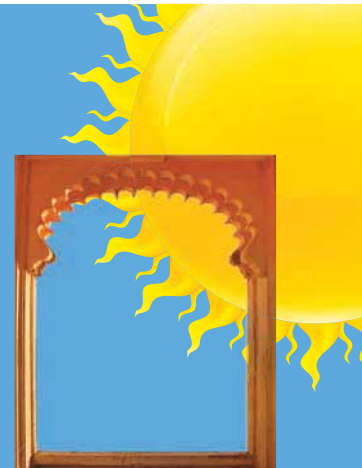


## CORPORATE GOVERNANCE IN STATE-OWNED ENTERPRISES

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### Executive Summary

- State-Owned Enterprises (SOEs) constitute an integral part of India's economy, and their performance has generally been encouraging;
- They are subject to stringent governance norms: those applicable to private sector companies and more;
- Although SOEs are owned by the government, their control, supervision and management are somewhat diffused;
- They suffer from unique issues and challenges in corporate governance;
- Nevertheless, through appropriate reforms in their governance, the benefits of SOEs to the economy can be maximized.

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State-Owned Enterprises (SOEs) (also referred to as public sector enterprises (PSEs) or public sector undertakings (PSUs)) form an important part of the industrial and commercial sectors in India. Being substantially owned by the Government, they face business challenges as well as corporate governance issues that are somewhat unique in nature.

## The Evolution of SOEs in India

The origin of SOEs can be attributed to the economic policy of the Government of India immediately following independence. The “mixed economy” model laid tremendous emphasis on the role of the state in economic development. During this period, several SOEs were established that continue to operate to date. Subsequently, in the 1960s and 1970s, several industries (primarily banks) were nationalized by the Government, which also contributed heavily to the SOE pool.

Although SOEs enjoyed limited competition from the private sector during their initial years, that position substantially changed in 1991 with economic liberalization, whereby they were exposed to competition from the expanding private sector within India as well as businesses abroad. In the post-liberalization phase, effort has been made towards disinvestment of SOEs. While waves of disinvestment have been attempted, sustained efforts towards that end have been stymied due to political considerations. Not only many SOEs continue to be wholly owned by the government, but also those that were partially divested still continue to be under government control. In view of the same, a process of professionalizing the SOEs has been continued as a parallel strategy to confer greater freedom and flexibility to their management so as to enable them to compete effectively with the private sector players.

## Size and Performance

### Size of the SOE Sector

- Overall, there are 248 Central Public Sector Enterprises (CPSEs), out of which 220 are operational. Among the operational PSEs, 158 are profit-making and 62 are loss-making.
- Apart from these, there are several State-level PSEs.
- About 70 PSEs (including some state PSEs) are listed on the National Stock Exchange on India (NSE).
- The market capitalization of PSEs constitutes 17% of the overall market capitalization of the NSE as on March 31, 2015.

*Sources: (i) Department of Public Enterprises (DPE), Annual Report 2012-13; and (ii) NSE*

The available empirical evidence suggests that SOEs have played an important role from an industrial and financial standpoint. They have substantially contributed to the GDP of the country. Several SOEs have even outperformed private sector companies. Despite their exposure to competition from within and outside the country, most SOEs have been able to withstand pressures and demonstrate positive results.

## Corporate Governance Framework

When it comes to governance and management, SOEs are subject to different levels of regulation. Most SOEs in India are structured as government companies. Hence, they would be subject to the general principles of corporate law, primarily the Companies Act. While the newly revamped Companies Act, 2013 has come into force in parts (which include the principal corporate governance provisions), the erstwhile Companies Act, 1956 governs other matters such as schemes for arrangement and compromise and winding up. Corporate law in India recognizes the special nature of SOEs and hence, provides certain specific dispensations under law. For example, the Government may stipulate that certain provisions of the Companies Act are not applicable to SOEs. Given that the new Companies Act introduced stringent measures relating to corporate governance, the standards applicable to SOEs are similarly enhanced. Where SOEs are established under special statutes, they are governed by those statutes.

SOEs listed on stock exchanges are also governed by Clause 49 of the listing agreement, which stipulates the corporate

governance norms for listed companies. This too was significantly revamped with effect from October 1, 2014 so as to align it with the Companies Act, 2013.

In addition, CPSEs are also subject to the Guidelines on Corporate Governance for CPSEs issued by the Department of Public Enterprises (DPE), Government of India. These guidelines were introduced on a voluntary basis in 2007, but were subsequently made mandatory for CPSEs in 2010. These guidelines also encompass unlisted CPSEs, which are not covered by Clause 49. The guidelines deal with matters such as board of directors, audit committee, remuneration committee, subsidiary companies, disclosures, reporting, compliance and schedule of implementation.

Finally, SOEs are subject to additional checks and balances that are beyond those applicable to companies in the private sector. Given that SOEs are substantially owned by the Government, they are subject to the expansive transparency requirements set out by the Right to Information Act, 2005, which is a momentous piece of legislation in India. Similarly, rulings of the Supreme Court of India have unequivocally treated SOEs as “state” under the Indian Constitution that allows affected persons to institute legal proceedings against them by way of writ petitions.<sup>1</sup> Hence, SOE decision-making is subject to review by the court against the touchstone of constitutional principles. The operations and management of SOEs are also subject to oversight by the Comptroller and Auditor General and the Central Vigilance Commission.

All of these demonstrate the rather onerous nature of governance and management requirements applicable to SOEs.

### **Government oversight over CPSEs**

Although the Government of India is the owner of shares in CPSEs, it is the Ministry pertaining to the industry in which the relevant CPSE operates, that wields substantial power. For example, although the Government of India is the controlling shareholder of ONGC, the Ministry of Petroleum and Natural Gas would effectively carry a significant influence over the affairs of the company. In other words, power is overtly concentrated in the Government, but in practice it is rather diffused due to the several Ministries that oversee the operation of different CPSEs. The DPE has been established to ensure coordination among the various Ministries in their actions relating to CPSEs, but it is only a coordinating body and exercises limited direct powers.

At the same time, the Government has been cognizant of the need to confer greater powers and flexibility to the CPSEs to manage their businesses and to operate in markets alongside private sector competition. In the post-liberalization era, CPSEs were categorized into Maharatna, Navaratna and Miniratna to confer greater autonomy and flexibility to their managements. CPSEs which are larger, more profitable and whose securities are listed on the stock exchange enjoy greater autonomy compared to their smaller and less profitable siblings.

### **Corporate Governance: Issues and Challenges**

Indian companies are replete with concentrated shareholding structures due to which corporate governance is required to address the agency problem between the controlling shareholders (i.e. promoters) and the minority shareholders. However, even in companies with concentrated shareholding, the issues may vary according to the precise nature of the controller. For example, where the controller is a private owner (such as a business family) with identifiable ownership, the corporate governance concern relates to whether such a controller can obtain private benefits of control and extract value from the company to the detriment of the minority shareholders. This occurs through related-party transactions and similar methods of tunneling wealth. Corporate governance norms address these types of conduct through measures that deal with related-party transactions, such as through a review of the transaction by an independent committee of directors and obtaining a shareholder vote in which the interested shareholder cannot participate.

However, when it comes to SOEs, although the state is a controlling shareholder, its role does not fit within the above paradigm. At one level, the state may be considered as a single controller, but that notion would be rather superficial. Unlike a single private controller, the state is not a unitary actor. Different governmental bodies and agencies may carry differing interests that may be difficult to reconcile. In that sense, the state’s position could be akin to that of a group of controllers with no coherence in approach.

Moreover, the state’s incentives as a controller are likely to be very different from that of private controllers. The state as a controller is unlikely to indulge in transactions that benefit it financially. But, other considerations may operate. For example, the state may pursue transactions that help achieve certain political goals that are detrimental to the financial interest of the firm (and thereby its minority shareholders). For example, Indian SOEs have been subject to criticism on the ground that they have sold their products at less than market price (effectively operating as a subsidy) to achieve

political goals of the state, thereby depriving minority shareholders of wealth maximization through their investment. Unlike the case of private controllers, the diverse goals and political considerations surrounding SOEs make it more difficult to regulate from a governance perspective.

Given this background, several studies conducted on the governance and operation of SOEs have identified issues and concerns that need to be addressed.<sup>ii</sup>

### Issues and Concerns

- Complex ownership and governance structure of SOEs.
- Robust governance norms, but lack of proper implementation.
- High level of non-compliance by SOEs with provisions of Clause 49 compared with the private sector.
- Boards are not entirely free from government interference.
- Stakeholder interests determined by political goals that are preferred over minority shareholders.

The nature of corporate governance problems faced by SOEs in India is evident from anecdotal evidence through case studies. One such case relates to the SOEs' lack of compliance with the provision for appointment of independent directors.

### Non-Compliance with Board Independence

After Clause 49 was amended with effect from January 1, 2006 to introduce stringent board independence requirements for listed companies (including SOEs), a study found that nearly 13% companies were yet to appoint the minimum number of independent directors representing a failure to even “check the box”.<sup>iii</sup> The principal offenders turned out to be the SOEs and not private sector companies. In a string of cases, SEBI initiated action against several SOEs for non-compliance with Clause 49.

However, the actions were subsequently dropped by SEBI on the principal ground that in the case of the government companies, the articles of association provide for the appointment of directors by the President of India (as the controlling shareholder), acting through the relevant administrative Ministry. SEBI found that despite continuous follow up by the government companies, the appointments did not take effect due to the need to follow the requisite process and hence the failure by those companies to comply with Clause 49 was not deliberate or intentional.

This case does not augur well for corporate governance in India. Compliance or otherwise of corporate governance norms by SOEs has an important signaling effect. Strict adherence to these norms by government companies, which are typically perceived as role models (since the Government is their owner), may persuade others to follow. But, when SOEs themselves violate the norms with impunity, it is bound to trigger negative consequences in the market place -- thereby making implementation of corporate governance norms a more arduous task.

Another case demonstrates the tension between the public policy considerations or political goals of the state as a controlling shareholder on the one hand and the interests of the minority shareholders in SOEs on the other.

### **Subsidies: Sacrificing Minority Shareholders**

Several SOEs in the natural resources sector have been selling their produce at a substantial discount to international market prices. For example, oil companies were selling at subsidized prices despite increase in international market prices. Similarly, Coal India Limited was selling coal to utility companies much below international market price.

While these moves benefited consumers and satisfied political considerations, it was the minority shareholders who bore the brunt of these decisions by the SOEs. There was effectively a transfer of value from the minority shareholders to consumers as stakeholders. Arguably, the boards of these companies were hamstrung as they were operating under the influence of the Government, and they were unable to protect the interests of the minority shareholders.<sup>iv</sup>

The lessons from these cases indicate not only the continued influence of the government (and its policies) on the decision-making and operations of the SOEs but also the disregard for minority shareholder interests by the SOEs.

### **Way Forward**

Given the current situation regarding corporate governance of SOEs in India, it is beyond doubt that there is considerable room for improvement, and much scope for further reform. It would be imprudent to impose governance norms on SOEs in a manner similar to private companies. The state is a unique type of shareholder and governance norms require targeted treatment. International bodies such as the OECD and the World Bank have issued guidelines for governance of SOEs. While international experience may be relevant, care must be taken to ensure that any such adoption pays adequate attention to the unique circumstances that prevail in India.

### **Some Suggestions for Reform**

- Empower boards of SOEs to take decision after considering all relevant interests, including those of minority shareholders;
- Emphasize the independence of SOE boards, including by strengthening the process of appointing independent directors;
- Ensure minimal government interference in the functioning of SOEs;
- Simplify the holding structure of SOEs by possibly consolidating ownership in a single entity as in the case of the State-owned Assets Supervision and Administration Commission (SASAC) in China, Temasek in Singapore or Khazanah in Malaysia, for example;
- Greater recognition and protection of minority shareholder interests; and
- Appropriately balancing the interests of shareholders and other stakeholders (such as consumers and the general public interest).

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<sup>i</sup> *Som Prakash Rekhi v. Union of India*, AIR 1981 SC 212.

<sup>ii</sup> The Organisation for Economic Co-operation and Development (OECD) has issued the OECD Guidelines on Corporate Governance in State-Owned Enterprises with a view to address some of these concerns. These Guidelines are currently undergoing a set of revisions.

<sup>iii</sup> N. Balasubramanian, Bernard S. Black & Vikramaditya Khanna, *Firm-Level Corporate Governance in Emerging Markets: A Case Study of India 5-6* (2008), available at <http://ssrn.com/abstract=992529>.

<sup>iv</sup> In the case of Coal India Limited, one significant investor, The Children's Investment Fund (TCI) initiated legal action against the company and its directors (for breach of fiduciary duties). This was discussed in the NSE Quarterly Briefing No. 1 (April 2013). That legal action has since been withdrawn as TCI exited the investment.

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## About NSE CECG

Recognizing the important role that stock exchanges play in enhancing corporate governance (CG) standards, NSE has continually endeavored to organize new initiatives relating to CG. To encourage best standards of CG among the Indian corporates and to keep them abreast of the emerging and existing issues, NSE has set up a Centre for Excellence in Corporate Governance (NSE CECG), which is an independent expert advisory body comprising eminent domain experts, academics and practitioners. The 'Quarterly Briefing' which offers an analysis of emerging CG issues, is brought out by the NSE CECG as a tool for dissemination, particularly among the Directors of the listed companies.