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Investor Capitalism and the Reshaping of Business in India

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There is general agreement that institutional shareholders have been the major force driving the movement for better standards of governance and accountability in corporate business worldwide. How does this work in an 'emerging' market where foreign institutional investors can establish a dominant market position but need to interact with business cultures run by local promoters and low in corporate transparency? This paper argues that while the foreign institutional investors (FIIs) have established considerable leverage over Indian companies, and mounted successful pressure for modernisation of the stock market, their role in corporate governance is unlikely to be as significant as that of the domestic institutions which own substantial chunks of equity in Indian industry. The paper looks at the controversy surrounding the Securities and exchange Board of India's, (SEBI)'s, draft code of corporate governance and suggests that regulators seeking to enforce higher standards of governance in globally integrating markets should reinforce the position of institutional shareholders rather than undermining it.

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Introduction

The last decade of the 20th century produced a landslide in the corporate hierarchies of Indian business. The opening of the economy in the 90s has meant that global investment banks, management consultancies, and fund managers are active in the market today, and the evolution of business can no longer be isolated from their influence. The private business sector in particular has had to adjust both to increased levels of competition, following the delicensing of industry and dismantling of tariffs, and to the changing nature of the capital market, which has seen a revolution in terms of infrastructure and considerable *re*-regulation to improve disclosure and transparency. The net result of these changes has been that by the end of the decade it was clearly felt that in the family-controlled business sector, which is the backbone of private business in India, 'Only big family-run businesses with global operations and professional management will survive'.[1] In other words, liberalisation and the renewed integration of the domestic economy with the world economy have undermined the political defences of Indian capital, even though these survive on a large scale in the form of a durable nexus between businessmen and politicians. More interestingly, however, firms that benchmark themselves internationally have opted into disclosure standards that are *more* rigorous than those required in India itself, reversing the logic of regulatory arbitrage. They have done this in the recent past by seeking listings on the NYSE or NASDAQ, thus exemplifying a model of 'functional convergence' in corporate governance standards which seems to be a rapidly expanding alternative to the kind of reform perspectives represented by local self-regulation or mandatory corporate law reform.[2] Under 'functional convergence' the crucial advances are made at the level of securities market regulation and the mechanism that allows for convergence itself is the migration of firms to better regulated jurisdictions with substantial pools of capital, and of course the influence this exerts on the domestic market. But transparency has a complex architecture and the case of at least one of these foreign issuers (Reliance) will show us why functional convergence may work within rather narrow institutional limits.

Before coming to the Indian case, it may be helpful to outline at least four interesting perspectives on the study of governance, which I shall call 'regulatory', 'financial', 'institutional', and 'corporate law' respectively. Corporate governance may be seen as part of a world-wide countertrend to deregulation which seeks to 'maintain the confidence of the investing public in the financial markets'. Here the assumption is that deregulation and re-regulation are not two opposing forces but 'processes that run hand in hand'.[3] Secondly, the pressure for 'better corporate governance' can also be seen as a function of the fierce competition within the Anglo-American fund management industry, and, more specifically, as a response to the problem of short-termism which has come about with the

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[1] Mukherjee, 'Most mid-cap family companies erode shareholder wealth', *Economic Times* 20.9.99, citing 'analysts'.

[2] See John Coffee Jr., 'The future as history: the prospects for global convergence in corporate governance and its implications', 93 *Northwestern University Law Review*, 641 (1999).

[3] Harry McVea, *Financial Conglomerates and the Chinese Wall: Regulating Conflicts of Interest* (Oxford, 1993).

new financial capitalism of the 80s and 90s.[4] The competition in question is a competition for institutional clients or, more precisely, for the savings that they embody, between the large fund-management groups. Thirdly, corporate governance may be seen as in some sense an inevitable expression of the 'socialisation' of capital and the tensions this generates between financial and managerial capitalism. This is a perspective in perfect harmony with Marx's views about the 'abolition of capital as private property within the framework of capitalist production itself' in the famous chapter on the credit system in vol.3 of *Capital*, but its fullest statement is the classic study by Berle and Means, *The Modern Corporation and Private Property,* which has exerted an enormous influence on subsequent literature. In the leveraged buyouts of the 1980s, 'managerialism' became a battering ram in the hands of academics who set out to reassert the claims of ownership against effete corporate managers whose self-seeking had ostensibly ruined American industry.[5] But the universality of this vision is doubtful: concentrated ownership survives in many business regimes throughout the world and assumes a variety of forms. Finally, much of the academic interest in corporate governance can also be seen as in some sense an acknowledgement of the *failure* of company law to legitimate corporate managerial power and the problems this raises for a future reconstruction of the legal architecture of the joint-stock company.[6] Needless to say, each of these perspectives is valid, and they are all essential to a more complete formulation of the issues. These are issues which are largely implicit in the paragraphs which follow, which start by looking at the kind of business transformation that is occurring in India.

Reform of the capital market is certainly the most tangible achievement of the Indian liberalisation.[7] Reforms here have 'far outstripped the process of liberalisation in every other sector of the Indian economy', it has been said.[8] The automation of the stock exchanges took roughly three years, and by 1998 all 23 exchanges in the country had 100 per cent automated screen-based trading, vastly improving market transparency, reducing bid-offer spreads, and effecting a reduction in transaction costs. Automation also facilitates order trading by allowing for tighter surveillance and monitoring of the market. Dematerialisation of shares has eliminated the risks associated with paper-based securities in terms of bad delivery, fake or forged certificates, etc., again reducing transaction costs. 85 to 90% of the actively traded securities are now traded in dematerialised form. For institutional investors the number of scrips on the compulsory demat list has been around

[4] David Blake and J. M. Orszag, *The Impact of Pension Funds on Capital Markets* (The Pensions Institute Discussion Paper PI-9803) (1998), esp. 10f.
[5] See G. P. Baker and G. D. Smith, *The New Financial Capitalists. KKR and the Creation of Corporate Value* (Cambridge, 1998) for a defence of the LBO. Against, see Lazonick, 'Controlling the market for corporate control', *Industrial and Corporate Change* 1(1992) 445ff.
[6] See esp. Mary Stokes, 'Company law and legal theory', in Sally Wheeler, ed., *The Law of the Business Enterprise: Selected Essays* (Oxford, 1994) 80-116.
[7] For the *problems* which continue to beset the capital markets, see P. J. Nayak, 'Regulation and market microstructure', in J. A. Hanson and Sanjay Kathuria, eds., *India: A Financial Sector for the Twenty-First Century* (New Delhi, **) 266ff.
[8] Sucheta Dalal, 'Setting the agenda for change in the Indian capital market', *Economic and Political Weekly*, 4 Sept., 1999, 2541ff.

500 since January this year. Virtually all institutional trades have been subsumed by demat within just two years. Thirdly, in 1998 SEBI began to shift the market from the accounting period (or account dealing) system to a five day rolling settlement, barely three years after the London Stock Exchange made a similar move. Shorter settlement cycles mean better liquidity and larger trading volumes. Finally, in terms of regulation, cash flow statements and quarterly reporting of results are now mandatory for listed companies, and the committee on disclosure standards set up by SEBI has recommended consolidation of accounts and segmental reporting. There has also been a plethora of new regulations involving all the main market intermediaries from brokers and merchant banks to credit rating agencies, mutual funds, and financial analysts. In short, between SEBI and the National Stock Exchange the financial landscape is being significantly reworked to bring India into line with international best practice. However, when one looks at the domestic business system, these transformations appear close to inexplicable, if not anomalous. The reference here is not to the kind of resistance that the evolution of the NSE encountered, as a nation-wide, professional exchange *not* run by brokers, among the coteries controlling the Bombay Stock Exchange,[9] but the wider business system that saw itself being outflanked by the transition in the market. Interviews suggest that the committee on disclosure standards encountered a fair degree of resistance, precisely from the 'industrial houses and big industrialists', as one respondent stated. What, one might ask, in that case, is driving the transformation of the Indian capital market?

Investor capitalism: the FIIs

Much of the change in the capital market has been driven by the presence and activity of the so-called foreign institutional investors. Their demands were of prime importance in the rapid modernisation of the market which occurred between 1996 and 1999. As of January 2000, the net cumulative investment by FIIs stood at $10.22 billion, up from less than a billion in 1993 when they first entered the market. The obvious question is – how significant is this figure? In late January 2000 the market capitalisation of the Bombay Stock Exchange was roughly $239 billion, which would mean that FII investment was barely 5% of market capitalisation. However, the denominator that matters is not total market capitalisation but the level of the free float, that is, the shares that are actually publicly available for trading. In interviews it was established that the floating stock in the Indian market is probably less than 25 to 30 per cent on the aggregate, and that the FIIs probably own 50% of the free float in most of the big stocks. (Much of the retail segment does not form part of the free float, since small investors have often never traded in their shares since the date of the original allotment.) Interviews with fund managers conducted mostly in 1998 confirm this impression. The investment universe of the leading fund managers is structured around a core portfolio of the top 50 companies, even if most fund management firms might track up to 300 companies very closely. Concentration on the big stocks means a higher average size of holding in those companies, and it seems likely that

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[9] Dalal, 'Setting the agenda', 2541-42.

collectively this is generally anywhere between 15 and 30% in most large companies.[10] (Till the most recent budget, the aggregate cap on all FII subaccounts was 24% of the total paid-up capital of a company, with a restriction of 10% on each individual fund, and companies allowed to raise the ceiling to 30% by a special resolution. It follows that FIIs were fully invested in a large range of companies.) The general conclusion reached by Barth and Zhang in their study of the East Asian markets is thus certainly true of India, namely, that 'in the context of limited free float, foreign investors are a major presence'.[11] (The reference here, of course, is to portfolio investors.)

By "investor capitalism" I mean a system of capitalism where financial institutional investors control a significant and increasing chunk of the world's stock markets and the accumulation of capital, that is, corporate management and production are largely driven by the returns to financial capital. In the rapid changes which the Indian business sector has seen since the early 90s, the FIIs are the obvious expressions and exemplars of this system, and it is worth looking more closely at the nature of their impact on the private sector. As of March 1999 there were 450 FIIs registered with SEBI but interviews suggest that only between 50 and 100 of them are actually active at the moment. The foreign brokerages who form part of the same investment banking groups also control the bulk of the foreign institutional business. (Indian brokers, by contrast, dominate the speculative trades which account for the bulk of the turnover on the exchanges.) With investment time-frames of 6 months to 2 years,[12] active management of portfolios, and fierce competition in the asset management business world-wide, the ability and credibility of managements become of paramount importance to the fund managers, and the discourses of "shareholder value" spread through the market as a benchmark language in which these messages are conveyed and valuations established. Fund managers rate quality of management as their most important investment factor. Unlike growth prospects, quality of earnings, or the strength of the balance sheet,[13] factors like execution of corporate strategy or management credibility are not quantifiable and not even financial data in the conventional sense.[14] They are in fact shorthand expressions for rather complex business cultures and structures which are never apparent on the surface. At any rate, fund managers have to make assessments of the general quality of a business depending on their view of the integrity of management. Management integrity was especially important because when they first entered India in the early 90s institutional investors poured money into a market they barely understood. At that stage the market had been massively manipulated and was much higher than it should have been. 'GDRs suddenly became a possibility…but Indian managements saw it as an opportunity to get some cash…

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[10] This is roughly comparable with the UK situation where Stapledon calculated that the mean *collective* holding of the top institutions among large UK companies was about 26%, G. P. Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford, 1996).

[11] Michael Barth and Xin Zhang, 'Foreign equity flows and the Asian financial crisis', in Alison Harwood *et al.*, *Financial Markets and Development: The Crisis in Emerging Markets* (Washington, 1999), 179ff., at 187.

[12] Dewe Rogerson, *Perspective India III: General Section*, June 1998. (I'm grateful to Rosie Catherwood for the opportunity to consult the general section of this report.)

[13] Dewe Rogerson, *Perspective*, 87-88, the other factors mentioned.

[14] See Lubna Kably, 'Value added information', *Economic Times* 17.7.99

cheaply… on the back of *these completely ramped* share prices and domestic valuations… went out into the market, raised 50 million dollars or a 100 million dollars or whatever it was, they worked up huge amounts of money, came back, and did absolutely nothing with it! And the rumour was that there were fund managers around the world who didn't even know the name of the company to pay for those records…They believed in the companies, though the domestic valuations were completely rigged anyway, and they've all lost an enormous amount of money'.

The late 1990s were thus marked by a prolonged slump in the equity market, a flight to quality, and a severe erosion of the market capitalisation of whole swathes of Indian industry. This, and the general recession in industry, was the background against which Indian businessmen began to mouth platitudes about 'Corporate Governance'. What also happened in this period is that the fund managers rapidly created a position of leverage over companies, and by the late 90s the more forward-looking family businesses reciprocated by scrapping proposals investors disapproved of (mergers, investment projects, diversification, etc.), claiming to professionalise boards, and setting up regular channels of communication with analysts and fund managers. In private corporate managers would complain that the FIIs were 'driving their investment decisions', and senior executives referred repeatedly, in interviews, to the considerable amounts of time they spent in meetings and presentations with research analysts and chief investment officers. For their part, the fund managers are naturally conscious of their position of strength. As one of them explained, 'FII investments are spread over no more than 300 to 400 companies. Clearly for these companies *it makes a big difference what foreign investors think about your management practices*'. That was in the asset management arm of one of the big US investment banks. Another respondent said, 'We have large funds. We have to take reasonable stakes in a company, so we do some serious work, try to find out whether these are the companies which can give us value over the medium term. And if we think so, then we take a very good stake in a company, (so much so) that that the promoter cannot ignore us…*I think we are in a position of strength most of the time*. If we call, he'd better return the call if he's not there'. In the financial markets in India there is a widespread view that the governance culture of Indian business is being revamped by the market, and this model of 'accountability to the market' is something I wish to come back to later.

Transparency and the issue of control in the family business sector

Against this background let me turn, briefly, to the subject of these seeming metamorphoses, namely, the Indian business houses. The 'reshaping' of business is largely a story about transparency, but a brief background would be useful. With a few striking exceptions, the vast majority of Indian companies are family-controlled and a significant proportion of them among the larger listed concerns belong to business houses which have traditionally formed the mainstay of the Indian private sector. The other important type of enterprise is the foreign-controlled company, usually a subsidiary. In one survey of the top 150 companies (by market cap) in 1999, MNCs accounted for 26% of the total, which is substantial.[15] Of course, both sets of companies raise Cadbury-style issues of corporate governance, but at this stage, certainly to some degree in rather different senses. Leaving the MNCs aside for the moment, it is interesting to note that the 90s produced a strong differentiation within the family business sector, undermining any common front of family capital. Among the older family conglomerates, the majority were plagued by fragmented businesses and problems of succession. Families which retained a labyrinth of cross-holdings but accommodated the pressures of succession by dividing the companies in terms of management control, would face considerable dissension in the 90s, and the public financial institutions did little to stop the fragmentation of these groups as if they were estates run by a family of landlords. These businesses have simply sunk quietly into oblivion, ruined by family feuds, lack of professionalism, and the plunder of company resources. Secondly, there were promoter groups of more recent origin and unbridled ambition. The majority of these groups took liberalisation to mean a licence to expand recklessly into the high prestige deregulated infrastructure sectors which had formerly been reserved for the PSUs – oil & gas, power, telecoms, etc. These were unrelated diversifications, funded by the term-lending institutions with astonishing standards of project appraisal (or so it appears), and the downturn of the middle 90s left almost all of them stranded with huge liabilities, over-stretched resources, and unfinished projects. It may be worth remarking that these two categories of promoter businesses account for the *largest* share of the non-performing assets (NPAs) of the financial institutions.[16] They are mostly substantial defaulters, and became notorious for siphoning funds from their listed companies. A third type of family conglomerate, more successful than any of the others, is chiefly represented by the Tatas and the Aditya Birla group which is now run by his son Kumar Mangalam Birla following his untimely death in 1995. These are the old venerable businesses of India, and their problem is one of survival through restructuring, of retaining control over a diversified set of businesses which remain competitive and injecting a much deeper sense of cohesion into the group. This streamlining of the conglomerate business structure coupled with corporate branding is best exemplified by the Tata group, where Ratan Tata's emphases have been very much on welding a core set of businesses (ten to twelve) into a tightly-knit group with a strong sense of its own corporate values. Individual boards are now subject to the supervision of a Business Review Council which will represent the group. The Tata companies have always had professional managers, even if the Tatas themselves have insisted on having a large number of their own nominees on the boards. Control has been a major preoccupation of this strategy, both in the functional sense of removing the dead wood from the dispersed oligarchies of the earlier period, and in the financial sense of increasing the holding companies' stakes in key operating companies of the group. Whether this strategy succeeds is anybody's guess. Ratan Tata himself is now a few years from his own much-publicised retirement age of 65, and it is far from obvious how the succession will be structured. At any rate, groups in this category have been consolidating furiously and struggling to retain a sense of leadership in a world turned upside down by 'globalisation'. Finally, a fourth category, the stars of the *fin-de-siècle* family business galaxy, highly focused single-company businesses driven by

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[15] Booz Allen & Hamilton, *"Owners" versus Shareholders? Erasing the "Promoter Value Discount"* (January 2000),

[16] Prabodh Agarwal, 'India's NPL problem – how bad is it?', *CLSA Global Emerging Markets*, Dec. 1998, App. 7.

first-generation entrepreneurs or software engineers who have built world-class enterprises which have been handsomely rewarded by the stock markets. Again, these companies are in various stages of evolution, with Reliance on its way to becoming an integrated conglomerate giant exploiting global economies of scale in petrochemicals and oil, Ranbaxy professionalising its management and expanding in the global pharmaceutical industry, Infosys listing on NASDAQ as the fifteenth largest IT scrip, and so on. Taken with the best-run and fastest-expanding multinational subsidiaries such as Hindustan Lever, with the best of the PSUs, and the more successful companies in the third category, they form the dynamic core of Indian business in the era of global economic integration. In short, taking the four categories together, the landscape of family business is a highly differentiated one, with distinct models, overlapping characteristics, and intersecting cycles of growth and decline. The least likely to survive are the third- or fourth-generation inheritor businesses, the most likely are the aggressive, fast-expanding, focused companies.

Having said this, however, and drawn these contrasts, it is particularly important to note that with a very few notable exceptions, the business culture that has sustained growth through the complex and changing regulatory environment of India is one common to *most* of these companies. In other words, governance is much less differentiated than strategy or performance. Indian promoters have traditionally retained control through inter-corporate investments and holding companies. This is not a recent feature of the business houses, it was apparent to R. K. Hazari when he studied business groups in the early sixties, using data from 1951 and 1958, and explained the evolution of these structures in terms of the steep tax rates on incomes and heavy estate duties after death, which, as he said, 'induced the rich to impersonalise their shareholdings'. Indeed, one of the chief recommendations of his study was the regulation of the investment companies. 'Inter-corporate investment is the main instrument, and an increasingly important one, for the control of companies', Hazari wrote.[17] For example, the Birla controlling blocks in the 1950s were based on 'substantial holdings by investment companies supplemented by circular chains of investments which return to their starting points, and investments by industrial companies in other companies the business of which is altogether different'.[18] In most cases, he observed, 'the chains of inter-corporate investment can be traced back to large investment companies registered mostly in the forties in the former princely states of Madhya Pradesh and Rajasthan…[T]hese companies have played a crucial role in the holding of Birla controlling blocks, besides trading in shares and commodities, sometimes among themselves at arbitrary prices…'.[19] Hazari calculated that the Birlas had 151 investment and trading companies in 1958. The decades that followed do not appear to have made a dent in this picture. Investment companies are legion within the hidden recesses of corporate groups. Interviews conducted jointly with colleagues reveal that the Sarabhais, for example, are said to have 'more than 200 [investment] companies, and all the companies were named after rivers, they ran out of names!'. Reliance, I was told by the legal director of a foreign company, has 400 investment companies operating from one common premise. This was stated 'on the authority of the Secretary, Company Affairs'.

[17] R. K. Hazari, *The Structure of the Corporate Private Sector* (London, 1967) 316.
[18] Hazari, *Structure*, 55.
[19] Hazari, *Structure*, 57-8.

The R.P. Goenka group is reported to control its stakes in the operating companies through at least 59 investment companies.[20] And the papers report that it took the government arbitrator eight years to unravel the cross-holdings of the Modi group before he could award a settlement in an acrimonious dispute between the brothers.[21] Cross-holdings and investment companies are thus the mainstay of promoter control, and their immediate implication is that a very large number of operating companies are publicly listed but woven into dense networks of control through the holdings of group investment companies and cross-holdings of other group operating companies. This situation is fraught with conflict of interest, as in many other family-dominated business regimes such as France, Italy or South Korea, and for institutional investors transparency is thus all-important as a *tool of control* over corporate managements. Consolidation of accounts, the international reporting standard on related party transactions, the institution of Audit Committees, the strengthening of boards, and the independence of Auditors are thus all perfectly logical and consistent demands, and give the international drive for 'corporate governance' an obviously progressive aspect. But regulation doesn't function in a vacuum, and the working group set up to draft amendments to the Companies Act 1956 ruled out mandatory consolidation of accounts, for example, because it would expose those patterns of control, as one was reliably told. 'The reason why consolidation was opposed was precisely this reason. And it was opposed by people who were, let's say, closest to the Indian business houses'. Not only had the mainstream of domestic business ensured that the redrafting of the Companies Act would largely reflect their own perspectives, but 1997 saw a significant move by companies and businesses to engage in and publicise corporate governance initiatives. Since then these initiatives have taken various forms such as the induction of professionals on the board, the setting up of Audit Committees, the drafting of formal succession plans, a growing move to adopt US GAAP or start the preparatory work for a listing on the New York Stock Exchange, and, finally, the revamping of Annual Reports to convey substantially better information or include a formal section on Corporate Governance. Significantly absent in this welter of self-improving initiatives has been any widespread move to set up nomination committees composed exclusively of independent directors. Without independent directors (and not just "grey area" non-executives) Audit Committees are largely meaningless, boards remain cosmetic and subject to control, and there is still no clear mechanism of accountability. There is, in other words, a subtle interplay of form and substance at work, acceptance of form, rejection of substance. In saying this, it is not my intention to deny that there is a fluid core of well-run, professionally-managed companies which are keen to prove their credentials by public statements of governance structure or reform and support for better standards of disclosure. Indeed, it would be foolish to downplay the value of this vanguard. The point is one about realism. Indian business has in the past demonstrated a superlative capacity to subvert or escape regulation by 'incorporation' or creative compliance, and in the growing genuflection before corporate governance both anti-regulatory strategies may well be at work. The recent SEBI Code of Corporate Governance requires all listed companies to have at least a one-third proportion of independent directors on the board, and even offers a definition of "independent" that rules out 'material pecuniary relationships or

[20] *Economic Times*, 17.5.99
[21] *Business Standard*, 29.8.97

transactions with the company, its promoters, its management or its subsidiaries, etc.' But nomination committees are a telling omission in the Code and the selection of these so-called independent directors is thus left to the existing promoter-dominated boards.[22] How does SEBI propose to ensure that boards will really contain the requisite core of independent directors? And why, if independent directors are so crucial anyway, does it further undermine the accountability of boards by being so deeply ambivalent about the role of institutional nominees? Again, the point is not that the Code is not a step forward by the standards of Indian business but that regulation is shaped by both regulatees and regulators. The danger of having a code of best practice mandating a series of committees without any substantial change in the integrity of business or the dominant corporate culture is fairly obvious. As one respondent company argued, 'All the Indian promoters will be absolutely delighted!…The fact is that you will continue to do what you do but you will have the complete shelter and umbrella of protection from these committees, and the committees will be staffed by a whole series of people who are, in quotes, as I said, "independent"…(It boils down to not having genuinely independent directors, is that what you're saying?) Well, at the end of the day who will appoint them? Is the Central Government going to sit and appoint the independent directors? And what *can* an independent director do? He would comment on what is brought to him, and that is where, at the heart of the issue, is the ethics and integrity inherent within a corporation...'.

The domestic financial institutions: towards institutional activism?

Let me turn, finally, to the most interesting issue of all, namely, the role of the institutional shareholders in the general revamping of corporate governance and accountability. The domestic financial institutions have substantial stakes in a very wide range of companies, because the expansion of domestic capital was for decades funded by the so-called development banks with the ultimate widespread conversion of their loans into equity, and because of the substantial investments of the UTI and LIC, one a unit trust, the other an insurance company. The widespread failure of boards in India is largely a failure of the public financial institutions to enforce the requisite supervision over companies which promoters ran with unilateral authority and minimum interference, even when their own stakes in the companies in question were minimal. But the public financial institutions are, or have been till very recently, government-controlled, and it was their unstated or understood function to bolster incumbent managements against possible hostile bids, in other words, stabilise control by existing promoters. Given the political constraint on their role as potential institutional monitors, it seems pointless to make too much of the fact that in relying on internal resources in the appointment of nominees to boards, the institutions failed to provide quality monitors with the characteristics required of so-called independent directors, namely, the ability to question and challenge management (rather than provide them with comfort) and of course a good understanding of the business itself. However, today the situation is different and changing fast, because liberalisation has put

[22] By contrast, the recent joint statement issued by the NAPF and the ABI in the UK makes the selection of a director part of the definition of her independence (or lack of), cf. Lubna Kably, 'A re-look at independence', *Economic Times*, 14.12.99.

an end to the era of development banking, the term-lending institutions have been redefining themselves as universal banks operating to commercial imperatives in a highly competitive industry, and they themselves are under pressure to perform from their own expanding base of shareholders. The chief legacy of the earlier epoch of directed lending with poor standards of appraisal or, as some allege, outright corruption, is of course a huge backlog of non-performing assets which most experts agree are substantially understated and which is certainly the most worrying feature of the Indian financial system today. (A banking analyst at one of the FIIs has estimated that the government will have to pump in $6½ to 14 billion to recapitalise the banks.) The second interesting aspect of the changing circumstances is that the investment institutions have begun to change their own trading strategies, under the demonstration effect of the FIIs, and given the massive erosion in the net asset values of the UTI's holdings in the market, which recently triggered both public outcry and a blueprint for reform. In short, if previously the institutions enjoyed neither liquidity nor control due to political restrictions, today there is a distinct if tentative and cautious move towards *both* liquidity and control, and the general thinking seems to be that it would make sense for the institutions to concentrate their monitoring skills rather than disperse them widely, and liquidate stakes where managements have consistently under-performed, by selling to strategic investors (i.e. competitors). The sense of this almost seismic shift in institutional psychology has in turn spread panic among promoters, and led to orchestrated campaigns to remove their nominees from boards, pre-empt stake sells by the right of first refusal, and so on. The most telling vertical split in the ranks of Indian business today relates precisely to this issue of whether domestic institutional shareholders should increase or decrease their monitoring role, with all the apex chambers and particularly the CII pressing for a dramatically reduced role, and the institutions themselves seeking stronger standards of governance. There is, thankfully, a sector of the Indian corporate class, especially professional managers in both Indian and foreign businesses, which supports the idea that institutional activism will be the saving grace of the future.

Before I say more about this, however, let me return to the foreign institutional investors who have in some sense been the prime movers in this whole transformation. It seems overwhelmingly obvious to me that unlike the role they play in their own domestic markets, particularly the UK, their role in emerging markets like India will continue to be largely one of seeking accountability through the market, that is, exiting companies rather than using voice. As the head of one of the largest US funds stated, 'We are not long-term strategic investors…By and large you vote with your feet, you exit, dump the stock if you're unhappy with the management…By and large we vote with our feet'. There are a few exceptional fund managers who believe that the mutual funds should intervene actively in the AGMs, but so far there is a clear consensus that the FIIs have not been vocal enough. Thus it seems to me that even with the US pension funds entering the Indian market,[23] one is not likely to see any significant change in the kind of governance impact the FIIs have had so far, certainly not their active involvement on boards, unlike the private equity funds who mainly finance smaller unlisted ventures and supervise businesses rather closely. The model of 'accountability to the market' is an acceptable but imperfect

[23] Singh, 'Conference Board centre in India to aid governance', *Economic Times*, 31.3.00.

form of regulation, and this, it seems to me, bounces the ball back into the domestic institutional court. SEBI's ambivalence about the role of institutional shareholders is contrary to the trend in other markets, but stems, ostensibly, from the argument that nominees are privy to price-sensitive information which renders the institutions vulnerable as insiders. One should note, however, that studies in the UK show that the flow of price-sensitive information is a regular feature of company/institutional interaction and not peculiar to a situation such as that in India, where, uniquely, the institutions have their nominees on the board. Therefore, unless the proposal is to restrict *all* interaction between FIs and investee companies – something manifestly absurd and contrary to the Code's own recommendation for more activism from these shareholders – the question of removing nominees from the *board* is beside the point. What is required is a thorough review of the Chinese Wall in both domestic and foreign institutions, in view of the widespread perception that frontrunning is rampant among institutional investors. Secondly, and more fundamentally, institutional *participation* in the market is still not sufficiently broad based, despite the rapid institutionalisation of the market in the 90s. That is to say, even if the *level* of institutional holdings is high, somewhere between 30 and 40% in the aggregate, the holdings are also highly concentrated rather than dispersed more widely over a multiplicity of institutional investors. This coupled with government control of the domestic institutions opens the way to political influence and corruption. As the head of one of the larger business houses stated candidly, when asked whether he was worried by the prospect of hostile bids, 'It will largely happen that way, but *right now, of course, to put it politely or impolitely, you use your contacts, political and otherwise, etc., to see that takeover bids…hostile takeover bids don't succeed, so you go along to the financial institutions, etc., whatnot, put pressure on government*, it's happened in the past, it's likely to happen'. In other words, government control of the FIs has been crucial to the control promoters have exercised over their companies. On the other hand, '*the day the government lets loose these institutions, in terms of their control over them, you will certainly see a lot more aggressive activism from them*'.[24] Here, then, is a further paradox - reduction of government control over the public financial institutions should mean *greater* activism and more professionalisation. Coupled with the willingness to vote out promoter directors, this should be a boost to the market for corporate control and accelerate the rationalisation of business structure through Mergers & Acquisitions, speeding up consolidation in fragmented industries and adding scale to individual businesses. Mergers & Acquisitions are currently the cream of the investment banking business in India and expected to grow in a substantial way once the takeover code becomes sufficiently aggressive. Overriding all of these is the desperate need for the growth of a properly developed institutionalised savings sector, in pension funds and life insurance, in other words, a *domestic* fund management industry with a much wider coverage of the PF beyond the meagre ten percent of the labour force which it currently provides for. As the investment guidelines regulating the Provident Fund corpus are liberalised and the provident funds managed competitively, with more than a single fund manager and some portion of the funds flowing into investment-grade securities in the private sector (to boost real rates of return), the share of institutional shareholdings would expand significantly and promoter control will increasingly be a thing of the past.

[24] Interview with a large business house headquartered in Delhi, 1st October 1999.

Certainly, these are the international trends and the issue is not whether they will happen in India, but how long it will take.

Summary

To sum up: Since 1993 foreign institutional investors have driven change in the Indian market. This has produced a crisis in the traditional hierarchies of Indian business as asset size and political influence matter much less now than business factors and the valuation of companies in the market. Standards of research have improved dramatically in the last five years and the top 200 companies are heavily researched today. There is a close and regular interaction between management, research analysts and fund managers. One implication of all this is a huge premium on transparency. On the other hand, few corporates want transparency, because, as one industrialist said, 'One of the banes of Indian family-owned business is keeping their holding close to their chest'. Corporate governance has been put on the agenda of Indian business because of all these changes, and one has seen a clear differentiation between companies with reputational capital and the larger swathes of industry who are sinking rapidly into oblivion. In this context, a major issue concerns the role that the domestic institutions will play in shaping new standards of accountability and governance. Those who wish to see more sweeping changes in Indian society have an ideal opportunity to debate a vital set of issues about the role the financial institutions should play and the inevitable underlying question of 'who should be regarded as having a valid interest in the company'.[25]

[25] Judith Freedman, 'Accountants and corporate governance: filling a legal vacuum?' *Political Quarterly* 1993