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Policy Brief

Vol. I - Issue 2

Financial Sector Policy Series

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POLICY BRIEF

Role of Good Governance in a 5 Trillion Economy: 5 Years Post Kotak Committee

Role of Good Governance in a 5 trillion Economy: 5 Years Post Kotak Committee

September, 2022

1. Defining Corporate Governance

Environmental, social, and governance (ESG) parameters have been an important part of investor decision making. While environmental and social parameters are relatively new parameters, governance parameters have been in existence for a few decades now.

It was as early as 1991 when academia and civil society began discussing corporate governance. Its earliest definition was provided in the Cadbury Committee Report of 1991, set up jointly by the London Stock Exchange and Bank of England, in which corporate governance was defined as, "…the system by which companies are directed and controlled." The focus of the Cadbury Committee was mainly on the functions of the board of directors, and it laid out a 'Code of Conduct' for the boards to follow.

In India, the discussion on corporate governance had also moved beyond academia and discussions were abound on its impact on capital markets and on industry. Bearing this in mind, the Securities and Exchange Board of India (SEBI), in 1999, set up the first committee on corporate governance under the Chairmanship of Shri Kumar Mangalam Birla. In the wake of the Asian Financial Crisis, the nexus between corporate governance, company management, financial reporting, and engagement with all other stakeholders came to light. The Kumar Mangalam Birla Committee concluded that, "Strong corporate governance is thus indispensable to resilient and vibrant capital markets and is an important instrument of investor protection." This committee while recognising the efforts of SEBI and many proactive companies in ensuring good corporate governance, stated that India needed statutory codes rather than voluntary codes. This committee also laid out the basic tenets of corporate governance in India under the heads of "…accountability, transparency, and equality of treatment for all stakeholders."
In 2003, SEBI constituted another committee under the chairmanship of Shri N R Narayana Murthy of Infosys to delve deeper into the issues of corporate governance bearing in mind the changing dynamics of India's capital markets and industry. This committee provided a more general definition of corporate governance for the Indian context. The Committee states that corporate governance is "…about ethical conduct in business…is beyond the realm of law. It stems from the culture and mindset of management, and cannot be regulated by legislation alone…is a key element in improving economic efficiency of a firm." The Committee notes that good corporate

governance provides investor confidence, and also reduces risks. It is also crucial for attracting long term capital for a firm.

2. Global Developments

The pandemic highlighted new areas of attention in corporate governance across theglobe. The Organization for Economic Cooperation and Development (OECD) report on The Future of Corporate Governance in Capital Markets Following the Pandemic (2021)[1] highlights the need for corporate governance frameworks to take into account problems that may arise due to increased concentration of ownership, either in the form of institutional investor ownership from one country, or in the form of concentration of ownership in the hands of a few companies. While the report draws attention to other parameters, such as, creditor rights, digitization, audit quality, and insolvency and bankruptcy codes, in the current global paradigm, concentration of ownership presents fresh challenges to corporate governance.

In a closely integrated global financial world that is also heavily influenced by diplomatic considerations, concentration of ownership in the hands of few, be it domestic or global, can raise many concerns. The report states that concentration of ownership in any form draws attention to company group structures. "For example, private corporations and holding companies in several Asian economies hold more than 30% of the total equity capital in publicly listed companies[2]."

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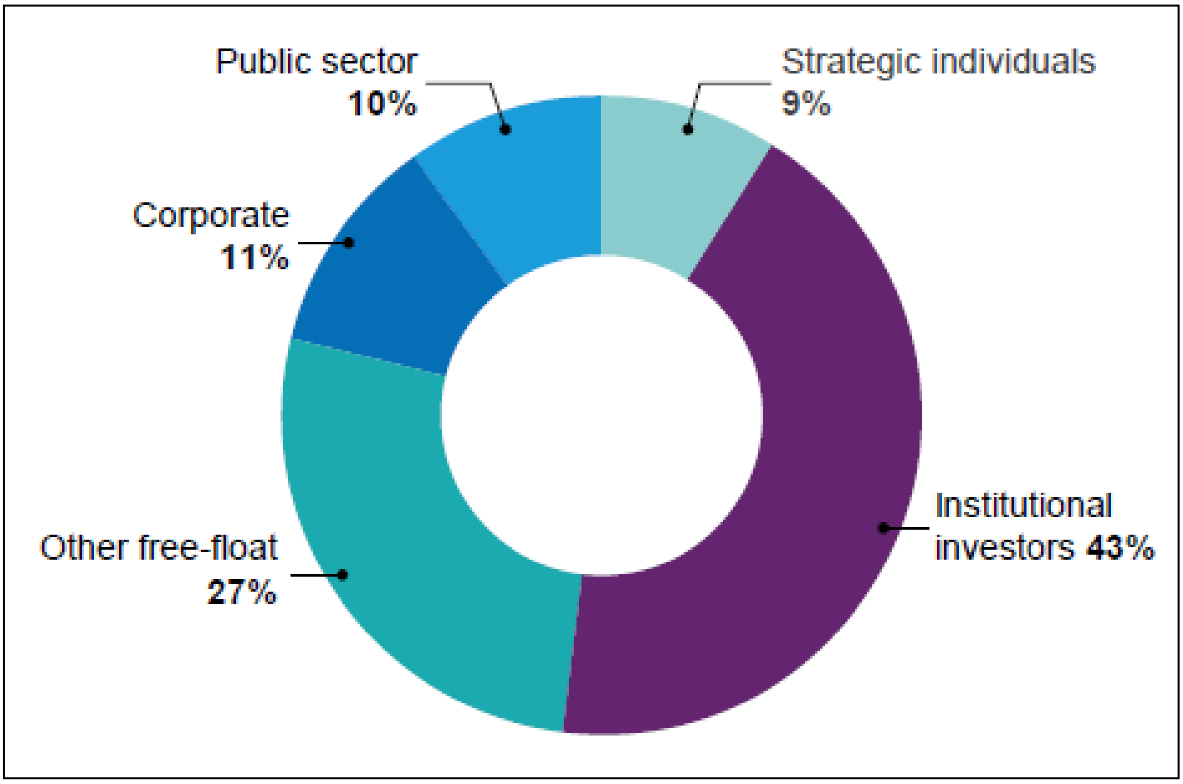
[1] https://www.oecd-ilibrary.org/sites/efb2013c-en/index.html?itemId=/content/publication/efb2013c-en
[2] Ibid

Figure 1: Investors' public equity holdings, as of end 2020



Source: OECD Corporate Governance Factbook (2021), https://www.oecd.org/corporate/OECD-Corporate-Governance-Factbook.pdf

Among the five different types of investor categories, the largest investor at 43 per cent are institutional investors (Figure 1). Another reason that has been identified for this concentration of ownership is on account of public sector holding. The report posits that nearly 10 per cent of global capitalization (USD 10.7 trillion) is owned by central governments and sovereign wealth funds[3].

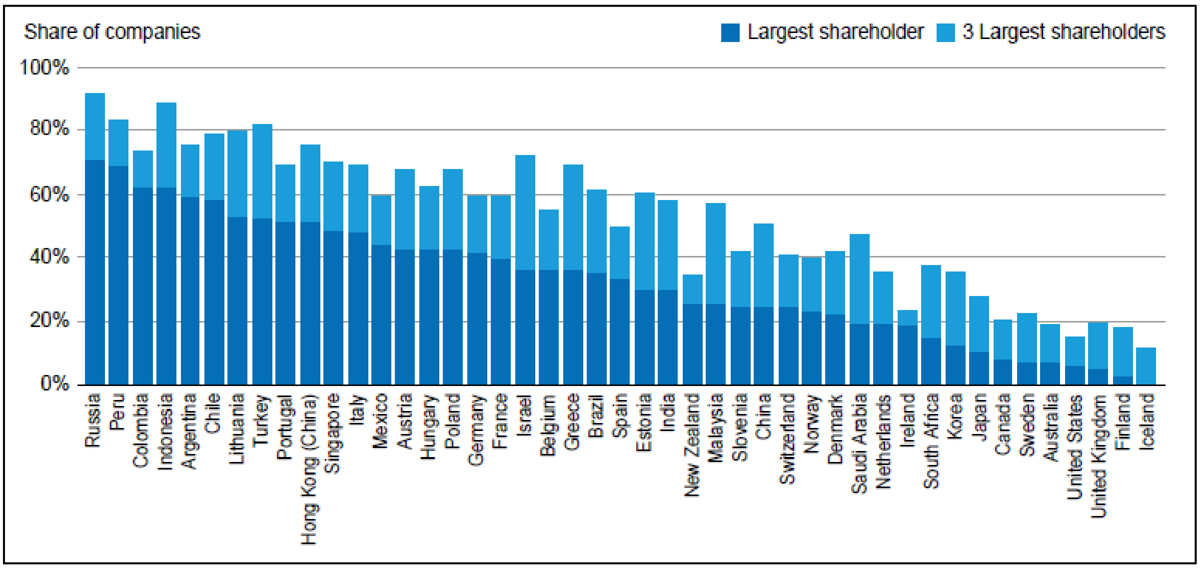
Figure 2 shows the domestic concentration of ownership across geographies. The least amount of ownership concentration are the countries at the tail of the graph, such as United States of America (USA), United Kingdom (UK), Japan, Canada, Iceland, to name a few. For countries such as Russia, Peru, Columbia, and Indonesia, the concentration of ownership is very high.

For India, these are extremely relevant observations on account of India-China relations, the emergence of large conglomerates, and large government owned businesses. In terms of domestic concentration of ownership, India lies somewhere in the middle (Figure 2). In India, in almost 60 per cent of the companies, 50 per cent or more of the

[3] OECD Corporate Governance Factbook (2021), https://www.oecd.org/corporate/OECD-Corporate-Governance-Factbook.pdf

ownership is concentrated in the hands of one or three large companies. This could be due to the presence of large conglomerates and their holding company structure and because of large public sector share. This is a fresh challenge for India that has so far not been considered.

Figure 2: Ownership Concentration by Market, as of end 2020



Source: OECD Corporate Governance Factbook (2021), https://www.oecd.org/corporate/OECD-Corporate-Governance-Factbook.pdf

3. Kotak Committee Report

The Kotak Committee Report submitted its findings in 2017 with the mandate to improve the corporate governance of listed companies in India. The Committee Report concluded that companies with better corporate governance practices earn almost a 10 – 40 per cent premium over those companies that do not. The Committee also surmisedthat value creation took place when companies paid attention to details on composition of their board, the level of expertise of the board members, the extent of independenceof some of the key committees, such as audit and remuneration, the quality of the audit and auditors, the nature, extent, and quality of disclosures being made, and the way shareholder interests (majority versus minority) are balanced. The Committee also interestingly points out when firm level good governance measures are adoptedvoluntarily, then the short comings of the legal and policy framework, a counter pointto the Kumara Mangalam Committee that stated that voluntary adoption of corporate governance practices was not enough and that statutory measures were necessary. The Kotak Committee Report made a series of recommendations from board composition and diversity, instituting independent directors, to board committees and their constitution, to name a few.

Vyshak et al (2021)[4] list many corporate governance failures that have occurred over the last two decades both internationally and within India. Even after the release of the seminal Kotak Committee Report, there continued to be corporate governance failures across sectors. They also broadly discuss some of the major recommendations that the committee made and have been incorporated by industry. These include the appointment of truly independent directors, including women directors on the board,the size of the board, the need for updated credit ratings, the formation of committees to deal with risk and information technology, and the separation of the roles of the Chairman and MD/CEO.

While one can acknowledge that the recommendations of the Kotak Committee Report are important and have put in place both in the form of laws and best practices a corporate governance framework at par with the world, one must consider why despite such a robust framework, there have been substantial levels of failures in corporate governance of large listed firms, that have not only had an impact on capital markets, but disastrous spill over impact on the economy.

4. Corporate Governance across India Inc.

India Inc. has a sizeable number of public sector enterprises, micro, small and medium enterprises (MSMEs), listed companies, and unlisted companies. Even while several committees have varying recommendations on whether corporate governance principles must be regulation based, rule based, or voluntary (and combinations thereof), in India, thus far, the regulation-based approach seems to have taken precedence.

While there is universal acceptance that corporate governance is a philosophy that needs to be espoused in spirit and in principle, so far, rules and regulations-based approach in India has led to better results (arguably) in corporate governance. This is not to say that there have been no failings. In recent times, the instances of IL&FS, Gitanjali Jewellers/Nirav Modi, and DHFL are all cases in point of corporate governance failures that have occurred despite all three of them being listed companies and being subject to 'robust' corporate governance regulations.

[4] Vyshak PK, Dr Jayarajan TK, and Vishnu PK (2021), "Moving towards Better Corporate Governance in India: An Analysis of the Uday Kotak Committee on Corporate Governance," International Journal of Trend in Scientific Research and Development (ijtsrd), ISSN: 2456-6470, Volume-5 | Issue-4, June 2021, pp.685-691, URL:www.ijtsrd.com/papers/ijtsrd42355.pdf

Furthermore, there has been many a discussion on the extent of corporate governance in public sector enterprises (PSEs). A constant criticism of PSEs, often highlighted at the time of any divestment discussion, has been on poor corporate governance performance, be it in terms of board composition, board independence, managing the interests of all stakeholders, or in terms of ensuring any value creation for the company. It can be easily argued that the failure to create any value for many PSEs, which has ultimately resulted in appalling valuations at the time of disinvestment has been on account of poor corporate governance.

For the banking sector, especially public sector banks (PSBs), the PJ Nayak Committee Report (2014)[5] laid down several recommendations to improve the quality of the boardof these banks, with the ultimate objective of improving their corporate governance. Many of these recommendations have also been implemented, some effectively and some on paper. The impact of the implemented recommendations is still debatable.

In a similar vein, corporate governance for non-banking financial companies (NBFCs), has not been discussed in as much detail as it probably should. In recent times, the failure of two large NBFCs have brought to fore the need for a more structured and regulation-based approach for corporate governance (RBI's master circular currently mandates predominantly internal board approved policies[6]).

Today's India is witnessing a new breed of companies that are demonstrating stupendous growth in a short span of time. With the growing number of startups generally, and unicorns, specifically, current corporate governance regulations and frameworks will have to be rethought to include these companies into the framework as well. Startup boards typically consist of promoter and non-promoter board members, but rarely independent directors. Ramasubramanian (2022)[7] opines that the probability of governance failures in startups are most likely to occur in the early stage, growth stage, and expansion stage, with the latter two exhibiting high chances. He further states that the desire for faster growth and high valuations often come at the cost of good governance.

5. What next for India Inc.

Three critical areas of debate present themselves. First, how effective have corporate governance laws and regulations been, and why have huge failures occurred despite

[5] https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/BCF090514FR.pdf
[6] https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9819#:~:text=All%20applicable%20NBFCs%20shall%20frame,for%20the%20information%20of%20various
[7] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4124917

having an arguably well thought through framework? Second, in the context of ESG principles, where good governance norms are expected of all firms, irrespective of size and ownership, will India Inc readily and voluntarily adopt a 'Code of Conduct?' Third, will it be enough for non-listed companies, MSMEs, and a new brand of behemoth startups and unicorns that are emerging?

It has been five years since the submission of the Kotak Committee Report. In this context, it is prudent to examine the impact that the Committee recommendations have had on India Inc. and whether the recommendations are still applicable to India Inc. today, given its changing composition and dynamics.

6. Recommendations

Level Playing Field for PSUs

At present, corporate governance norms in public sector units (PSUs) are mostly relaxed as most PSUs have their own legislations such as the State Bank of India (SBI) Act, the LIC Act among others. This has created an unlevel playing field between the private sector and PSUs. Although, listing of PSUs on exchanges (that is mandated by RBI) need adherence to SEBI's listing norms however, such standalone Acts let PSUs enjoy relaxed norms regarding board evaluation, passing related party transactions through board, board approval for paying dividends etc. In spirit of better competence, corporate governance of PSUs should be of the same standard as that of larger corporates. Hence, regulators, market participants and stock exchanges must push for level playing field in corporate governance among PSUs and the private sector.

Discourage Weaponising of Laws to Penalise Board Members on Failures of Organisation (Culpability vs Responsibility)

Finding quality human capital is always a challenge. Individuals aware of the subject of governance as well as familiar with the core business of a company are hesitant in joining the board as independent and non-executive directors of any organisation nowadays as they are liable to be prosecuted in case of a corporate fraud. There is a need for balancing culpability and responsibility to attract right talents for corporate governance on board of companies and policymakers should implicitly make it clear through circulars that board members would not be prosecuted in case of corporate frauds unless there is concrete evidence of involvement with such fraud.

Peer Reviewing

Each participant from a certain sector is ranked by its peers on certain parameters on governance based on publicly available information.

Shift of focus from shareholder to stakeholder

Empanelment of Auditors

Empanelment of auditors with regulator and assigning of independent auditor from the end of regulator. Moreover, officials from regulatory agencies inspecting and auditing businesses need to have streamlined process and manual, which is available to both sides i.e., the regulator and the business so as to improve efficiency.

Incentivising Companies for following Corporate Governance

Reduce compliance cost for companies with gold standards of corporate governance. Rate them on parameters of ESG, BRSR etc. Tie up short term monetary and non-monetary benefits with incentives.

Stewardship Code-Next Step towards Good Governance

Stewardship Code-Next Step towards Good Governance

November, 2022

Background

In recent times, adherence to stewardship code by institutional investors is being increasingly pushed by global financial market regulators around the world with the aim of countering unwanted decisions pushed in the board that are detrimental to investors' interest. The Stewardship Code, regarded as one of the critical aspects of the UN supported Principles for Responsible Investment (PRI) is an important aspect of good governance practices under global ESG norms. While United Kingdom (2009) and Japan (2014) are considered to be the pioneers of Stewardship Code, India is not too far behind in the game.

What is Stewardship Code?

Stewardship Codes are usually created for institutional investors and outline good practices for engagement with investee companies. This helps in furthering their long-term returns and in adhering to their governance responsibilities, ultimately resulting in enhancing the financial markets and increasing economic growth.[8] The PRI defines stewardship as "the use of influence by institutional investors to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend."[9] The PRI further suggests various methods through which Stewardship Code can be implemented such as engaging with current or potential investees or issuers across all asset classes, voting at shareholders meetings, filing of shareholder resolutions/proposals, direct roles on investees boards and boards committees, and wherever necessary through litigations. Engaging with policymakers and standard setters, research and public discourse, negotiation and monitoring of services providers in the investment value chain etc is another method. Moreover, evolving financial markets are increasingly aligning Stewardship Code with ESG norms and principles. In simple terms stewardship code is a set of regulatory guidelines that assist institutional investors to act in a responsible manner by being transparent, protecting, and enhancing the value of their clients.

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[8] NSE Market Pulse, June 2022, "Stewardship Code: Where does India stand:", Vol. 4, Issue 6, pg. 158
[9] https://www.unpri.org/stewardship/about-stewardship/6268.article#:~:text=The%20PRI%20defines%20stewardship%20as,and%20beneficiaries'%20interests%20depend.%E2%80%9D

Origin of stewardship code

The first stewardship code was introduced by the United Kingdom in the year 2009, Walker Review recommendation for Stewardship Code. In July 2010, the Financial Reporting Council (FRC) issued the UK Stewardship Code, and this code was further revised in September 2012. Further in November 2016, the FRC introduced tiering of UK Stewardship Code signatories, but in December 2018, the Kingman Review suggested that the stewardship code is "not effective in practice" which led to the formation of UK Stewardship Code 2020 by the FRC in October 2019. The code (UK Stewardship Code 2020) came into effect from January 1st, 2020. The code was published with the aim to enhance the relationship between the institutional investors and the companies which will in turn help to improve long-term returns.

The Japan Stewardship Code was first released by the Financial Services Agency (FSA) in February 2014, setting out the principles for institutional investors to fulfil their responsibilities for sustainable growth of investee companies and enhancing the medium to long-term investment return, for their clients and beneficiaries, through constructive engagement or purposeful dialogue. The Code was revised in 2017 to specify the role of asset owners, such as pension funds, and to encourage asset managersto strengthen their governance and management of conflicts of interest. The number of signatories to the Code has been increasing, and as of 13 March 2020, 280 institutional investors have signed up to the Code.[10]

Since its initial release, the Code has continued to adopt the following approach:

- Soft Law Approach – although the Code is not legally binding, the FSA encourages institutional investors to voluntarily adopt the principles of the Codeby disclosing a list of institutional investors who have become signatories.
- Principles-Based Approach – the Code adopts a principles-based approach (instead of a rules-based approach) so that the way in which the Code's principles are applied in practice, can differ depending on factors such as the investor's size and investment policies, as long as the purpose and spirit of these principles are followed.
- "Comply or Explain" Approach – the Code adopts a "comply or explain" approach under which an institutional investor can either disclose its intention to comply with a principle or provide sufficient explanation as to why it is not suitable to adopt such principle.

[10] https://www.dlapiper.com/en/hongkong/insights/publications/2020/04/revisions-to-japans-stewardship-code/

The Revision Code consists of eight principles and guidance for each. Key changes reflected in the Revision Code include the following:

- Focus on sustainability including ESG factors
- Application of the Code to asset classes other than listed shares
- Stewardship activities of asset owners such as corporate pension funds
- Principles applied to service providers for institutional investors

A Comparison between the UK Stewardship Code and Japan Stewardship Code

There are certain similarities between Japan's Stewardship Code and the UK Stewardship Code. For example, both the UK and Japan Codes explicitly require signatories to consider ESG issues to fulfil their stewardship responsibilities. They also encourage signatories to explain their rationale for some or all voting decisions, particularly where: (i) there was a vote against the board; (ii) there were votes against shareholder resolutions; (iii) a vote was withheld; or (iv) the vote was not in line with voting policy. The UK Code applies to asset classes other than UK stocks and asks investors to explain how they have exercised stewardship across asset classes, such as listed equity, fixed income, private equity, infrastructure investments, and investments outside the UK. The UK Code generally has an extended focus on asset owners, such as pension funds and insurance companies, and has a separate set of principles for service providers like investment consultants and proxy advisors.

On the other hand, there are also notable differences. Particularly, the UK Code takes an "apply and explain" approach with clear reporting expectations and a strong focus on the activities and outcomes of stewardship, not policy statements. Additionally, the UK Code explicitly requires the integration of climate change norms and identifying and responding to systemic risk, including climate change. The explicit reference to climate change is significant as ESG frameworks do not always address climate risk adequately. While Japan has positioned itself as a leader in implementing climate-related corporate disclosures, the Revision Code does not mention climate change.

The global crisis of 2008 threw up a need for a stewardship code, and engagement of the institutional investors was considered important to avoid such crises in the future. The code contains principles/standards for asset owners, asset managers, and service providers, and it is based on the concept of 'apply and explain'".[11] However, countries such as Australia, Malaysia, Hong Kong and Taiwan differ in obligations of the

[11] NSE Market Pulse, June 2022, "Stewardship Code: Where does India stand:", Vol. 4, Issue 6, pg. 158

Stewardship Code which is based on the concept of "voluntary but encouraged".[12] In 2018, the European Fund and Asset Management Association (EFAMA) integrated stewardship principles into a revised version of its Code of External Governance of 2011 to bring it in line with the revised EU Shareholder Rights Directive (SRD) and current terminology.[13]

Stewardship Code in India

The Insurance Regulatory Development Authority of India (IRDAI) was the first regulator to introduce Stewardship Code for insurance sector to adopt the stewardship code on exception basis i.e., comply-and-explain in March 2017. As per the code, insurer should have a board approved stewardship policy which should identify and define the stewardship responsibilities that the insurer wishes to undertake and how the policy intends to fulfil the responsibilities to enhance the wealth of its policyholders who are ultimate beneficiaries. The IRDAI revised the guidelines on Stewardship Code based on the experience in implementation, compliance by the insurers and the feedbacks in February 2020 suggesting insurers should have mechanisms for regular monitoring of their investee companies in respect of their performance, leadership effectiveness, succession planning, corporate governance, reporting and other parameters that are considered important. The IRDAI guidelines for Stewardship Code includes the following principles to be followed by the institutional investors.

Table 1: IRDAI guidelines on Stewardship Code for insurers in India

Principle 1	Policy on the discharge of Stewardship Responsibilities and its Public Disclosure
Principle 2	Policy on management of conflicts of interest
Principle 3	Monitoring of investee companies
Principle 4	Policy on intervention in Investee companies
Principle 5	Collaboration with other institutional investors to preserve the interest of Policy holders (ultimate investors)
Principle 6	Policy on voting and disclosure of voting activity
Principle 7	Periodical Report on Stewardship activities

Source: IRDAI Guidelines on Stewardship Code for Insurers in India.

The Report of the Committee on Corporate Governance (SEBI, 2017) emphasised on the need for shouldering greater responsibility by institutional investors in capital market through enhanced monitoring of and engaging with their investee companies which would ultimately benefit their clients, beneficiaries as well as retail investors in these

[12]https://www.asifma.org/uploadedFiles/Events/2016/Annual_Conference/1045-1130%20Panel%203%20Stewardship%20and%20Responsible%20Investment.pdf
[13] https://www.ipe.com/efama-adopts-stewardship-code-to-align-with-eu-laws/10024971.article

companies.[14] The need for a common policy was further discussed at length at the 21st meeting of the Financial Stability and Development Council (FSDC) held under the Chairmanship of the then Governor of the Reserve Bank of India (RBI) Dr Urjit Patel. The meeting was attended by the Chairmen of IRDAI, SEBI, PFRDA along with other office bearers.[15]

The Pension Fund Regulatory and Development Authority (PFRDA) issued its guidelines on Stewardship Code for all pension funds under the New Pensions Scheme (NPS) architecture in May 2018. The Securities Exchange Board of India (SEBI) prescribed the Stewardship Code for Asset Management Companies (AMCs) and all categories of investments of Alternative Investment Funds (AIFs) in relation to their investment in listed equities in December 2019, which finally became applicable in July 2020. Further, in April 2021, SEBI asked other institutional investors such as banks, insurance companies, and pension funds to follow the "transparent" Stewardship Code which will act as a counter force to unwanted decisions being pushed in the board that are detrimental to investors' interest.[16] SEBI has also mandated mutual funds to cast votes compulsorily in respect of company resolutions on some specified matters. The PFRDA and SEBI guidelines on Stewardship Code principles are similar where the institutional investors are to undertake the following activities.

Table 2: PFRDA and SEBI Guidelines on Stewardship Code in India

Principle 1	Formulate a comprehensive policy on the discharge of their stewardship responsibilities, publicly disclose it, review, and update it periodically
Principle 2	Have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it
Principle 3	Should monitor their investee companies
Principle 4	Should have a clear policy on intervention in their investee companies. Institutional investors should also have a clear policy for collaboration with other institutional investors where required, to preserve the interests of the ultimate investors, which should be disclosed
Principle 5	Should have a clear policy on voting and disclosure of voting activity
Principle 6	Should report periodically on their stewardship activities

Source: SEBI, PFRDA Stewardship Guidelines

The National Stock Exchange (NSE) of India did a comparative analysis of the different shareholders and their evolution between March 2008 and March 2022. It was found that

[14] SEBI, (2017), Report of the Committee on Corporate Governance
[15] https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=44208
[16] https://economictimes.indiatimes.com/markets/stocks/news/sebi-asks-institutional-investors-to-follow-transparent-stewardship-code/articleshow/81930149.cms

the previous trend of institutional shareholders being passive and voting along with the controlling shareholders and management has changed over time. Under the current system, institutional shareholders have larger independence which can be gauged from Table 3, which indicates that there has been a decrease in the share owned by controlling shareholders (promoters) in the NSE listed companies from 56.6% in March 2008 to 50.7% in March 2022, while that of institutional shareholders has jumped from 27.1% to 32.9%.[17]

Table 3: Evolution of shareholding pattern in NSE listed companies

Shareholder-Type	Mar-08	Mar-22
Promoters	**56.6%**	**50.7%**
Domestic Mutual Funds	3.8%	7.7%
Banks, Financial Institutions, Insurance and Other Institutions	5.8%	6.0%
Foreign Institutional Investors	17.5%	19.2%
Total Institutional Shareholders	**27.1%**	**32.9%**
Corporate Bodies	4.3%	3.6%
Individuals	9.1%	9.7%
Others	2.9%	3.1%
Total Non-institutional Shareholders	**16.3%**	**16.3%**

Source: CMIE Prowess, NSE EPR.

Recommendations

Our discussion revolved around the current adoption and implementation of stewardship code as a part of corporate governance among India Inc. The discussion further saw suggestions on better implementation, enhanced supervision and assessing the impact of stewardship code among organisations in India. Some of the recommendations from the discussion are as follows.

- Policymakers should publish a detailed annual or bi-annual impact assessment report on the actual impact of stewardship code in increasing corporate governance among corporates. This would in turn increase public awareness and encourage smaller companies including MSMEs to adopt stewardship code in their corporate code of conduct.

- Policymakers should encourage more analytics firms to take up the role of proxy advisors. This would be a good capacity building exercise for creating a robust corporate governance ecosystem in India. At the same time, policymakers should discourage corporates from shopping for credit rating.

[17] NSE Market Pulse, June 2022, “Stewardship Code: Where does India stand:”, Vol. 4, Issue 6, pg. 158

- Policymakers should educate and encourage all institutional investors on "responsible voting" such as considering ESG standards among others of a firm for improving corporate governance.

- Globally, proxy advisors while collecting information, frequently reach out to companies directly apart from gathering information and data which are available in the public domain. This enables them to acquire crucial inside information and helps in better understanding of company health and its adherence to corporate governance norms. However, this practice is not allowed in India as SEBI considers this akin to insider information which may be used for trading. SEBI may reconsider this decision to bring it at par with global standards.

- Government institutions such as Employee Provident Fund Organisation (EPFO) must be involved in stewardship code and must take part in voting mechanism during Annual General Meetings (AGMs) of investee companies.

- Listed Public Sector Companies (PSUs) must adopt stewardship code in their corporate governance norms. Additionally, the Reserve Bank of India (RBI) should reconsider allowing banks and other systemically important financial institutions for adopting stewardship code.

Towards Good Governance for NBFCs

Towards Good Governance for NBFCs

January, 2023

1. Background

In today's world, good corporate governance principles have become synonymous to running a successful business, more so when the core business is connected to the world of finance. Business failures due to lack of proper corporate governance dates back to as early as 15th Century Europe, the fall of the Medici Bank. Even in India, the fall of the Presidency Bank of Bombay in pre-independent India in mid 1860s to the very recent problems with Punjab and Maharashtra Cooperative (PMC) Bank, Yes Bank and Lakshmi Vilas Bank (LVB) can all be largely attributed to the lack of good corporate governance among these institutions. Even the collapse of the Infrastructure Leasing & Financial Services (IL&FS) and the Dewan Housing Finance Corporation Limited (DHFL), two of the largest non-banking financial institutions in India, in 2018 and 2019 respectively, were due to the failure of internal governance of these institutions, the effects of which are still somewhat visible in the domestic financial sector. The cascading effects of these institutions failing could have been more catastrophic had there not been timely intervention by the financial regulators and the Government machinery.

2. Importance of Corporate Governance in Financial Institutions

Globally, the urgency of adoption of corporate governance among larger financial institutions (FIs) has heightened post the global financial crisis (GFC)of 2007-08. A report by the United Nations Conference on Trade and Development (UNCTAD) published in 2010 has identified lack of board oversight in the areas of risk management and incentive structures among major American financial institutions as two critical factors contributing to GFC. Detailing these two factors further, the Report very specifically mentions that, "… Over exposure to liquidity risk, inadequate stress-testing scenario analysis, a failure on the part of large financial institutions to observe the intent of regulations to which they were subject, and the poor transmission of risk-related information up to board level are all identified as key weaknesses in the area of risk management. Incentive structures that failed to incorporate longer term, firm-wide performance measures and that made inadequate use of risk metrics are considered to have encouraged excessive risk taking by key decision-makers at large financial institutions…"[18] Further, to address the fundamental inadequacies in the banking sector across the globe that became apparent during GFC, the Basel Committee on Banking Supervision issued a set of principles for enhancing corporate governance practices in

[18] UNCTAD, 2010, "Corporate Governance in the Wake of the Financial Crisis", United Nations, New York and Geneva

banks in 2010, which were again revised in 2015. The areas broadly covered under these guidelines are role of the board of directors in overseeing the implementation of effective risk management systems, increased responsibilities on individuals and collective board members for better governance, better implementation of risk management criteria and risk culture within institutions, standard process for selection of board members and senior managements, and acknowledging the role of compensation and incentive systemin risk management and company risk culture.[19]

In 2011, the Financial Stability Board (FSB) started a "global" monitoring exercise to examine all nonbank credit intermediation institutions (or shadow banks), considering the fact that shadow banks in the United States of America (USA) played a major role in turning home mortgages into securities and further selling and buying of bundles of such securities, ultimately starting a "securitisation chain" leading up to a worldwide financial crisis.[20] Under this monitoring system, the FSB examines shadow banks in 20 major advanced and emerging market economies (the G20), (now covering 28 jurisdictions and the euro area) by their "function" or type of operation rather than by "entity". However, even though the FSB's move to examine activities (rather than institutions) comes closer to measuring risks, the measure still falls short of accurately gauging risks that shadow banking poses to the financial system. The FSB also does not measure the amount of debt used to purchase assets (often called leverage), the degree to which the system can amplify problems, or the channels through which problems move from one sector to another (although there has been some attempt to gauge these latter linkages using balance sheet data between nonbanks and banks).[21]

3. Shadow Banking in India

In India, shadow banking institutions have been in existence even before mainstream banks came into existence. Shadow banking institutions, better known as Non-Banking Financial Companies (NBFCs) in India, have been playing an active and important role in the development of a vibrant financial system by contributing significantly towards improving access to credit while driving financial inclusion across India. They complement mainstream banking operations in India and serve niche financial needs of the country. In fact, there are certain areas of finance where NBFCs have excelled over mainstream banks in India. This isn't surprising considering the sheer size and the range of business activities undertaken by the sector which has 9506 registered NBFCs as on October 2022 (Reserve Bank of India (RBI), Oct 2022)[22]. Apart from these, there are

[19] https://www.bis.org/bcbs/publ/d328.htm
[20] https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/Shadow-Banks
[21] IBID
[22] https://rbi.org.in/Scripts/BS_NBFCList.aspx

countless registered businesses operating as non-registered NBFCs. However, what works in favour of NBFCs is also a disadvantage when it comes to regulation and supervision of the sector. The RBI has classified NBFCs into 12 different categories based on their nature of activity (Appendix A). On 22nd October 2021, the RBI issued a notification on "Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs" (SBR Framework) where, it introduced four scale-based layers i.e., base layer, middle layer, upper layer and top layer for regulating NBFCs (Appendix B).[23]

3.1 Corporate Governance Standards set by RBI among NBFCs in India

Prior to 2011, implementation of corporate governance included constitution of risk management, audit and nomination committees, disclosures and transparency in putting a risk management system and risk management policy, conforming with corporate governance standards, and policy against loans and credits offered to directors and their family members, for deposit taking NBFCs (NBFC-D) with deposit above INR 20 crore and systemically important non-deposit taking NBFCs (NBFC-ND-SI), in India.

Additionally, publically listed NBFCs had to adhere to the corporate governance rules under Clause 49 Listing Agreement of the Securities and Exchange Board of India (SEBI).[24] However, following the recommendations made by the "Working Group on the Issues and Concerns in the NBFC Sector" formed under the Chairmanship of ex Deputy Governor of RBI, Smt. Usha Thorat in August 2011, multiple changes were madeto the corporate governance policy of NBFCs with asset over INR 1000 crores. Asubsequent RBI circular[25] clarified the need for prior written approval in case of takeover/merger/acquisition of deposit taking NBFC by another company or change in control of transfer of shareholding to the extent of 25 per cent or more of the paid up equity capital of the company, prior approval for appointment of CEO in such an NBFC, maximum number of directorship to be held by a serving director on the board, criteria for ascertaining of a fit and proper criteria for appointment of board and directors and annual submission of such certificate to RBI, additional disclosure such as Capital to Risk Asset Ratio, exposure (both direct and indirect) to the real estate, and the maturity pattern of assets and liabilities in financial statements of a NBFCs-ND-SI, and formation of a remuneration and compensation committee for deciding compensation payable to executives by such NBFCs. In addition, the RBI also suggested NBFCs with asset size less than INR 1000 crore to voluntarily adhere to such good corporate practices.[26]

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[23] https://www.mondaq.com/india/corporate-governance/1127680/rbi-notifies-scale-based-regulatory-framework-for-nbfcs
[24] Usha Thorat Committee Report, 2011, Reserve Bank of India
[25] https://rbidocs.rbi.org.in/rdocs/content/pdfs/CCORGO121212_A1.pdf
[26] Ibid

The Master Circular - "Non-Banking Financial Companies – Corporate Governance (Reserve Bank) Directions, 2015" published by the RBI has mandated all NBFCs-ND-SI with asset size of INR 500 crore and above and all NBFCs-D to follow the RBI approved corporate governance policy on constitution of committees of the board (audit, nomination, and risk management committees), put in place a policy for fit and proper criteria for approval of board of directors, improve disclosure and transparency through communication of a proper risk management system and risk management policy to the board, and disclosure of an annual financial statement of such NBFCs, rotation of partners of the statutory audit firms at least every three years, and frame and publish internal guidelines on corporate governance with the approval of the board.

3.2 Adoption of Corporate Governance among NBFCs

Despite such clear guidelines from RBI, implementation and adoption of corporate governance among NBFCs still remains a challenge. The downfall of IL&FS and DHFL, are clear examples of how failures in the corporate governance in these firms almost brought the Indian financial market to a grinding halt.

3.2.1 Case of IL&FS

In June 2018, IL&FS, an infrastructure project financing company, which had earlier funded projects such as the 9 kilometer Chenani-Nashri tunnel (India's longest road tunnel in South India), Delhi-Noida Toll Bridge, Ranchi-Patratu Dam Road, Baleshwar-Kharagpur Expressway, Tripura Power Project, and Gujarat International Finance Tech-City (GIFT), defaulted for the first time on repayment of commercial paper (short-term borrowing) and inter corporate deposit (unsecured borrowing) worth INR 450 crore leading to the resigning of its Non-Executive Chairman of 30 years, Mr. Ravi Parthasarathy. Even as new infrastructure projects dried up, IL&FS' running construction projects faced cost overruns amid delays in land acquisition and approvals. It defaulted on repayment of bank loans (including interest), term and short-term deposits and also failed to meet commercial paper redemption obligations. It reported that it had received notices for delays and defaults in servicing some of the inter-corporate deposits accepted by it. Following the defaults, rating agency ICRA downgraded the ratings of its short-term and long-term borrowing programmes. The defaults also jeopardised hundreds of investors, banks and mutual funds associated with IL&FS, and sparked panic among equity investors, even as several non-banking financial companies faced turmoil amid a default scare. Serious Fraud Investigation Office (SFIO) probed into this to find huge procedural lapses at the NBFC, leading to prosecution and arrest of several senior executives of the firm. The initial SFIO probe also revealed that there were major lapses in Deloitte's audit of the IL&FS. SFIO investigation found Deloitte guilty of painting a “rosy picture” of the company despite being aware of the poor financial health of the company, triggering the ministry to seek a ban on the auditors. The Enforcement Directorate (ED) investigating the case for money laundering in the firm, in its chargesheet pointed out that the senior management had falsified the accounts and indulged in circuitous transactions. This was done ostensibly to maintain the credentials of IL&FS, in order to continue receiving high remuneration and to artificially boost the balance sheet of IL&FS group. However, these activities led to further losses.[27]

3.2.2 Case of DHFL

In June 2019, DHFL, a major housing finance company (HFC) established in 1984, delayed interest rate payments which hit the net asset values (NAVs) of debt funds. Mutual funds had lent to the company in the form of debt securities. As a result, the company’s shares fell by over 90 per cent and the government launched a probe into the company. By August 2019, the creditors of the company decided to draft a resolution plan to let the government take the reins of the insolvency process. DHFL instead proposed to pay all of its creditors in full through an Inter-Creditor Agreement. In September 2019, DSP Mutual Funds dumped INR 300 crore worth of commercial papers of DHFL starting a rating downgrade. In the next few months, DHFL was hit by raids and probes as government agencies were looking into allegations of money launderingand involvement with criminal enterprises, even as the insolvency process continued. The board of directors of DHFL were removed by RBI citing “governance concerns and defaults” regarding payment obligations and an administrator of the company was temporarily appointed. The RBI had then handed off the insolvency proceedings to the National Company Law Tribunal (NCLT). The promoters of the company were arrested by the ED, for money laundering and other supplementary charges. The NCLT briefly halted the resolution process as it had to ascertain the views of the then industry regulator and refinancer, the National Housing Bank (NHB), that had invoked regulatory provisions to seek a bigger share of the resolution proceeds.[28]

3.3 The Aftermath

The crisis had hit the market caps of large NBFCs. Post the IL&FS failing, between 21st and 24th of September 2018, large NBFCs such as House Development Finance Corporation Limited (HDFC Ltd.) and Bajaj Finance’s market capital eroded by around

[27] Collated from https://www.business-standard.com/about/what-is-il-fs-crisis and https://bfsi.economictimes.indiatimes.com/news/nbfc/how-the-ilfs-crisis-ravaged-indias-nbfc-sector-a-timeline/90541212
[28] https://www.cnbctv18.com/business/companies/dhfl-crisis-and-piramal-groups-resolution-plan- a-timeline-9570151.htm

INR 18600 crore and INR 13800 crore respectively. Twelve other NBFCs including L&T Finance Holdings, DHFL, and Indiabulls Housing Finance also witnessed sharp drop in market cap. The effect of NBFC rout affected the stock and debt markets with Nifty and Sensex hitting a six-month low of 10,234 and 34,001 respectively in October 2018. Between February and April, 2019, Reliance Home Finance and Reliance Commercial Finance defaulted on loan repayments leading to closure of both firms in September 2019. In September 2019, another real estate financing company Altico Capital defaulted in interest payment leading to credit rating agencies downgrading its debt to junk status. By the end of September 2019, cost of borrowing was exceptionally high for all NBFCs.[29]

4. Recommendations

Both cases of IL&FS and DHFL are a reminder that the range of business activities undertaken by NBFCs are both unique and complex, however, less transparent compared to the mainstream banking sector. This makes it even more important for NBFCs to adhere to the ethics of corporate governance. While ethical norms such as a sound risk management framework, forensic accounting, code of conduct of the board, independent audits, or whistle blowing policy are some ways to improve corporate governance in an NBFC, it still remains a challenge to create a water tight corporate governance framework for NBFCs to prevent any ethical violations.

It is with this intent that Pahle India Foundation (PIF) and National Stock Exchange of India Limited (NSE) organised this seminar to debate such issues and find solutions to better corporate governance among NBFCs in India. Some of the recommendations suggested in the seminar are as follows.

- **Holistic Supervision and Voluntary Discipline**
  For effective adoption and implementation of corporate governance among NBFCs, there should be a social change rather than regulatory mandates which needs to come from within the industry and not through a regulator. For e.g., larger NBFCs lending to smaller ones, must mandate adherence to ESG norms and corporate governance rules for the smaller borrowing NBFCs. This would not be an overnight process and would need handholding and help from larger NBFCs. Handholding with smaller NBFCs would go a long way in developing a healthy financial ecosystem in India.

[29] https://bfsi.economictimes.indiatimes.com/news/nbfc/how-the-ilfs-crisis-ravaged-indias-nbfc-sector-a-timeline/90541212

- **Group Risk Management and Conglomerate Supervision**
  In light of catastrophic incidents such as the DHFL and IL&FS crises in recent years, there should be heightened supervision of financial conglomerates through the board of directors in addition to regulators. The board of directors should oversee group risk of the conglomerate that may transpire from non-regulated entities of the group to the regulated entities in the group. At present, NBFCs do not have macroprudential policies such as counter cyclical capital buffer, defined capital conservation buffer etc. Appropriate macroprudential policies must be developed for better functioning of NBFCs.

- **Need for a Self-Regulatory Organisation (SRO) for NBFCs**
  To enhance best corporate practices and better adoption of corporate governance, the Reserve Bank of India (RBI) must recognise and allow for setting up of a self-regulatory organisation (SRO) for NBFCs in India. This would also allow for the industry to develop good governance standards for the different segments of NBFCs and educate its member bodies to adopt industry best practices in terms of corporate governance. Once the SRO is set up, RBI must mandate registering of all NBFCs with the SRO. This would also help in better oversight from within the industry.

- **Developing better ESG Standards**
  While all corporate NBFCs need to adhere to Business Responsibility & Sustainability Reporting (BRSR) norms to be listed on stock exchanges in India, smaller and unlisted NBFCs do not list or conform to such norms and standards. However, such NBFCs should be encouraged and educated to follow ESG norms. This may be done through associations and chambers of commerce. Additionally, such NBFCs must be encouraged to make higher disclosures.

- **Room for Error**
  Policymakers must take adequate steps to develop a flexible process where a company could report a wrong fearlessly. In other words, penalty for voluntary disclosure/reporting of a fault should not be treated at par with "unearthing a fault" by the regulator. A flexible process would build a company's trust on the system and the regulator creating a healthy corporate governance process. The solution lies in effective supervision and implementation, not more regulations.

Appendix A

The Reserve Bank of India (RBI) has classified NBFCs into twelve different types based on their activities or functions. These are as follows.

Table I: Classification of NBFCs by Activity[30]

Type of NBFC	Nature of activity / Principal business
Investment and Credit Company (ICC)	Lending and investments.
Infrastructure Finance Company (IFC)	Providing loans for infrastructure development.
Infrastructure Debt Fund (IDF)	Facilitate flow of long-term debt to infrastructure projects.
Core Investment Company (CIC)	Investment in equity shares, preference shares, debt, or loans of group companies.
NBFC- Micro Finance Institution (NBFC-MFI)	Collateral free loans and advances to small borrowers.
NBFC – Factor	Factoring business i.e., financing of receivables.
Non-Operative Financial Holding Company (NOFHC)	For setting up new banks in private sector through its promoter/promoter groups.
Mortgage Guarantee Company (MGC)	Providing mortgage guarantees for loans.
Asset Reconstruction Company (ARC)	Acquiring and dealing in financial assets sold by banks and financial institutions.
Peer-to-Peer Lending platform (P2P)	Providing an online platform to bring lenders and borrowers together to help mobilise funds.
Account Aggregator (AA)	Collecting and providing information about a customer's financial assets in a consolidated, organised and retrievable manner to the customer or others as specified by the customer.
Housing Finance Company (HFC)	Financing for housing.

Source: RBI

30 https://m.rbi.org.in/scripts/BS_ViewBulletin.aspx?Id=21206

Appendix B

Regulatory structure for NBFCs shall comprise of four layers based on their size, activity, and perceived riskiness. NBFCs in the lowest layer shall be known as NBFC - Base Layer (NBFC-BL). NBFCs in middle layer and upper layer shall be known as NBFC - Middle Layer (NBFC-ML) and NBFC - Upper Layer (NBFC-UL) respectively. The Top Layer is ideally expected to be empty and will be known as NBFC - Top Layer (NBFC-TL). The RBI has separate criterions and regulatory norms for each layer of the framework.

Table II: Classification of NBFCs as per RBI's SBR Framework[31]

Scaled Based Layer	**Composition**
Base Layer	Non-deposit taking NBFCs below the asset size of INR 1000 crore NBFCs undertaking the following activities NBFC-Peer to Peer Lending Platform (NBFC-P2P), NBFC-Account Aggregator (NBFC-AA), Non-Operative Financial Holding Company (NOFHC) and NBFCs not availing public funds and not having any customer interface
Middle Layer	All NBFC-Ds, irrespective of asset size non-deposit taking NBFCs with asset size of ₹1000 crore and above NBFCs undertaking the following activities Standalone Primary Dealers (SPDs), Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs), Core Investment Companies (CICs), Housing Finance Companies (HFCs) and Infrastructure Finance Companies (NBFC-IFCs).
Upper Layer	NBFCs identified by RBI as warranting enhanced regulatory requirement based on a set of parameters and scoring methodology drawn up by the RBI, with top 10 of the companies permanently being on this list
Top Layer	This layer will ideally remain empty and can get populated if the RBI is of the opinion that there is a substantial increase in the potential systemic risk from specific NBFCs in the Upper Layer. Such NBFCs shall move to the Top Layer from the Upper Layer.

Source: RBI

[31] Collated from https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12179&Mode=0

As the regulatory structure envisages scale based as well as activity-based regulation, the following prescriptions shall apply in respect of the NBFCs

- NBFC-P2P, NBFC-AA, NOFHC and NBFCs without public funds and customer interface will always remain in the Base Layer of the regulatory structure.
- NBFC-D, CIC, IFC and HFC will be included in Middle Layer or the Upper Layer (and not in the Base layer), as the case may be. SPD and IDF-NBFC will always remain in the Middle Layer.
- The remaining NBFCs, viz., Investment and Credit Companies (NBFC-ICC), Micro Finance Institution (NBFC-MFI), NBFC-Factors and Mortgage Guarantee Companies (NBFC-MGC) could lie in any of the layers of the regulatory structure depending on the parameters of the scale based regulatory framework.
- Government owned NBFCs shall be placed in the Base Layer or Middle Layer, as the case may be. They will not be placed in the Upper Layer till further notice.

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