NSE - ECGI Roundtable on

Long-term impact of institutional ownership on governance and sustainable investment

13 November 2017

The National Stock Exchange of India, Mumbai

The NSE - ECGI Roundtable on ‘Long-term impact of institutional ownership on governance and sustainable investment’ took place on 13 November 2017 at the National Stock Exchange of India in collaboration with the European Corporate Governance Institute (ECGI). The event focused on the role of foreign institutional investors and proxy advisory firms in promoting corporate governance and sustainable investment.

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Discussions were structured around a presentation and two panel discussions.

Indian capital markets are increasingly becoming one of the most favoured investment destinations for leading international institutional investors. At the firm level, improvement in corporate governance, greater accountability and adoption of IFRS, and at the political level, a commitment to generate sustainable economic growth are just some of the factors that have contributed to rising international capital flows into Indian markets, which have been among the best performing in 2017. But, are these foreign institutional investors committed to long-term sustainable growth in India? Or, are they likely to withdraw their investment when the going gets tough? This roundtable considered the academic evidence in other markets and debated the policy implications of such evidence for Indian capital markets, companies and long-term economic growth. It also debated whether proxy advisory firms have made a dent on corporate governance in India and how far can these firms be relied upon in the future to preserve high governance standards.

Welcome

Vikram Limaye, NSE and Guy Jubb, ECGI

Mr. Vikram Limaye, the Managing Director and CEO of the NSE, welcomed the Roundtable participants to the NSE and emphasized the benefits of academics and practitioners coming together to share their views on corporate governance and related issues. He expressed his thanks to the ECGI for their collaborative support. He stressed the importance of foreign institutional investment in India and drew attention to the improvements which have been made to corporate governance in recent years, noting that the recent recommendations of the Kotak committee are likely to further strengthen corporate governance in India.

Mr. Guy Jubb, a non-executive director of the ECGI, thanked Mr. Limaye for his welcome and kind comments. He reciprocated the thanks conveyed by Mr. Limaye and commended Mr. Nirmal Mohanty, Chief Economist of NSE for following through on his discussions with the Chairman of the ECGI that took place in Switzerland in April, ahead of the ECGI AGM, which were the seeds of the Roundtable.

Institutional investors & corporate governance: international evidence

Professor Pedro Matos

The presentation slides of Professor Matos can be found on the ECGI website.

Professor Matos drew attention to the fact that India has a much lower level of institutional share-ownership than most other major economies. He cited 19% institutional share ownership[1] for 100 largest listed firms in India, which compares to 73% in the US and around 66% in the UK. He described the dynamics of institutional ownership structures, noting that they become more dispersed as emerging markets, such as India, grow.

Focusing on his research, Professor Matos pointed out that overseas investors can be more independent in their views on sensitive corporate governance issues than their local counterparts, who tend to be less willing to recognize such issues and step up to the plate.

He pointed out that higher level of foreign institutional share-ownership tends to push up the value of companies. He said that his research demonstrated that it also increased the likelihood of cross-border merger and acquisition activity, notwithstanding local resistance.

Professor Matos went on to explain how institutional investors are exporting corporate governance practices from developed markets. In support of his views, he drew attention to the very significant increase in executive compensation when there is more dispersed share ownership involving foreign institutional investors. He went on to address whether increased foreign institutional investor ownership is inhibiting long-term investing by investee companies. He said that his research demonstrated that foreign institutional investor ownership is positively associated with higher long-term investment, employment and innovation output (as measured by the number of patents).

[1] Source: OECD http://www.oecd.org/corporate/OECD-Equity-Markets-Review-Asia-2017.pdf

Professor Matos then addressed the specific status of India in respect of foreign institutional share-ownership and pinpointed their concerns, particularly about audit committee composition, audit reports and poor board attendance. Furthermore, he emphasized that it is likely that executive pay levels in India will rise to converge to international levels as foreign institutional investment in India increases. Also, commenting on relatively low levels of R&D expenditure by Asian companies relative to their Western counterparts, he suggested that this could change shortly in line with increased levels of foreign institutional share-ownership.

In closing, Professor Matos encouraged strongly the use of academic, scientific-based research to inform policy making.

Higher level of foreign institutional share-ownership tends to push up the value of companies

Panel 1: Is greater for institutional ownership of Indian companies consistent with sustainable long-term investment and improved governance discipline?

Chatham House Rules were applied to the discussions which are anonymised.

It was noted that India has a unique profile in respect of share-ownership. Promoters hold about 48% of listed shares. In addition, a further 5% of listed companies' shares are owned by the Life Insurance Corporation of India, which is government owned. Also, it was pointed out that many independent asset managers are part of large conglomerates, which can impact their independence. Also, historically there has been high level of abstentions in voting. However, the situation has improved in the recent years. The requirement of mutual funds disclosing their voting records has had the desired impact of significant reduction in the level of abstentions. In the near term, other institutional investors will be subject to similar regulations.

Commenting on the presentation by Professor Matos, the panel made the following observations:

- Are companies willing to engage with investors who have an increasingly short-term focus?
- Will improvements to corporate governance arising from the improved discipline from increased foreign institutional investor ownership be sustained when that ownership goes into reverse? It was felt that there would be a tendency for the companies to go back to their old ways.
- Foreign investors tend to prefer buying shares in large companies, many of which already have good corporate governance by international standards.
- Since 1992, Indian regulations relating to foreign institutional ownership have been progressively relaxed. The definitions used for different categories of foreign institutional investors are now more liberal than before. From a regulatory point of view, it is recognized that many foreign institutional investors have a relatively short term holding period but when they sell one Indian stock they often buy another Indian stock and, therefore, on the macro level there has been no significant leakage of foreign institutional investment capital, if at all.
- Many of India's larger companies already have listings overseas, notably in London and New York. This has been a good motivator for improving and maintaining high corporate governance standards.

- Foreign institutional investors regard good standards of corporate governance as a prerequisite for investment in Indian companies.
- The introduction of International Financial Reporting Standards in India has made investment in Indian companies more attractive for foreign institutional investors.
- The awareness of corporate governance has improved significantly since 1992, when foreign institutional investors were allowed to invest in India.
- Engagement by domestic Indian investors with companies is now much easier to undertake than in previous years, with the notable exception of engagement relating to executive pay, which is still a delicate and sensitive subject. Even the foreign institutional investors feel challenged to engage effectively in the area of executive pay, especially in terms of quantum.
- Many Indian companies are family run and there is little scope for institutional investors, foreign or domestic, to exercise effective influence over corporate governance practices and principles.
- Foreign institutional investors want to give Indian companies the support they need to govern and direct their companies successfully. They do not invest with the intention of agitating for a change.
- Foreign institutional investors can sometimes be challenged by the local custom and practice of Indian companies. An example was cited of a company which had several directors aged over 75 and one aged well into his 90's.
- The role of media in influencing corporate governance change should not be underestimated. Media comments can have a significant bearing – positive and negative – on reputations, personal and corporate.




There was considerable discussion about corporate governance engagement processes in India, keeping in mind that there will likely be an All-India Stewardship Code in the foreseeable future. A company director participating in the panel was supportive of chairman and senior independent directors meeting directly with their company's major institutional investors – foreign or domestic - to discuss corporate governance but stressed that it would be advisable for the executive directors to be involved as well. The benefits of getting the feedback directly, rather than through the executives or intermediaries was highlighted. The institutional investors on the panel expressed strong support for having an opportunity to speak to independent directors, especially chairmen and senior independent directors. An Indian institutional investor noted that hitherto it had very limited opportunities to speak to independent directors.

Questions were asked about how to increase investment in government controlled companies in India. It was suggested that investors need confidence that their corporate governance will improve. Whilst acknowledging the substance of the issue, a major Indian institutional investor drew attention to the fact that the investors are fearful of government intervention but it was noted that there has not been very much of such intervention in recent years, which has helped investor sentiments. An experienced company director suggested that if government owned companies focused on defining the purpose of the company, then better corporate governance would ensue.

A foreign investor participant enquired about the level of collaboration amongst domestic investors and also between domestic investors and foreign investors to collectively encourage corporate governance change. In response, it was noted by an Indian institutional investor that there is a reasonable degree of collaboration on key issues between domestic investors but there are perceived difficulties when it comes to domestic investors engaging with international investors.

An investor enquired about the engagement behaviour and appetite of behemoth institutional investors, observing that they are so large that they are, in effect, locked into owning shares in a company and have little or no scope to sell out. Professor Matos noted that in the US, antitrust authorities are starting to examine the influence of such shareholders, who tend to feature regularly as the largest shareholders in many companies, because of concerns about competition implications, especially in respect of any collusion.




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Panel 2: Outsourcing corporate governance – Are proxy advisors measuring up to expectations?

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It was noted that proxy advisors provide services that are valued by many institutional investors when voting for large, geographically diverse investment portfolios. However, it was also noted that there can be a tendency for such institutional investors to indulge in "lazy stewardship" by merely following the recommendations of proxy advisors without exercising due consideration as to their appropriateness for the company or portfolio concerned. Such an approach enables the institutional investors to claim that they have voted their shares when challenged by their clients or regulator: however, it is questionable whether they have voted with due care when taking this approach.

From the perspective of many company directors, there is often a feeling that the proxy advisers do not always understand the special circumstances pertaining to their company and that a "tick box" approach is taken. Also, it was noted that in the UK - where there can often be contentious voting issues relating to remuneration policies and outcomes - remuneration committees increasingly place significant importance on engaging with proxy advisers at an early stage regarding their proposed policies with a view to ensuring a supportive recommendation from the proxy advisory firm.

A representative of a leading Indian proxy advisory firm drew attention to the changing ownership patterns in India since 2010, noting that institutional ownership is now approximately 32%. He said that the introduction of e-voting and a requirement for voting disclosure by institutional investors has had a huge impact on institutional investor voting levels and decisions. In the past, most Indian institutional investors abstained from voting on all resolutions – now they abstain on only 11% of resolutions of Indian companies. He noted the new stewardship code for insurance companies will further improve institutional investor voting in India and will stimulate a further reduction in the level of abstentions.

The Chief Investment Officer of a large Indian investment manager said that engagement relating to corporate governance issues and voting increased hand-in-hand. He pointed out that this particularly related to resolutions on sensitive topics such as ESOPs and related party transactions. Referring to the recommendations of the proxy advisory firms that they used, he emphasised that his firm has its own views and that although they will often follow the proxy advisor's recommendations, this was not a given. Referring to the approaches used by global proxy advisors compared to those based in India, he stressed that Indian proxy advisors have a much better understanding of local customs and practice.

A corporate governance director of a major global investment manager explained how they apply a customised policy, which is used by the proxy advisory firm to analyse voting resolutions and to make recommendations in accordance with the customised policy, which takes into account the specific preferences of the investment manager. He emphasised that his firm does not "outsource" corporate governance to the proxy advisory firm and that when his firm has particularly large shareholdings they will undertake their own analysis of the voting resolutions and calibrate them with the recommendations of the proxy advisory firm. He expressed the view that, in general, the proxy advisory firms measure up to expectations.

An academic member of the panel questioned what are expected of proxy advisory firms. He asserted that the expectations of investors are not well defined and that more should be done to address these shortcomings. Also, he questioned whether the proxy advisers always provide independent advice, noting that it can be difficult for investors to be assured on this matter.

The introduction of e-voting and a requirement for voting disclosure by institutional investors have had a huge impact on institutional investor voting levels and decisions

A vote of thanks

In drawing the formal proceedings of the Roundtable to a close, Ms. Saloni Agarwal, an executive of the NSE, conveyed thanks to Professor Pedro Matos, the panel moderators, the panellists and all the Roundtable participants for their valuable contributions. Also, she expressed appreciation of the significant collaborative support given by the ECGI to the NSE, as well as the assistance of the Asian Corporate Governance Association in promoting awareness of the Roundtable.

Contact:

Elaine McPartlan
Head of Conferences, Membership & Administration
European Corporate Governance Institute (ECGI)
elaine.mcpartlan@ecgi.org
+32 2 550 2340
www.ecgi.global

Saloni Agarwal
Deputy Manager - Economic and Policy Research
National Stock Exchange of India Limited (NSE)
sagarwal@nse.co.in
+91 22 265 98163
www.nseindia.com

About the European Corporate Governance Institute (ECGI)

www.ecgi.global

The ECGI is an international scientific non-profit association which provides a forum for debate and dialogue focusing on major corporate governance issues and thereby promoting best practice. It is the home for all those with an interest in corporate governance offering membership categories for academics, practitioners, patrons and institutions.

Its primary role is to undertake, commission and disseminate research on corporate governance. Based upon impartial and objective research and the collective knowledge and wisdom of its members, it can advise on the formulation of corporate governance policy and development of best practice. In seeking to achieve the aim of improving corporate governance, ECGI acts as a focal point for academics working on corporate governance in Europe and elsewhere, encouraging the interaction between the different disciplines, such as economics, law, finance and management.

About the National Stock Exchange of India (NSE)

www.nseindia.com

National Stock Exchange of India (NSE) is the leading stock exchange in India and the fourth largest in the world by equity trading volume in 2015, according to World Federation of Exchanges (WFE). It began its operations in 1994 and was the first exchange in India to implement electronic or screen-based trading. NSE has a fully-integrated business model comprising exchange listings, trading services, clearing and settlement services, indices, market data feeds, technology solutions and financial education offerings. NSE also oversees compliance by trading and clearing members with the rules and regulations of the exchange. As a pioneer in technology, NSE ensures the reliability and performance of its systems through a culture of innovation and investment in technology. The scale and breadth of its products and services, sustained leadership position across multiple asset classes in India enable NSE to be highly reactive to changes in market demand and deliver innovation in both trading and non-trading businesses.


AANCHAL DHIR
TENISHA ELLIOTT










AMIT TANDON