Corporate Governance And Development: Why It matters?

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Corporate Governance and Growth

It has always been intriguing to me why some economies are christened as developed and some others as developing, emerging or transition economies. I have luxuriated into several engaging discussions at different points in time with renowned economists to lift the veil of euphemism. While the distinction is by and large based on the level of per capita income, there is no consensus as to why they are so. Over six billion human beings inhabit planet earth; nearly five billion of them are rooted in so called transition, developing or emerging economies. That is, over 80% of human race shares 20% of the global income. Such wide spread disparity in the endowment, rather in deprivation, is heart-rending. This has provoked the intelligentsia to research into what explains the health of the economies.

Research seems to indicate that though it is difficult to conclude firmly what approaches and programmes can lead to economic advancement, there is a fair degree of consensus about certain approaches / programmes contributing to economic advancement. One major debate – whether market or state can propel economic advancement – is almost settled. A number of empirical studies reveal that, economies with market friendly policies like disciplined fiscal and monetary system, well developed financial markets experience display long term growth performance. Evidence is also available to substantiate that reforms which usher in market friendly policies register improved growth performance. This essentially means that the state and market have to co-exist and complement each other's effort. Neither market nor state alone can ensure a high rate of economic advancement. They need to focus on the areas of their respective core competence for an economy to perform well. The state should provide basic support services such law and order, a conductive legal environment, a decent supervisory and regulatory infrastructure, a reliable accounting system, a vibrant securities market, etc. while the private economic agents carry on economic activities. And if market fails for some reason, the state must step in. In fact, state should make efforts to provide an environment which can prevent market failure. The state must lay down the manner of conduct of economic agents so that the activities of the agents create synergy and markets do not fail. If the agents do not on their own volition adhere to such prescribed manners and try to distort market forces to their advantage, the state must have mechanism to prevent such recalcitrant agents from doing so and penalize them adequately so that no agent dares to do so in future. What it means is that the economic agents, for fear of punishment from market or authorities or lure of strengthening their position in market, follow a certain code of conduct, which ensures not only their advancement, but also the advancement of the economy as a whole. Each economic agent –

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individual or corporate – adheres to certain standards, ethical or regulatory, while pursuing its objectives. If it follows the standards, while it attains its own objectives, others are benefited simultaneously. Since the corporates are the major economic agents and their activities determine the level of output and growth in the economy, it is necessary that while they have freedom to act in the manner dictated by the market, they must conduct themselves in a manner that it produces synergy for all others agents in the economy. Corporate governance is nothing but such conduct on the part corporates and if corporates follow such conduct, it inevitably leads to better economic performance. If they do not do on their own, state intervention is warranted. Hence economic performance depends crucially on the conduct of economic agents, particularly the corporate sector, and it is supplemented by government intervention when the corporate deviate from standards of corporate governance. And the need for corporate governance standards and mechanism to enforce them is more acute in a liberalized economy when the economic agents have a tendency to be guided by market forces only.

The growing discomfort with closed, inward looking, market unfriendly and relationship based institutions and practices has impelled some governments to bring about the succedaneum to state interference in markets with private incentives, public ownership with private ownership, and protection of domestic industries from competition of foreign producers and investors. Government engagement in economic activity has been scaled down. Domestic markets have been opened to international participation and cross border flows. Tax codes have been rewritten. The price determination and the allocation of resources are propelled more by the market forces rather than state policies. Wherever such reforms have been ardently perused and the economic agents have conducted in a befitting manner, growth has assumed multiplier effect. When the economic activities are increasingly being carried out by corporates, the economic performance is jeopardized if the corporates do not adhere to corporate governance standards. To me, it is the level of corporate governance which can make an economy developed, developing, emerging or transitional.

Securities Market and Economic Growth

At this stage it may be fair to bring in securities market to discussion. It is the securities market which reflects the level of corporate governance of different companies and accordingly allocates resources to best governed companies. If the securities market is efficient, it can penalize the badly governed companies and reward the better governed companies. Hence not only the corporate governance standards need to improve, but also efficiency and efficacy of securities market need to improve so that the resources are directed to the deserving companies which can really boost economic performance. The securities market can not make best allocation of resources if the standards of corporate governance are not followed in letter and spirit.

I strongly believe that a well functioning securities market is conducive to sustained economic growth. A number of studies, starting from World Bank and IMF to various scholars, have pronounced robust relationship not only one way, but also the both ways, between the development in the securities market and the economic growth. This happens, as market gets disciplined / developed/ efficient, it avoids the allocation of scarce savings to low yielding enterprises and forces the enterprises to focus on their performance which is being continuously evaluated through share prices in the market and which faces the threat

of takeover. Thus securities market converts a given stock of investible resources to a larger flow of goods and services.

It is reasonable to expect savings and capital accumulation and formation to respond favorably to developments in securities market. The provision of even simple securities decouples individual acts of saving from those of investment over both time and space and thus allows savings to occur without the need for a concomitant act of investment. If economic units rely entirely on self-finance, investment is constrained in two ways: by the ability and willingness of any unit to save, and by its ability and willingness to invest. The unequal distribution of entrepreneurial talents and risk taking proclivities in any economy means that at one extreme there are some whose investment plans may be frustrated for want of enough savings, while at the other end, there are those who do not need to consume all their incomes but who are too inert to save or too cautious to invest the surplus productively. For the economy as a whole, productive investment may thus fall short of its potential level. In these circumstances, the securities market provides a bridge between ultimate savers and ultimate investors and creates the opportunity to put the savings of the cautious at the disposal of the enterprising, thus promising to raise the total level of investment and hence of growth. The indivisibility or lumpiness of many potentially profitable but large investments reinforces this argument. These are commonly beyond the financing capacity of any single economic unit but may be supported if the investor can gather and combine the savings of many. Moreover, the availability of yield bearing securities makes present consumption more expensive relative to future consumption and, therefore, people might be induced to consume less today. The composition of savings may also change with fewer saving being held in the form of idle money or unproductive durable assets, simply because more divisible and liquid assets are available.

The securities market facilitates the internationalization of an economy by linking it with the rest of the world. This linkage assists through the inflow of capital in the form of portfolio investment. Moreover, a strong domestic stock market performance forms the basis for well performing domestic corporate to raise capital in the international market. This implies that the domestic economy is opened up to international competitive pressures, which help to raise efficiency. It is also very likely that existence of a domestic securities market will deter capital outflow by providing attractive investment opportunities within domestic economy.

Any financial development that causes investment alternatives to be compared with one another produces allocational improvement over a system of segregated investment opportunities. The benefits of improved investment allocation is such that Mc Kinnon defines economic development as reduction of the great dispersion in social rate of return to existing and new investments under domestic entrepreneurial control. Instead of emphasizing scarcity of capital, he focuses on the extra-ordinary distortions commonly found in the domestic securities markets of the developing countries. The distortions in the real sectors such as monopoly power, tariff protection, import quotas, credit rationing and so forth add salt to injury. In the face of great discrepancies in rate of return, the accumulation of capital does not contribute much to development. A developed securities market successfully monitors the efficiency with which the existing capital stock is deployed and thereby significantly increases the average return.

Globalisation and Corporate Governance

The development of information technology and financial innovations transformed the international financial architecture in the nineties. Capital moved freely and we saw the emergence of transnational corporations which have presence in all parts of the globe. The world economy was globalized and nations were trying to seek a pie of new economy by entering into alliances, agreements etc.

Globalisation represents the movement of the four elements of the economy across the national borders and thanks to the information technology this can happen very fast. The first element is physical capital in terms of plant and machinery. The second one is financial capital in terms of money invested in the emerging capital markets and in the form of foreign direct investment. The third is the technology and the fourth is labour.

Since, the emerging economies had abundant natural and human resources and had requisite technical infrastructure, the MNCS targeted emerging economies as potential markets. The opening of economies and advent of MNCs helped the emerging and transition economies in two ways. The investment made by these companies provided the much needed resource for development and these companies imparted global standards in the emerging economies. Thus, these countries are getting slowly and gradually integrated into the global economic system and adopting the global practices of an efficient and efficacious governance system.

However, such countries were opaque, closed or inward oriented with market unfriendly systems. When financial capital moves across national borders, it become necessary for the investors to ensure that the enterprises or the markets in which they are investing are not only managed competently that means they have good corporate management but also they are governed properly. The collapse of the South East Asian tiger economies like Thailand, South Korea, Malaysia, Indonesia in 1998 brought home the fact that if there is no proper corporate governance in the financial sector, it leads to crony capitalism and corruption. It was observed that Corporate governance was not even getting lip service in these economies.

The success of the transnational corporations made it imperative that sound national systems of corporate governance are essential for all countries, including the poorest, to reap the benefits of globalisation. Virtually all developing, transition and emerging market economies now face one of the greatest challenges, that is, how to move successfully from institutions of economic and political governance that tend to be heavily relationship-based to institutions that are more effectively rules-based. They take the challenge head on as they realize that the standards of corporate governance brought in by globalization bring enormous benefits to them in the form of:

- enhancing the wealth creation
- ensuring the efficacious management of wealth, and
- equitable sharing of wealth amongst all stakeholders

These objectives facilitate and stimulate the performance of corporations — the principal generators of economic wealth and growth in society — by creating and maintaining a business environment that motivates managers and entrepreneurs to maximize firms'

operational efficiency, returns on investment and long–term productivity growth, which inevitably contributes to economic growth.

Corporate Governance and Discipline

Not only a higher standard of corporate governance contributes to economic advancement, the failure to maintain standards brings in major shocks to the economy. Recent corporate scandals, such as Enron and World.com have rocked the global financial markets and shaken the confidence of investors. The authorities and the regulators all over the World are burning midnight's oil to prevent recurrence of such scandals. Though efforts are being made to instill good governance practices and rebuild confidence, it is easier said than done. What is needed a stitch in time saves nine. This is possible, only if the corporate management is disciplined. If they are not so on their own, they need to be coerced by the state.

The systems should be in place to avoid corporate misconduct and ensure discipline. What instill discipline are the corporate governance institutions comprising both formal and informal rules (the latter notably include a country's generally accepted business practices and ethical standards, though these are normally unwritten) that are established among private actors as well as by the state or other public authorities. Some of the key institutions and actors are corporate law, securities laws, securities regulations, listing requirements, judicial system, professional associations, business associations, financial accounting standards, stock tendering requirements, proscription of self-dealing, public disclosure, auditing standards, etc.

These institutions and actors impose three kinds of disciplines on the corporates:

- **Self Discipline**
- **Market Discipline**
- **Regulatory Discipline**

Good corporate governance requires all three disciplines to ensure required the checks and balances.

The first and foremost persons responsible for the quality of a company are its management and controlling shareholders. They set the standards of ethics and performance that the company is judged by. They must exercise **self-discipline**. This works when the controlling shareholders or management are highly ethical and treat minority shareholders fairly. The system breaks down when the internal checks and balances, such as independent board committees, internal and external audits, and the transparency of disclosure do not function well.

Where self discipline alone does not work, **market** enforces **discipline** on the management. The fear of losing in the market place forces management to behave responsibly. Companies, when protected from competition, may develop cartels or monopolistic tendencies that do not treat consumers or investors fairly. This may be a deterrent for development of securities markets

When self and market discipline fails to regulate the conduct of corporate in the best interest of all the stakeholders, we need **regulatory discipline**. Regulators set the rules of the game

in consultation with the private sector, and enforce these agreed rules, fairly and transparently. They must also protect investors through greater public education and disclosure rules. When cheating or fraud occurs, there must be the discipline to take necessary enforcement action.

Governance and Value Creation Ratings

I believe that while a lot has been done in the filed of corporate governance, we need to advance it to the centre-stage of corporate operations. Otherwise, it would remain as an ineffective side agenda, which will get a lot of lip-service but would never be used as the important tool in improving corporate behavior. In order to bring it to centre stage, we must have an unambiguous yardstick which can be used to measure and monitor the progress on the path of corporate governance.

Indian market has developed a yardstick in the form of 'Governance and Value Creation Rating (GVC)' architectured by CRISIL, a leading credit rating agency in India and one of the four largest agencies in the world. This is significantly different from the 'Traditional Corporate Governance Rating (TCG)', which is available in several regulatory jurisdictions. The GVC approach stems from the belief that good governance, over and beyond its process aspects, is fundamentally a sustainability issue - good governance should result in the creation and fair distribution of tangible benefits. It is based on the following premises:

- → The strength of stakeholder relationships can add to/impede future wealth creation by the corporation
- → Governance processes must be such that wealth created is evenly distributed across all classes of stakeholders.
- → Management quality must be such that it is able to adapt the above two to match the dynamics of the business environment
- → All these impact stability of future wealth creation

While the corporate governance is expected to enhance the interests and fulfill the aspirations of all stakeholders, it does not necessarily happen always. While the ultimate purpose of all corporations is to create wealth for its shareholders, it is important to recognize that shareholders are indeed the residual stakeholders. The obligations towards the contractual stakeholders such as customers, employees, vendors, creditors and the society get precedence over the interests of the shareholders. The contribution of other stakeholders to the success of the corporation is not less important than that of the shareholders. Unless the company blends a harmonious relationship among all the stakeholders, it may jeopardise its ability to create wealth on a sustained basis. The GVC rating seeks to capture this sentiment.

- The assessment evaluates how governance processes are conducive to these factors and the true spirits at work.

- **Wealth Creation:** This is assessed in detail for each kind of the stakeholder. The finances of the company are assessed with a view to understanding the level of wealth creation (inputs minus outputs), particularly with reference to macro-

economic environment and micro industry environment and if the wealth has been created in a manner beneficial to all stakeholders. A methodology similar to Economic Value Addition (EVA) is used for this.

- **Wealth Management:** This is assessed across the stakeholders. The wealth generated from management of inputs and the functioning of the organisation has to be managed well. The wealth must at all times remain on multiplier matrix so that it grows optimally. Even if the wealth is being utilised for purposes other than the core businesses and activities of the company, it should be for the ultimate good of all the stakeholders in the medium and long term.

- **Wealth Sharing:** Similarly, GVC assesses if the wealth is being shared proportionately i.e. those who are entitled for contractual sharing get their dues and in time. Further, residual is shared amongst various classes of shareholders proportionately and equitably. There is no disproportionate sharing in particular through instruments like ESOP, Sweat Equity disproportionate compensation etc.

Conclusion

I strongly believe that an efficient securities market and a high standard of corporate governance can do wonders to developing, emerging and transition economies. As a regulator, SEBI is trying to ensure both in India so that Indian economy can rub shoulders with the most developed countries. With this aim, we have successfully reformed corporate governance practices and securities market in the last decade so much so that we are models in these respects for many, including the developed markets. Our endeavour has paid well in the sense that no major scandal involving corporate governance has taken place in India so far. It did not contract any contagion effect of the overseas corporate governance scandals, even though the Indian economy is substantially integrated with the global order, a number of transnational corporations operate in India and quite a few large Indian firms are listed on various overseas stock exchanges.

Raising the quality of corporate governance is a challenge that involves all the market participants – issuers, directors, regulators, policy-makers, auditors, advisors, educators and investors. We all have to work together to make this work.

Good corporate governance is not just a matter of pre-scribing particular corporate structures and complying with a number of hard and fast rules. There is a need for broad principles. All concerned should then apply these flexibly and with common sense to the varying circumstances of individual companies. Ethical behavior isn't an output of codes of ethics or codes of conduct, it's a human activity shaped on a daily basis by the existing organizational social framework. It is absolutely imperative that a corporate governance ethic emerges and envelops all market participants: issuers, auditors, rating agencies, directors, underwriters, and exchanges. Its foundation must be an unwavering commitment to integrity. Its cornerstone – an undying commitment to serve the investor.

The corporates have to adhere to the Triumvirate of Indian values:

- **SATYAM** (Truth), which is the ethical component of business
- **SHIVAM** (Welfare), which should be the economic objective of business
- **SUNDARAM** (Beauty), which should be aesthetical outlook for business)

  (Aesthetics does not imply physical beauty but purity of ideas, morality in behavior)

I have tried to examine the reasons why corporate governance has become a significant issue in recent times and the different types of corporate governance and the relationship between corporate governance and development . In the ultimate analysis we examine how to translate the concept of corporate governance into reality or turn rhetoric into reality, we find the most important aspect is the commitment of the management to observe the highest values.

GCGF has to play a crucial and important role in ensuring that governments and corporates follow ethical governance practices . This is necessary for the development of this planet. We have all gathered here to find out ways to ensure good governance. Ultimately there is no alternative but to put our heads together and learn to practice the lessons of one of the ancient and sacred texts of India : the Taitreya Upanishad.

Sahanavavathu sahanau bhunaktu saha viryam kara va vahai Tejasvinam aditamastu ma vid visha vahai om shanti shanti shantihi

Let us come together, let us enjoy together, let our strengths come together, let us move from darkness to light, let us avoid the poison of misunderstanding or hatred, that way lies progress.