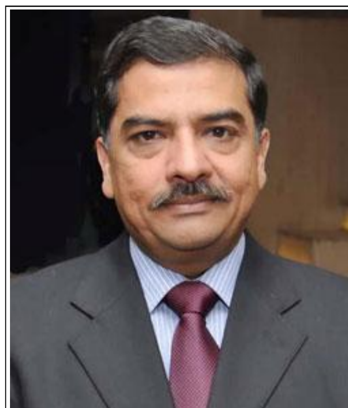
Role of Institutional Investors in Ensuring Better Corporate Governance



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Institutional Investors

In the 1970s, when the Country was in the threshold of an industrial revolution, Development Financial Institutions emerged as major players in providing funds to the industry. This was a time when the concept of public participation in funding projects through equity/ preference capital or debenture / bonds were not in vogue. These institutions provided funds to corporates, the terms of which included stringent conditions not only with regard to security, repayment of the principal and timely payment of interest but also "dos" and "don'ts" for the managements in running projects funded by them. There was a system of lead institution and participating institution in line with the present consortium arrangement of banks.

In many cases, the terms included a right to convert part of the loan to equity capital during the life of the loan at a predetermined price and also a right to nominate one or more directors to represent the Development Financial Institutions on the Board of the assisted company. The major Development Financial Institutions were Industrial Finance Corporation of India (present IFCI Limited), erstwhile Industrial Development Bank of India (IDBI Bank Ltd.), Industrial Credit and Investment Corporation of India (ICICI Bank Ltd.), Unit Trust of India, Life Insurance Corporation of India, State Industrial Investment Corporations, etc LIC, UTI and similar institutions being investment institutions, stopped lending subsequently. In this way these institutions had placed their representatives in assisted companies and acquired stakes in their capital. All these institutions changed their characters from bodies created by Acts of Parliament to companies incorporated under the provisions of the Companies Act or to Banks as per RBI Act. Those directors, termed as nominee directors, enjoyed certain privileges such as being not liable to retire by rotation, not required to hold qualification shares, etc. They are supposed to safeguard not only the interest of the nominating institutions but also the public interest by acting as watchdogs against undesirable activities of promoters/ management.

Genesis of Corporate Governance

Those institutions used to lay down guiding principles to be followed by the nominee directors. The concept of 'Audit Committee of the Board', to monitor the accuracy of the financial reporting and also the effectiveness of internal control systems, etc. followed by assisted companies was conceptualized and implemented by the Development Financial Institutions, several decades before the term 'Audit Committee' found place in the Companies Act and Listing Agreement. One tends to believe that the guidelines governing the nominee directors in those days were the pre-cursor to the present day corporate governance guidelines, of course with substantial refinement and coverage.

Corporate Governance

Corporate Governance refers to the system of structures, duties and obligations by which corporations are directed and controlled. Governance provides the structure through which corporations set and pursue their objectives, while reflecting the context of the social, regulatory and market environment. Governance is a mechanism for monitoring the action policies and decisions of the corporations. Though the practices underlining corporate governance were in vogue the concept gained credence with the introduction of Clause 49 of the listing agreement more than a decade back.

Corporate Governance philosophy should be based on the principles of equity, fairness, transparency, spirit of law and honest communication. Flow of transparent and honest communication helps investors to take informed investment decisions. It is here the institutional investors can play a role with the expertise available with them by extracting and analysing information about the stability and prospects of investee companies. Such data can be disseminated in the public domain for helping investors to take informed decisions with regard to investment through bourses.

The role of institutional investors in influencing and moulding corporate governance practices of a company depends on its relationship with the company, whether it is only a major shareholder or has a representation on the Board or it has a stature to influence the market movement of the shares of the company, etc.

Institutional Investors in the present context

The constituents of Institutional investors have become wider over the period of time and consist of organizations which pool large sums of money and invest those sums mostly in securities and in some cases in other investment assets as well. Such investors include banks, mutual funds, insurance companies, retirement or pension funds, hedge funds, etc. Whereas the motive

of Development Financial Institutions used to be primarily to act as catalysts for industrial development of the Country, as envisaged in the particular legislations by which they were created, they endeavour to make reasonable returns on the funds deployed. The present day institutional investors' main consideration is to enhance returns on their investments to the benefit of the people who put their money in their Schemes. Their role in the economy is to act as specialized investors on behalf of others. For example, an ordinary employee has a right to pension from his employer. The employer gives that person's pension and his matching contribution, if any, to a Fund, which is administered by an institutional investor called Fund Manager. The Fund will buy shares in a company or some other financial products. 'Funds' are useful because they will hold a broad port-folio of investments in many companies, which spreads risk, so if one company fails, it will be only a small part of the Fund's investments.

Right of institutional investors

In India, the above type of institutional investors seldom have any say or power in the management of the affairs of the company, unless the stake is acquired under a share subscription agreement out of a private placement prior to listing of the securities. Their ability to nominate a director on the Board of the investee company depends on the voting rights they command. They keep on shuffling their portfolios with the aim to achieve maximum returns to the Funds and in turn to those who invested in the funds. Therefore, unlike the erstwhile Development Financial Institutions, the role of other institutional investors in the matters of Corporate Governance is rather limited. An institutional investor can however, have some influence in the management of corporations because it will be entitled to exercise the voting rights in a company in proportion to its stake in the equity. By this, one can to some extent influence the Board of Directors and the Management of a company to adopt fair corporate governance methods.

Role of Institutional Investors

The performance of fund managers is evaluated over a shorter time period. They therefore act under tremendous pressure to beat some index or the other. So when they find a case of bad governance, they find it rather economical to exit the company rather than interfere in the functioning of the company. The short term performance measures of the fund managers force them to become very short term oriented. However, analysis of the Fund managers can be of use for the retail investors in taking informed investment decisions.

The largest institutional investor in India is the Life Insurance Corporation of India, which also happens to be the largest fund manager in the Country. Life Insurance Corporation of India has placed directors on the Board of several companies in which it has stakes and play a pivotal role in the functioning of such companies and in ensuring adherence to Corporate Governance practices by those companies. Such a role cannot be expected from all fund managers, who are fair weather investors with the ultimate motive of enhancing the value of the Units of their schemes/ Funds, which in turn is linked to one or more indexes. In such a situation, the present day institutional investors cannot be expected to play any major role in the corporate governance arena of companies in which they hold stakes. This is particularly so in the case of Foreign Institutional Investors, whose aim is to enhance wealth and return without any long term commitment.

Nominee director Vs. Independent Director

Nominee directors used to be categorized as 'independent directors' earlier as per Clause 49 of the Listing Agreement, dealing with Corporate Governance. No provision with regard to independent directors existed under the companies Act, 1956. The scenario has changed. Nominee directors no more come under the category of independent directors under the Companies Act, 2013 and also under the revised Clause 49 of the Listing Agreement, to be effective from 1.10.2014. The reasons being that there is a conflict of interest as they are more concerned with the interest of their nominating institution than the interest of their stakeholders. This is somewhat unfounded. Whereas it can be appreciated that the nominee directors' prime concern is to protect the interest of the nominating institution, he is equally responsible to the shareholders and other stakeholders. His position is fiduciary in nature like other directors. Instead of excluding him from the category of independent directors more onus should be put on such nominee directors categorizing him at par with independent directors. The nominating institution's stake in the company also come from public funds and therefore, the nominee director is a trustee of not only of the institution's interest but also of those who have put their money in the institution. At least those nominee directors who are nominated under any specific law or under a term lending agreement by a public financial institution or a bank, should continue to have the status of an independent director, with onus to ensure adherence to the Corporate Governance Guidelines by the assisted company in the same way as the other independent directors.

A couple of decades ago, when the takeover regulations of SEBI were not in existence, nominee directors were instrumental in thwarting destabilizing bids on some large corporates by some marauders with the sole aim of taking over those long nourished and well established corporations and which would have been detrimental to the stakeholders as there were no regulations to safeguard their interests during those days.