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Corporate Governance in India: Understanding the History and Peeking into the Future

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(This is Part III and the last part of an extended essay on Corporate Governance in India. Part I and II were published respectively in Volume 6, Issue 3 and 4 of A₹tha. Part I deals with corporate governance practices in India from the colonial period until the economic liberalization in 1991; Part II outlines the governance practices in India post economic liberalisation.)

PERSPECTIVE ON THE CORPORATE GOVERNANCE IN FUTURE

Family-controlled Companies

Family-controlled enterprises are undergoing several changes. First, socio-cultural change has changed the concept of a *family firm* from a firm governed by extended families to a firm controlled by individualistic families (Roy, 2018, p 233). However, the concept of family-controlled business remains intact.

Second, due to a strengthening of professional management education in India, scions of business families are well educated, exposed to the outside world, and conversant with managerial practices and business environment in developed societies (Tripathi and Jumani, 2013, p 212). Consequently, those who are currently at the helm of family-controlled companies are well-qualified professionals. As a result, their attitude towards their children has changed. They appreciate that their children have the right to pursue their passion and choose a career of their own. A recent statement by Kumar Mangalam Birla, who is at the helm of the 162-year old conglomerate, signals the change in attitude. He said that growing up, he did not have a choice to pick his career path, unlike children today who have options to pursue their interests. He and his wife feel that children should have a chance to pursue their passion (Tandon, 2020).

Third, family-controlled companies find it challenging to place family members in critical positions, such as that of a CEO. In 2017, when Anand Mahindra was asked why his two daughters did not join the family business, he replied, "I'm asked this probably once a day. And I think it's a good question because it means that women are being accepted as inheritors of corporate legacies. In my case, my daughters have made their own choice. Recently, at our annual shareholder meeting, somebody asked why they weren't there and I said that they are part of the family business. They are working with my wife. We don't view Mahindra as a family business." (Gupta, 2017). From November 2021, Dr. Anish Shah, who is not related to the Mahindra family, will head the Mahindra and Mahindra Group, whereas Mr. Anand Mahindra will be the group's non-executive chairman. In the coming decades, we may expect more such cases.

Fourth, family succession planning has improved. For example, let us consider the case of the Bajaj Group, which is the fourth largest Indian business group in terms of market capitalisation. In 2018, Rahul, Shekhar, Madhur and Niraj — third-generation Bajaj family members — signed a new family settlement agreement that outlined how the family would jointly own the group companies and deal with issues related to succession, ownership and conflict resolution (Raj, 2020).

Fifth, families have realised the necessity of good governance and a greater role for the Board's Nomination and the Remuneration Committee in succession planning. They are increasingly cautious when selecting a successor because of pressures from institutional investors and activist shareholders. Moreover, even if the CEO is a family member, professional managers play a key role. Furthermore, it is difficult to manage a complex business in an environment characterized by VUCA (volatility, uncertainty, complexity, and ambiguity). It is also difficult to attract and retain talent unless the CEO is a competent and professional manager, who may or may not be a family member. In the future, the inheritance of wealth will not necessarily be accompanied by the inheritance of management.

These changes would improve the governance of family-controlled companies and transform these companies into professionally managed ones.

Unicorns

India already has 21 unicorns. With continued technological and other disruptions, new start-ups with innovative business models would emerge to challenge the business models of incumbent firms. The number of unicorns would also increase. Unicorns are financed by venture capitals, which install good governance system. In those companies, promoter shareholding remains low even when venture capitalists exit and they grow.

Within the next few decades, many such companies would displace family-controlled companies from their existing position in the capital market. As a result, the dominance of family-controlled companies would decline in the future.

Institutional Investors and Shareholder Activism

In its most general form, shareholder activism means nothing more than an active, engaging shareholder who does not simply consider the investment made as purely financial but as strategic. The most obvious way shareholders may voice their demands is to exercise the voting rights associated with share ownership (Ringe, 2018, p. 536). Shareholder activism takes two forms – formal and informal. Formal shareholder activism is observable in public, such as the voice of dissent in general meetings and hostile takeovers. Informal shareholder activism is close door engagement with the management. 'Rational apathy' of dispersed shareholders is a well-known phenomenon. The cost of shareholder activism is much more than the benefits they derive from the same. Institutional investors play an essential role in shareholder activism to benefit the company and improving corporate governance. They adopt informal mechanisms of shareholder activism. Earlier research reports that public pension funds like CalPERS actively engaged in improving corporate governance because they adopt a long-term perspective. On the contrary, mutual funds do not engage in shareholder activism and adopt exit strategy, as they cannot take a long-term view. However, it is now observed that with the fast growth of the mutual fund industry, mutual funds are compelled to change the exit strategy. Their stockholding in a company may be s significant when we consider investments made by various schemes. Consequently, they cannot afford to offload their total holdings in a company, which would adversely impact the share price and probably cause a significant reduction in the value of their portfolios (Ringe, 2018, p. 549). As a result, mutual funds have curtailed using exit strategy and show more significant participation in shareholder activism. The introduction of the stewardship code (effective from July 1, 2020) is expected to encourage shareholder activism by mutual funds and other institutional investors.

Institutional investment in Indian companies is increasing. Institutional ownership in Indian companies in 2010 was 15.8 per cent (Dyck et al., 2019), which increased to 33.58 per cent in 2019 (Coutinho, 2019). We may expect that with the general growth in institutional investment, investment in family-controlled companies will also grow. This will enhance shareholder activism and improve corporate governance standards. Foreign institutional investors and institutions from countries with strong shareholder protection are the main promoters of good governance outside the U.S.A. (Aggarwal et al., 2011). As per SEBI Annual Report 2018-2019, on March 31, 2019, a total of 9,390 FPI were registered of which 3,204 from the USA. They held 32.72% of the total AUM . It is not unreasonable to expect that an increase in the investment by institutional investors from the U.S.A. and other developed countries will improve the average standard of corporate governance in India.

Sustainability Business Model and Corporate Irresponsibility

Indian companies lag behind companies in developed countries in adopting a sustainability business model. A sustainable business creates, delivers, and captures value for all its stakeholders without depleting the natural, economic, and social capital. In a letter to the CEO, Larry Fink, the chairman of the Black Rock, the world's largest asset manager, wrote, "Given the groundwork, we have already laid engaging on disclosure, and the growing investment risks surrounding sustainability, we will be increasingly disposed to vote against management and board of directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them." (Larry, 2020). Most asset management companies across the globe are insisting on adoption of sustainability-related business practices. Pressure from institutional shareholders and SEBI's insistence for adopting the Integrated Reporting Framework will accelerate the adoption of a sustainable business model by Indian companies. In the age of social media and media activism, irresponsible behaviour of companies is circulated widely within no time. Professional managers do not want to get associated with companies having a low reputation. Therefore, companies which indulge in irresponsible behaviour will not be able to attract and retain talent. This will deter companies from indulging in unethical and irresponsible behaviour. Professional managers, who have emerged as the principal actor in the governance of companies, will restrain themselves from taking decisions that would be labeled as irresponsible and could damage their individual reputation and that of their company.

Market pressures

Tirole (2006, p 28) observes, "It is widely agreed that the quality of firm's management is not solely determined by its design of corporate governance, but also depends on the firm's competitive environment". Indian firms are now operating in a competitive environment. Therefore, the product market pressure will impact the quality of governance of Indian companies.

Fama (1980) posits that managerial labour market pressure disciplines the managers of large companies. The career progression and future compensation of managers within the company and outside depends on how the internal and external labour market evaluates the manager's performance. Labour market uses the performance of the firm to determine each manager's outside opportunity wage. Managers realise this and undertake some amount of monitoring in both directions – senior managers to junior managers and junior managers to senior managers. In a competitive environment, the relative performance of managers can be measured as having a positive impact on corporate governance. Moreover, as the practice of recruiting managers through talent search firms, the pressure on managers to perform will increase, as talent search firms collect information from various sources about aspirants for a managerial position.

Indian bankruptcy code

The Insolvency and Bankruptcy Code, 2016 (IBC) was enacted in 2016. It has is the consolidated the then existing framework for insolvency and bankruptcy. It has all the features of a contemporary bankruptcy law. Roe (2005) observes that when bankruptcy works well, it reduces the debt overhang problem by allowing new financing and removing managers incapable of engineering a turnaround. The Indian law prohibits certain persons from submitting a resolution plan in case of defaults. Those include: (i) wilful defaulters, (ii) promoters or management of the company if it has an outstanding non-performing debt for over a year, and (iii) disqualified directors, among others. Further, it bars the sale of property of a defaulter to such persons during liquidation. This provision disciplines the promoters of family-controlled companies, as promoters of defaulting companies stare at losing control.

CONCLUSION

In the next two decades, the average corporate governance standard will improve. This is driven by several factors, including a reduced dominance of family-controlled companies, better family governance, a dominant role of professional managers in all types of companies, stronger regulations, strengthening of corporate governance institutions and increasing awareness that good corporate governance makes business sense. This perception about the future is based on an analysis of the NSE Nifty-200 companies, which represent about 86.7% of the free-float market capitalization of the stocks listed on NSE as of March 29, 2019. We anticipate that the perception would not change even if we analysed more companies, say the top 2,000 companies. It is possible that the percentage of family-controlled companies will be much higher than that among the top 2000 companies. Still, their impact on the flow of capital to the corporate sector will not be significant. Moreover, through the demonstration effect, corporate governance practices in those companies will improve. However, it is a limitation of our analysis, and it will be interesting to analyse a larger sample of companies.

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