameworks.

In an analysis of corporate governance from a cross-country perspective, the question arises whether a common, global framework is optimal for all. With the emergence of China, India, and Brazil, among others, as global economic powers, the traditional model for corporate governance—monitoring and supervision through active investors, free and informed financial media, and so on—is not necessarily the framework that works best in the increasingly significant emerging market economies. Concepts such as accountability and safeguarding shareholders’ interests have cultural moorings in addition to legal and economic foundations. Western concepts and approaches may not be translatable, easily understood, or relevant to non-Western cultures. Because corporate governance is essentially about decision making, it is inevitable that social norms and structures play a role. These vary from country to country. In Islamic countries, for example, Sharia law has a large role in many aspects of life, ethical and social, in addition to its role in criminal and civil jurisprudence. Corporate governance must operate differently in these environments. These differences underscore the necessity for some level of adaptation of corporate governance principles, an area of increasing activity in recent reform efforts, and of much research interest.

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Another question arises over whether the framework extends to rules or institutions. Here, two views have been advanced. One—considered as prevailing in or applying to Anglo-Saxon countries—views the framework as determined by rules and, related to that, by markets and outsiders. The second, prevalent in other areas, views institutions—specifically, banks and insiders—as the determinants of the corporate governance framework.

In reality, both institutions and rules matter, and the distinction, although often used, can be misleading. Moreover, institutions and rules evolve. Institutions do not arise in a vacuum; they are affected by national or global rules. Similarly, laws and rules are affected by the country’s institutional setup. In the end, institutions and rules are endogenous to a country’s other factors and conditions. Among these, ownership structures and the state’s role are important in the evolution of institutions and rules through the political economy process. Shleifer and Vishny (1997) offer a dynamic perspective: “Corporate governance mechanisms are economic and legal institutions that can be altered through political process.” This dynamic aspect is especially relevant in a cross-country review, but only lately has it received attention from researchers. It is easy to become bewildered by the scope of institutions and rules that can be thought to matter. An easier way to ask the question of what corporate governance means is to take the functional approach. This approach recognizes that financial services come in many forms, but that if the services are unbundled, most, if not all, key elements are similar. This approach—rather than the specific products provided by financial institutions and markets—has distinguished six types of functions:

pooling resources and subdividing shares; transferring resources across time and space; managing risk; generating and providing information; dealing with incentive problems; and resolving competing claims on corporation generated wealth. We can operationalize the definition of corporate governance as the range of institutions and policies that are involved in these functions as they relate to corporations. Both markets and institutions will, for example, affect the way the corporate governance function of generating and providing high-quality and transparent information is performed. The presence of different definitions indicates that each author formulates a definition that spins around his or her theme.27 In fact, Wallace and Zinkin (2005) point out that the term good corporate governance is easy to phrase but difficult to understand and appreciate.28

The OECD Principles of Corporate Governance 29

I. Ensuring the Basis for an Effective Corporate Governance Framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

A. The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.

B. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.

C. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.

D. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

II. The Rights of Shareholders and Key Ownership Functions

The corporate governance framework should protect and facilitate the exercise of shareholders’ rights.

A. Basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and remove members of the board; and 6) share in the profits of the corporation.

B. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorization of additional shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.
C. Shareholders should have the opportunity to participate effectively and vote in 
general shareholder meetings and should be informed of the rules, including 
voting procedures that govern general shareholder meetings:

1. Shareholders should be furnished with sufficient and timely information 
   concerning the date, location and agenda of general meetings.

2. Shareholders should have the opportunity to ask questions to the board, 
   including questions relating to the annual external audit, to place items on the 
   agenda of general meetings, and to propose resolutions, subject to reasonable 
   limitations.

3. Effective shareholder participation in key corporate governance decisions, such 
   as the nomination and election of board members, should be facilitated. 
   Shareholders should be able to make their views known on the remuneration 
   policy for board members and key executives. The equity component of 
   compensation schemes for board members and employees should be subject to 
   shareholder approval.

4. Shareholders should be able to vote in person or in absentia, and equal effect 
   should be given to votes whether cast in person or in absentia.

D. Capital structures and arrangements that enable certain shareholders to obtain a 
degree of control disproportionate to their equity ownership should be disclosed.

E. Markets for corporate control should be allowed to function in an efficient and 
transparent manner.

1. The rules and procedures governing the acquisition of corporate control in the 
capital markets, and extraordinary transactions such as mergers, and sales of 
substantial portions of corporate assets, should be clearly articulated and disclosed.
so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

2. Anti-take-over devices should not be used to shield management and the board from accountability.

F. The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.

1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.

2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.

G. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.

III. The Equitable Treatment of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

A. All shareholders of the same series of a class should be treated equally.
1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected.

2. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.

3. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.

4. Impediments to cross border voting should be eliminated.

5. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

B. Insider trading and abusive self-dealing should be prohibited.

C. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

IV. The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
A. The rights of stakeholders that are established by law or through mutual agreements are to be respected.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

C. Performance-enhancing mechanisms for employee participation should be permitted to develop.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.

E. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.

F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

V. Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

A. Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company.

2. Company objectives.

3. Major share ownership and voting rights.
4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.

5. Related party transactions.

6. Foreseeable risk factors.

7. Issues regarding employees and other stakeholders.

8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

B. Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.

C. An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

E. Channels for disseminating information should provide for equal, timely and cost efficient access to relevant information by users.

F. The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by
investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.

VI. The Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.

A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

D. The board should fulfil certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

2. Monitoring the effectiveness of the company’s governance practices and making changes as needed.

3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

5. Ensuring a formal and transparent board nomination and election process.

6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

7. Ensuring the integrity of the corporation’s accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

8. Overseeing the process of disclosure and communications.

E. The board should be able to exercise objective independent judgement on corporate affairs.

1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.

2. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.

3. Board members should be able to commit themselves effectively to their responsibilities.
F. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.30

**Fundamental Corporate Governance Theories**

1- **Agency Theory**

Agency theory having its roots in economic theory was exposited by Alchian and Demsetz (1972)31 and further developed by Jensen and Meckling (1976).32 Agency theory is defined as “the relationship between the principals, such as shareholders and agents such as the company executives and managers”. In this theory, shareholders who are the owners or principals of the company, hires the agents to perform work. Principals delegate the running of business to the directors or managers, who are the shareholder’s agents.33 Indeed, Daily et al (2003) argued that two factors can influence the prominence of agency theory. First, the theory is conceptually and simple theory that reduces the corporation to two participants of managers and shareholders. Second, agency theory suggests that employees or managers in organizations can be self-interested.34

In the agency theory shareholders expect the agents to act and make decisions in the principal’s interest. On the contrary, the agent may not

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30 Ibid.
necessarily make decisions in the best interests of the principals.\textsuperscript{35} Such a problem was first highlighted by Adam Smith in the 18th century and subsequently explored by Ross (1973)\textsuperscript{36} and the first detailed description of agency theory was presented by Jensen and Meckling (1976).\textsuperscript{37} Indeed, the notion of problems arising from the separation of ownership and control in agency theory has been confirmed by Davis, Schoorman and Donaldson (1997).\textsuperscript{38}

In agency theory, the agent may be succumbed to self-interest, opportunistic behavior and falling short of congruence between the aspirations of the principal and the agent’s pursuits. Even the understanding of risk defers in its approach. Although with such setbacks, agency theory was introduced basically as a separation of ownership and control (Bhimani, 2008).\textsuperscript{39} Holmstrom and Milgrom (1994) argued that instead of providing fluctuating incentive payments, the agents will only focus on projects that have a high return and have a fixed wage without any incentive component.\textsuperscript{40}

Although this will provide a fair assessment, but it does not eradicate or even minimize corporate misconduct. Here, the positivist approach is used where the agents are controlled by principal-made rules, with the aim of maximizing

shareholders value. Hence, a more individualistic view is applied in this theory.\textsuperscript{41} Indeed, agency theory can be employed to explore the relationship between the ownership and management structure. However, where there is a separation, the agency model can be applied to align the goals of the management with that of the owners. Due to the fact that in a family firm, the management comprises of family members, hence the agency cost would be minimal as any firm’s performance does not really affect the firm performance.\textsuperscript{42} The model of an employee portrayed in the agency theory is more of a self-interested, individualistic and are bounded rationality where rewards and punishments seem to take priority.\textsuperscript{43} This theory prescribes that people or employees are held accountable in their tasks and responsibilities. Employees must constitute a good governance structure rather than just providing the need of shareholders, which maybe challenging the governance structure.

\textbf{Figure 4.1}

\textbf{The Agency Model}

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\textsuperscript{41} Clark, T., \textit{Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance}, op. cit., 2004.


2- Stewardship Theory

Stewardship theory has its roots from psychology and sociology and is defined by Davis, Schoorman & Donaldson (1997) as “a steward protects and maximizes shareholders wealth through firm performance, because by so doing, the steward’s utility functions are maximized”. In this perspective, stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. Unlike agency theory, stewardship theory stresses not on the perspective of individualism, but rather on the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained. Agyris (1973) argues agency theory looks at an employee or people as an economic being, which suppresses an individual’s own aspirations. However, stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust. It stresses on the position of employees or executives to act more autonomously so that the shareholders’ returns are maximized. Indeed, this can minimize the costs aimed at monitoring and controlling behaviors.

On the other end, Daly et al. (2003) argued that in order to protect their reputations as decision makers in organizations, executives and directors are

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inclined to operate the firm to maximize financial performance as well as shareholders’ profits. In this sense, it is believed that the firm’s performance can directly impact perceptions of their individual performance.\textsuperscript{49} Indeed, Fama (1980) contend that executives and directors are also managing their careers in order to be seen as effective stewards of their organization\textsuperscript{50}, whilst, Shleifer and Vishny (1997) insists that managers return finance to investors to establish a good reputation so that can re-enter the market for future finance. Stewardship model can have linking or resemblance in countries like Japan, where the Japanese worker assumes the role of stewards and takes ownership of their jobs and work at them diligently. Moreover, stewardship theory suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have greater role as stewards in the organization.\textsuperscript{51}It was evident that there would be better safeguarding of the interest of the shareholders. It was empirically found that the returns have improved by having both these theories combined rather than separated.\textsuperscript{52}


3-Stakeholder Theory

Stakeholder theory was embedded in the management discipline in 1970 and gradually developed by Freeman (1984) incorporating corporate accountability to a broad range of stakeholders. Wheeler et al, (2003) argued that stakeholder theory derived from a combination of the sociological and organizational disciplines. Indeed, stakeholder theory is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science. Stakeholder theory can be defined as “any group or individual who can affect or is affected by the achievement of the organization’s objectives”. Unlike agency theory in which the managers are working and serving for the stakeholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve – this include the suppliers, employees and business partners. And it was argued

that this group of network is important other than owner-manager-employee relationship as in agency theory (Freeman, 1999). On the other end, Sundaram & Inkpen (2004) contend that stakeholder theory attempts to address the group of stakeholder deserving and requiring management’s attention. Whilst, Donaldson & Preston (1995) claimed that all groups participate in a business to obtain benefits. Nonetheless, Clarkson (1995) suggested that the firm is a system, where there are stakeholders and the purpose of the organization is to create wealth for its stakeholders. Freeman (1984) contends that the network of relationships with many groups can affect decision making processes as stakeholder theory is concerned with the nature of these relationships in terms of both processes and outcomes for the firm and its stakeholders. Donaldson & Preston (1995) argued that this theory focuses on managerial decision making and interests of all stakeholders have intrinsic value, and no sets of interests is assumed to dominate the others.

4-Resource Dependency Theory

Whilst, the stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm. Hillman, Canella and Paetzold (2000) contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. Indeed, Johnson et al. (1996) concur that resource dependency theorists provide focus on the appointment of representatives of independent organizations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communication with the firm executives that may otherwise be more

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costly for the firm to secure. It has been argued that the provision of resources enhances organizational functioning, firm’s performance and its survival. According to Hillman, Canella and Paetzold (2000) that directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Directors can be classified into four categories of insiders, business experts, support specialists and community influential. First, the insiders are current and former executives of the firm and they provide expertise in specific areas such as finance and law on the firm itself as well as general strategy and direction. Second, the Business experts are current, former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision making and problem solving. Third, the support specialists are the lawyers, bankers, insurance company representatives and public relations experts and these specialists provide support in their individual specialized field. Finally, the community influential is the political leaders, university faculty, members of clergy, leaders of social or community organizations.

5- Transaction Cost Theory

Transaction cost theory was first initiated by Cyert and March (1963) and later theoretical described and exposed by Williamson (1996). Transaction cost theory was an interdisciplinary alliance of law, economics and organizations. This

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theory attempts to view the firm as an organization comprising people with different views and objectives. The underlying assumption of transaction theory is that firms have become so large they in effect substitute for the market in determining the allocation of resources. In other words, the organization and structure of a firm can determine price and production. The unit of analysis in transaction cost theory is the transaction. Therefore, the combination of people with transaction suggests that transaction cost theory managers are opportunists and arrange firms’ transactions to their interests.

6- Political Theory

Political theory brings the approach of developing voting support from shareholders, rather than by purchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges. The political model highlights the allocation of corporate power, profits and privileges are determined via the governments’ favor. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms’ mechanism.

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7-Ethics Theories and Corporate Governance

Other than the fundamental corporate governance theories: (agency theory, stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory and political theory), there are other ethical theories that can be closely associated to corporate governance. These include business ethics theory, virtue ethics theory, feminist ethics theory, discourse ethics theory, postmodern ethics theory.

Business ethics is a study of business activities, decisions and situations where the right and wrongs are addressed. The main reasons for this are the power and influence of business in any given society is stronger than ever before. Businesses have become a major provider to the society, in terms of jobs, products and services. Business collapse has a greater impact on society than ever before and the demands placed by the firm’s stakeholders are more complex and challenging. Only a handful of business giants have had any formal education on business ethics but there seems to be more compromises these days. Business ethics helps us to identify benefits and problems associated with ethical issues within the firm and business ethics is important as it gives us a new light into present and traditional view of ethics. In understanding the ‘right and wrongs’ in business ethics, Crane & Matten, (2007) injected morality that is concerned with the norms, values and beliefs fixed in the social process which helps right and wrong for an individual or social community.

Ethics is defined as the study of morality and the application of reason which sheds light on rules and principle, which is called ethical theories that ascertains the right and wrong for a situation. Whilst business ethics theory focuses on the ‘rights and wrongs’ in business, feminist ethics theory emphasizes on empathy, healthy social relationship, loving care for each other and the

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avoidance of harm. In an organization, to care for one another is a social concern and not merely a profit centered motive. Ethics has also to be seen in the light of the environment in which it is exercised. This is important as an organization is a network of actions, hence influencing trans-communal levels and interactions. On the other end, discourse ethics theory is concerned with peaceful settlement of conflicts. Discourse ethics, also called argumentation ethics, refers to a type of argument that tries to establish ethical truths by investigating the presuppositions of discourse. Meisenbach (2006) contends that such kind of settlement would be beneficial to promote cultural rationality and cultivate openness. Virtue ethics theory focuses on moral excellence, goodness, chastity and good character. Virtue is a state to act in a given situation. It is not a habit as a habit can be mindless. Aristotle calls it as disposition with choice or decision. For example, if a board member decides to be honest, now that a decision which he makes and thus strengthens his virtue of honesty. Virtue involves two aspects, the affective and intellectual. The concept of affective in virtue theory suggests “doing the right thing and have positive feelings”, whilst, the concept of intellectual suggests “to do virtuous act with the right reason”. Virtues can be instilled with education. Aristotle mentions that knowledge on ethics is just like becoming a builder.

Through the process of educating and exposure to good virtues, the development of ethical values in a child’s life is evident. Hence, if a person is exposed to good or positive ethical standards, exhibiting honesty, just and fairness, than he would exercise the same and it will be embedded in his will to do the right thing at any given situation. Virtue ethics is eminent to bring about the

75 Ibid., p. 20.
intangibles into an organization. Virtue ethics highlights the virtuous character towards developing a morally positive behavior.\textsuperscript{76}

Virtues are a set of traits that helps a person to lead a good life. Virtues are exhibited in a person’s life. Aristotle believed that virtue ethics consists of happiness not on a hedonistic sense, but rather on a broader level. Nevertheless, postmodern ethics theory goes beyond the facial value of morality and addressed the inner feelings and ‘gut feelings’ of a situation. It provides a more holistic approach in which firms may make goals achievement as their priority, foregoing or having a minimal focus on values, hence having a long term detrimental effect. On the other hand, there are firms today who are so value driven that their values become their ultimate goal.\textsuperscript{77}

The “New Corporate Governance” Framework

Martin Hilb (2006) defined “New Corporate Governance “as a system “by which companies are strategically directed, integratively managed and holistically controlled in an entrepreneurial and ethical way and in a manner appropriate to each particular context.”\textsuperscript{78} The “New Corporate Governance” framework presented here integrates the interests of the shareholders, customers, employees and public.

\textsuperscript{76} Crane, A. and Matten, D., \textit{Business Ethics}, op. cit.
\textsuperscript{77} Balasubramaniam, \textit{An International Perspective on Corporate Boards and Governance}, Malaysian Insurance Institute, 1999.
The reversed KISS framework comprises four parts:

**Part I: The Situational Dimension (Keep it situational)**

Here he differentiates between external and internal context. At the level of the external normative context, corporate governance practice differs with national, industrial and organizational culture. At the internal context level, every firm has a different development level, ownership and power makeup: the size and complexity of the firm, the degree of internationalization and the ambitions of the board.
Part 2: The Strategic Dimension (Keep it strategic)

He identifies four central success factors in corporate governance. The first prerequisite for a board culture characterized by constructive criticism and trust is the targeted selection of an exemplary board team, one that is comprised of people who act as role-models for both share- and stakeholders. The culture of constructive criticism and trust is implemented through simple networked board structures and processes. These three success factors are prerequisites for the development, implementation and evaluation of stakeholder oriented board success measures.

Part 3: The Integrated Board Management Dimension (Keep it integrated)

This dimension integrates the targeted recruitment, evaluation, remuneration and development of members of the supervisory and managing boards. For large, publicly listed companies, it is important to have a board management committee which handles not only nomination and remuneration, but also evaluation and development in an integrated way.

Part 4: The Controlling Dimension (Keep it controlled)

This dimension refers to auditing, risk management, internal and external communications and feedback functions of the board. By “framework” he means “an abstraction that preserves in economical form most of the points that have been developed.” The proposed framework is articulated into four parts (based on the KISS principle):

- Keep it situational (Context)
- Keep it strategic (Strategic direction)
- Keep it integrated (Board management)
The danger of simplifying a complex system, as the “New Corporate Governance” framework is attempting to do, should not be underestimated: as soon as parts of a system are isolated, the understanding of the system is altered. Only when we are aware of the limitations of any model and of the dangers of isolating sub-components in that model, can we call our approach scientific.

There are two main limitations of this framework:

• the visual representation lends itself to the usual critique of the social sciences, which is to “pay lip service to interdependence, and then to investigate the elements of the model in isolation from one another.”

• and, while the breakdown of corporate governance into single, central components has analytical relevance for our study, in practice these components are not always clearly delimited. There are a number of overlaps and interdependencies between the factors.

In spite of these caveats, “New Corporate Governance” meets the criteria proposed by Brown for the assessment of a [good] model: simplicity, clarity and logic of the formal structure, closeness to reality and, therefore, adequacy for relevant prediction.

According to Hilb differentiate between “New Corporate Governance” and “tracitional” corporate governance on the basis of four KISS dimensions, as follows:79
Table 4.1

Differences Between Traditional and "New Corporate Governance"

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Traditional corporate governance</th>
<th>New corporate governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Situational</td>
<td>No difference between national, industry and corporate culture</td>
<td>Implementation appropriate to the specific context of each firm (Keep it situational)</td>
</tr>
<tr>
<td>Implementation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategic Direction</td>
<td>Strategic development is not a function of the supervisory board</td>
<td>Strategic development is a central function of the supervisory board (Keep it strategic)</td>
</tr>
<tr>
<td>Integrated Board Management</td>
<td>Only isolated nomination and remuneration committees in publicly listed companies</td>
<td>Integrated and targeted selection, appraisal, compensation and development of the supervisory and managing boards (Keep it integrated)</td>
</tr>
<tr>
<td>Holistic Monitoring</td>
<td>Controlling the financial dimension only</td>
<td>Holistic monitoring of results from the perspectives of shareholders, clients, employees and the public (Keep it controlled)</td>
</tr>
</tbody>
</table>
Corporate Governance in India

Historical Background of Corporate Governance in India

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. 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.

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.\textsuperscript{81}

The World Bank published a Report on the Observance of Standards and Codes\textsuperscript{82} in order to assess the corporate governance in India. This evaluation is done by benchmarking India's corporate governance framework and company practices against the OECD Principles for Corporate Governance. The study has appraised the Indian companies on the adherence to the OECD principles in India

\textsuperscript{81} Ibid.
\textsuperscript{82} The World Bank Group, ROSC Corporate Governance Country Assessment India. World Bank, 2004.
methodically and has assigned ratings on each factor & sub-factor according to the OECD Benchmark. The report identifies a few problems areas in regard to the corporate governance practices in India. As per the report the sanctions provided by the Companies Act in India, for the violation of corporate governance norms were inadequate. The Stock Exchanges were not able to impose fines on market intermediaries. There were about 3,000 companies that were either illiquid or in the breach of listing rules. Hence, an efficient mechanism is needed to allow minority shareholders to exit from such investments at a fair price. The Department of Company Affairs, Stock Exchange Board of India and the stock exchanges share jurisdiction over listed companies. This creates a potential for regulatory arbitrage and weakens enforcement. The report stresses that there should be strong focus on director professionalism. It is suggested that there should be establishment of director training institutes. Lastly, the report recommends that the institutional investors should attend shareholders meetings and vote in order to promote shareholder activism. Also, the institutional investors should nominate independent directors to the boards of their portfolio companies. In this manner, the companies would avoid appointing their current or retired employees as independent directors that leads to conflicts of interest in the exercise of their fiduciary duties.

The role of independent directors in Indian Companies is being questioned since the controversies of year 2009. There was a corporate scandal at Satyam Computer Services and a hullabaloo regarding the role of Mr Nimesh Kampani as an independent director at Nagarjuna Finance. This led to strict scrutiny of Independent directors in India and hence at least 620 independent directors resigned from the boards of Indian companies. A study done by Mathew &
Khanna (2010)\textsuperscript{83} carried out interviews with the independent directors in India. The authors probed the opinions of independent directors regarding the clarity amongst these directors for their role in the boardroom. The responses by and large showed that we are far from following the ethos of corporate governance in its true spirit. In fact, the independent directors are quite confused about their role in the board. There is also a list of legal requirements of Clause 49 of Stock Exchange Listing Agreement by SEBI for corporate governance disclosure. It also updates on the voluntary guidelines produced by Ministry of Corporate Affairs (developed by Confederation of Indian Industry (CII), The Task Force chaired by Naresh Chandra and The Council of Institute of Company Secretaries of India (ICSI) in December 2009. This recent reform stresses on following points:

1. Nomination Committees
2. Executive Sessions
3. Access to Management and Other resources
4. Remuneration
5. Related Party Transactions
6. Independent Director Liability
7. Shareholder Activism
8. Director Training.

\textsuperscript{83} Mathew, S. J., & Khanna, V. S., “The Role of Independent Directors in Controlled Firms in India Preliminary Interview Evidence”, \textit{National Law School of India Review}, 2010, pp. 35-66.
Marcinkowsa (2012)\textsuperscript{84} conducts a study on the corporate governance mechanisms in banks, diagnoses the concern areas and prescribes remedies for the industry. She proposes that banks should focus on the core banking services rather than investment activities. Also, there should be adequate loans-deposits synchronization, asset-liability maturity match and level of leverage. The banks should link the remuneration of its executives according to their performance and risk exposure. However, the bonuses should be conditional on the long-term results that are sustainable. The internal and external auditor should be hugely accountable and should be liable to report any non-conformance to the supervisory agencies.

Sarkar, Sarkar, & Sen (2012)\textsuperscript{85} constructed a Corporate Governance Index for 500 Indian large listed firms. The index is constructed using 4 important mechanisms of corporate governance:

1. Board of Directors
2. Ownership Structure
3. Audit Committee
4. Auditor

The index has been created in two steps. First, a sub-index for each of four corporate governance components listed above was created. Secondly, the average of these sub-indices is calculated to compute the corporate governance index of a company. It reveals that companies with better corporate governance structures have a better rate of return in the market. Thus, Indian markets reward the companies with sound corporate governance mechanisms.


\textsuperscript{85} Sarkar, J., Sarkar, S., & Sen, K., \textit{A Corporate Governance Index for Large Listed Companies in India}, Indira Gandhi Institute of Development Research, 2012.
A study done by Kumar N. (2012)\textsuperscript{36} tested the impact of non-executive directors and insider ownership on the firm value of 157 Indian firms. The study was done using data from the Prowess database to test the correlation between Tobin’s-Q and non-executive directors. Interestingly, the grey directors (affiliate outside directors) give a negative impact on value of the company. This negative impact of grey directors is offsetting the positive (not very significant) impact of independent directors (non-affiliate outside directors). The results of other studies (Khanna & Palepu, 1999)\textsuperscript{87} (Kota & Tomar, 2010)\textsuperscript{88} shockingly reveal that promoter ownership is positively related to firm value. This study also corroborates the findings of these other studies stating that this insider ownership has a weak but positive impact on firm value.

The crisis of 2008 led to a revelation of inherent weaknesses in the corporate governance and control procedures of the large financial institutions globally. Senior Supervisory Group of Bank for International Settlements published a report on Risk Management Lessons from the Global Banking Crisis of 2008 (Senior Supervisor's Report, 2009)\textsuperscript{89}. The report lists a number of reasons due to which the crisis occurred. Among many other, the report point out that there were weaknesses in the corporate governance of the financial firms:

- The unwillingness or inability of the board of directors and senior managers to articulate measure and adhere to a level of risk acceptable to the firm. Several

\begin{itemize}
\item \textsuperscript{88}Kota, H. M., & Tomar, S., “Corporate governance Practices in Indian Firms”, \textit{Journal of Management & Organization}, No.16, 2010, pp. 266-279.
\end{itemize}
senior managers admitted that there was a disparity in the risk that the firm took, and the risk that was ‘perceived’ by the board of directors.

• Arrangements that favored risk takers at the expense of independent risk managers and control personnel. The stature and influence of revenue producers clearly exceeded those of the risk management and control functions.

• Compensation plans that conflicted with the control objectives of the firm. The compensation plans were not linked to the risk and the incentives were skewed to maximize revenues.

• An inadequate and often fragmented infrastructure that hindered effective risk identification and measurement. Inadequate IT infrastructure in the financial firms prevented them to complete integration of data that has resulted from firms’ multiple mergers and acquisitions.

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. 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 story. 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.

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*

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90 Omkar Goswami, “Corporate Governance in India,” *Taking Action Against Corruption in Asia and the Pacific*, op. cit.
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 (~ $2.5 million) or with a net worth of INR 250 million (~ $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 (~ $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; (vi) 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
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 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 “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.91 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

91 Tarun Khanna and Yishay Yafeh, Business Groups in Emerging Markets: Paragons or Parasites? (New Delhi: Sage Publications), 2005
announcement day compared to, Smaller firms that were required to implement the reforms at the same time.

A leading independent executive compensation and corporate governance consulting firm, Meridian Compensation Partners LLC conducted a survey (Corporate Governance and Incentive Plan Design Survey, 2012)\(^92\) on 250 large public companies in USA to investigate the executive compensation practices of these companies. Majority of companies surveyed follow a majority voting standard for directors’ elections and a declassified Board structure. Another article on CEO Compensation by the same firm\(^93\) points out that most of the shareholders are voting in the support of their Say on Pay vote. According to the authors the Compensation of CEO should be decided on the basis of six factors, company performance, individual performance, alignment with pay decisions for other executives, market data and expected trends, sending message to outsiders on views of performance and sending message to company employees regarding their CEO’s performance.

A report published by the Society of Corporate Secretaries and Governance Professionals and Deloitte (2012)\(^94\) covered 16 areas of governance practices. It was found that 84% of the companies reviewed their CEO succession plans. Shareholder engagement has increased and directors met with shareholders more frequently. It was also found that majority of companies has at least 25% women in the board.

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\(^92\) Meridian Compensation Partners, LLC, *Corporate Governance and Incentive Plan Design Survey* (Chicago: Meridian Compensation Partners), 2012.


\(^94\) Deloitte Center for Corporate Governance & Society of Corporate Secretaries and Governance Professionals.
SEBI in its consultative paper on Corporate Governance in India (2013) summarized recent policy changes in the Indian corporate governance regulations. It is mandatory to disclose details of the shares pledged by the promoters for listed entities promoted by them. Also, it is compulsory for the Promoter to hold the shares in dematerialized form. The auditor needs to be ‘peer reviewed’ in order to review a listed entity. The company should disclose its agreements with media companies on its website. Appointment of CFO needs to be approved by the audit committee of a company. Voting results or patterns need to be disclosed by the company on their websites and stock exchanges within 48 hours of the shareholders’ meeting. Companies should facilitate e-voting to its shareholders to ensure wider participation. The Companies Bill 2012 was passed in Lok Sabha in December 2012. The Ministry of Corporate Affairs in India decided that the core principles of corporate governance ought to be included in the bill. According the bill, at least one-third of the board should constitute of independent directors. It is mandated that the listed companies need to have a Nomination and Remuneration Committee. For companies where total number of shareholders, deposit holders, debenture holders exceeds 1000 in a financial year it is compulsory to have a Stakeholders Relationship Committee (SRC). The audit committee needs to appoint a registered valuer who will be responsible for any valuation of property, stocks, shares, debentures, goodwill or other assets, net worth and liabilities etc. The act also directs setting up of National Financial Reporting Authority (NFRA) to take action against the Auditors in the event of a


97 Ibid.
professional misconduct. The act also mandates rotation of auditors and restricts the auditors from providing non-audit services.

An independent body, the Asian Corporate Governance Association (ACGA) published a White Paper on Corporate Governance in India (Asian Corporate Governance Association (ACGA), 2010). The findings suggest that the issue related party transactions needs more attention. This is because Asian companies constitute a part of family or state-controlled groups and can be either listed or unlisted entities. The study recommends that this issue should be given more weight age in the Clause 49 provisions laid down by SEBI rather than leaving the same on the company law. It mentions other irregularities like, issuance of preferential warrants to the promoters of the company, lack of quality and consistency of financial information provided as disclosures and fragmented nature of the auditing industry in India. It endorses the legislative and regulatory framework of other Asian countries like, Hong Kong, Singapore Malaysia and China to improve India’s corporate governance milieu.

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

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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. 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.

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 1991.

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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.  

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). 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.

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However, busy independent directors also appear to be correlated with a greater degree of earnings management as measured by discretionary accruals.\textsuperscript{103} 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.\textsuperscript{104} 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. More recently, based on 2001 data that distinguishes between “controlling” insiders and non-controlling groups, Ekta Selarka reports a U-shaped relationship between 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%.105

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.106 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 (~ USD

52,530) to INR 6.4 million (= USD 160,000) in real terms. 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 0.55% to 1.06%. Fagemas also finds that doubled from CECs 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.

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 (= USD 132,500), with wide variation across firm size. The average board compensation is INR 7.6 million (= USD 190,000) for large firms and INR 2.5 million (= USD 62,500) for small firms. The board compensation also appears to be higher, on average, at INR 6.9 million (= 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

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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.\textsuperscript{109} 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.\textsuperscript{110} 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.\textsuperscript{111} There is also some evidence that firms associated with business groups have superior performance than stand-alone firms.\textsuperscript{112} 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.\textsuperscript{113} 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. 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.\textsuperscript{114} 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.\textsuperscript{115} 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.\textsuperscript{116}

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 No index entries
found. Recent years as institutions have adopted significantly greater market
orientation. 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, 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. 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 periods. 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. 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.

117 Jayati Sarkar and Subrata Sarkar, “Corporate Governance, Enforcement and the
Role of Non-Profit Organizations,” Background Paper for IFMR Conference on
Corporate Governance, IFMR, Chennai, India, 2005.
118 Manish Agarwal and Aditya Bhattacharya, “Mergers in India – a Response to
Regulatory Shocks,” Emerging Markets Finance and Trade, Vol. 42, 2006, pp. 46-
65.
119 Nandini Gupta, “Partial Privatization and Firm Performance,” Journal of Finance,
120 Sangeetha S., Empirical Essays on Enterprise and Ownership Reforms in Public
Sector Enterprises -Evidence from India,” 2006.
Corporate Governance in Banks

Banks play the role of financial intermediation in an economy. Hence, the public and the market are highly sensitive to any difficulties potentially arising due to weaknesses in the 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. 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 none 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 place.\textsuperscript{121} 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 nonperforming 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. After the financial crisis erupted in mid-2007, the Basel Committee on Banking Supervision revisited its guidelines on bank governance.\textsuperscript{122}

The Committee has summarized the key focus areas as: board practices, senior management, risk management and internal controls, compensation, complex or opaque corporate structure and disclosure and transparency. Poor corporate governance in banks leads to increased public costs and possibility of

\textsuperscript{121} Rajesh Chakrabarti, \textit{The Financial Sector in India – Emerging Issues}, (Delhi: Oxford University Press), 2006.
broader macro-economic implications such as contagion risk and impact on payment systems. OECD had conducted an Asian Roundtable on Corporate Governance Task Force on Corporate Governance of Banks (OECD, 2006). The Policy document identifies the most critical issues for corporate governance that affect banks in Asia. The task force believes that many Asian jurisdictions lack the institutional infrastructure like, sufficient resources, experience, focus and know-how necessary for effective enforcement of the corporate governance policy framework. Also, Asian banks play a dominant role in regional finance but have rather immature capital markets. In such a milieu, it becomes very important that there is a need to tackle institutional constraints and weaknesses in order to have effective corporate governance in banks. The policy brief gives special mention to the State-Owned Commercial Banks (“SOCBs”) and Family-Owned Banks (“FOBs”) as these are quite dominant in Asia. In case of FOBs, related party transactions hold importance. However, in case of SOCBs the role of government as an active accountable owner has to be carried out in such a manner that it doesn’t interfere with the day to day management of bank. For listed banks, the policy document stresses on the separation of ownership and control (i.e., the agency problem). Thought Arbitrage Research Institute (TARI), evaluates the role of RBI as a regulatory body of the banking industry in India. RBI plays an important role in laying down the corporate governance norms for the Indian Banking Industry. RBI works under the Board for Financial Supervision (BFS) which in turn inspects the banks using “CAMELS” (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems & Controls) Approach. RBI monitors bank governance through three activities, viz. Disclosure and

124 Thought Arbitrage Research Institute (TARI), Gatekeepers of Corporate Governance - Reserve Bank of India. Thought Arbitrage Research Institute (TARI), 2012.
Transparency, Off-site surveillance and Prompt corrective action. Disclosure and Transparency is monitored through the regularity and thoroughness in the financial reporting of the Indian banks as per the accounting standards. The Off-site surveillance mechanism checks the movement of assets, its impact on capital adequacy and overall efficiency and adequacy of managerial practices in banks. RBI gives ‘Peer Group Comparison’ on critical ratios to maintain peer pressure on individual banks for better performance and governance. Prompt corrective Action is a part of the Basel II requirements through which RBI initiates corrective action in case there is an irregularity in three ratios – Capital Adequacy Ratio, Non-Performing Assets Ratio and Return on Assets. BFS also monitors the quality of audit done by the banks. According to Sumedha Tuteja & C.S. Nagpal (2013)\textsuperscript{125}, Clause 49 has been taken as a benchmark for formulating CGI. However, practices that are usually followed by the banks in India have not been included in the Index:

1-Board of Directors

While formulating the CGI, a minimum and maximum limit has been decided. The rationale behind the same is that a board needs to have sufficient strength of directors for effective corporate governance. At the same time, there should not be too many directors as it would lead wastage of resources, time and efforts of the board. Hence, penalty has been assigned in the CGI for excess number of directors. According to Clause 49 of SEBI Listing Agreement, one-third of directors should be independent, in case the Chairman of the Board is a non-executive director and half of directors should be independent, if Chairman of the Board is an executive director. Therefore, in the CGI the companies that have more than fifty percent of the directors as independent are assigned higher points.

Number of board meetings is an important parameter for judging the activity level of the board. Clause 49 also specifies that the board would meet for a minimum of four times in a year. Hence, the CGI specifies a minimum and maximum limit. Post the GFC of 2007-08 many consulting agencies and companies globally have shown their preference towards declassified boards. This is because it ensures more accountability of the directors towards issues related to corporate governance.

2- Audit Committee

The requirements related to the audit committee, specified in OECD principles and Clause 49 of SEBI Listing Agreement have been listed in CGI. Apart from this, bonus points have been given if all the directors in the committee are independent and if internal auditor reports to the Audit Committee. It has been observed that if the auditor provides services other than the audit service to a company, it leads to conflict of interest. Thus, bonus points have been given if auditor in a company provides only audit service.

3- Remuneration Committee

Clause 49 lists existence of a remuneration committee as a non-mandatory requirement. Thus, the recommendations of this Clause have been listed in the CGI. Since compensation of CEO has been a contentious issue since the GFC in 2007-08, companies are setting performance based incentives for CEO. Hence, extra points have been given in CGI for this practice.

4- Nomination Committee

Although, Clause 49 is silent on this issue presently, nomination committee is essential for carrying out effective corporate governance in any company.
Therefore, a few salient points in this regard have been assigned extra points in the CGI.

5- Risk Management

Risk Management in financial institutions has been a major reason for collapse of financial markets in the GFC of 2007-08. The Indian Banking system has been more or less cautious on this factor when compared to other countries. However, globally there has been a need felt to include specific disclosures and practices for risk management in the corporate governance framework.

6- Related Party Transactions

Enough has been said about these transactions in academic literature and review by independent bodies. Bonus points have been assigned if a bank seeks approval from shareholders for divestment decisions, if a majority of the ‘minority shareholders’ are approving the transaction, or if prior approval from the audit committee has been taken for transactions.

7- Disclosures

The disclosure of Indian Banks is quite comprehensive. Thus, a few unique disclosures have been included in the Index to check the level of transparency maintained by the banks. A few material issues have been incorporated in the index like, related party transactions, penalties levied to company for non-compliance, remuneration of each director compared to the median salary of the company, existence of succession planning for CEO, Director or senior managers.

8- Policies of the banks

The suggestions from various reports and papers have been incorporated to check if Indian banks are following the best practices and non-mandatory
requirements of the corporate governance mandates. Bonus points have been affixed for issues like training provided to board members, evaluation of non-executive directors, separate meeting of independent directors, existence of evaluation system for CEO etc.