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A communiqué on corporate governance

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Academy of Corporate Governance

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Indian Corporate Governance – more slum-dog than millionaire?

The International Corporate Governance Network, London (ICGN) held its mid-year conference in Kuala Lumpur, 28th Feb-2nd March. This influential body - with membership largely of institutional investors with collective funds under management of over USD \$ 12 trillion – chose to debate, “*Asian Corporate Governance – the Future Steps*”. Of particular importance in this largely attended and outstandingly well organized conference is the reference to India in several sessions. Inherent message from leading institutional investors: *Indian corporate governance standards are way behind many others in Asia.*

Some Fund / Investment Managers admittedly keep India in their portfolio play, more to meet general expectations than as a great strategy. “*You have to be seen to be part of the emerging growth story as the economic fundamentals are sound and growth is impressive on all fronts*”, one Commented. This lot, as well as those who are more “bacon” than “egg” in their commitment, seems to have two key concerns – as evident from conversations and discussions.

First, the daily eruptions of corruption scandals and sustainability issues of volcanic proportions. Reputation risks for investors have increased on the one hand and on the other, the ground is increasingly uneven for those who want to abide by international Principles & Standards. Add to this, the increasing unpredictability of government policy on account of and in response to these issues. A comment, an extremely provocative one, was whether there is undue nexus between the business and the government that has created a new class of “untouchables”? Another wondered if it is the round-tripping of the stashed away bags that makes the foreign investments in India look big? Transparency International Corruption Perception Indices and the Report of the Global Financial Integrity Forum came handy for a few critics.

Tidbits:

International:

- * The Global Reporting Initiative (GRI) has revealed a 50% increase in sustainability reporting between 2007 and 2008 with especially hefty growth among developing countries. Surveys are also indicating greater readership of the elements in these reports, with Brazil revealing much insights.
- * The US Chamber of Commerce welcomed the proposed corporate governance standards with Dodd-Frank Act working as an “accelerator”, but was wary of implementation of the environmental reforms.
- * The clamour for “say on pay” has taken a major stride with Securities and Exchange Commission, USA making it official for shareholders to voice their opinion on CEO pay at least once every year through ballot. The Dodd-Frank Act already requires public companies to provide for non-binding votes by shareholders.
- * Compensation of directors in the US has reportedly risen sharply going by a few individual cases across all sectors. In 2009, the median for directors of USA’s biggest 200 publicly traded companies was \$228,000.
- * Stock market in Russia appears to be bearing the brunt of criminal activity, failure of legal system and misuse of authority in governance. It trades at 40% discount compared to other emerging markets. Amongst several scandals dogging the economy, the one relating to Hermitage Capital Management has drawn the attention of the world for systematic fraud with the complicity of government officials.
- * Grant Thornton’s Corporate Governance FTSE-350 review for 2010 identified key elements that need further improvement in the UK. For the first time, over half of these companies now claim full compliance with the code. While healthcare, telecommunications and utilities companies are fully compliant, the least compliant (77% score) appear to be those in the financial sector.
- * GovernanceMetrics International (GMI) has reportedly introduced a Score-card for S&P-500 for objective evaluation of executive pay plans. This tool will be helpful for making voting decisions during the current 2011 proxy season. The Dodd Frank Act makes voting on pay imperative for institutional investors.
- * Brazil’s BM and FBOVESPA announced a bidding process for the selection of a securities portfolio manager for the use of the Corporate Sustainability Index (ISE) and the Corporate

Second, is the continued weakness in India's corporate governance framework and standards. It was recalled from an ACGA survey, that India ranks much behind Singapore, Hong Kong, Japan, Taiwan, Thailand, and Malaysia. Keeps company with China. Korea, Indonesia and Philippines give it comfort being ranked lower. *If a "world class" benchmark is assumed at 80% (distinction mark?) both India and China are 31 points below with a score of 49% (third-class??).*

The main corporate governance concerns voiced are:

- *The regulation and practices at shareholder meetings and voting;*
- *Related party transactions including the scope for abuse of preferential warrants;*
- *Quality of disclosures and*
- *The absence of independent oversight for the audit profession.*

Add to these, the half-hearted efforts at reform. For instance, the AMC's of mutual funds have been advised by SEBI to make a general policy and disclose the same in respect of proxy voting and exercise of their voting rights – but this is pointless because the company law permits proxies to vote only in case of a poll. But no poll that will give one-vote-one-share can take place as resolutions are by a show of hands! The implication is that corporates continue to be fiefdoms in an apparently democratic state.

Needless to say, all was not that dark, of course. Three thick glittering silver linings were noted as the most encouraging and leading governance characteristic of the Indian markets.

a). The vibrancy and diversity of media - it provides traction for institutional improvement in conjunction with the activism of civil society organizations that leverage the powerful Right to Information Act.

b). The political and legal framework along with the intended regulatory reform (despite clichéd red-tape and weak enforcement) and

c). Improving corporate governance standards due to the positive impact of internationalization of Indian corporates.

Will India take quick steps in addressing its fault lines or remain smugly self-sufficient? Remember: elephants often lumber forward with every tickle behind the ear than gallop through the wilds.

(Dr. Y.R.K. Reddy was a speaker at this conference, as in earlier years)

Governance Trade Index (IGCT) as references for the respective launches of exchange traded funds. The license is offered on an exclusive basis for one year.

* Azerbaijan has issued National Corporate Governance Standards with the assistance of IFC and Global Corporate Governance Forum (was peer reviewed by Founder & Head, ACG).

* South Africa has taken a lead in promoting ethics, corporate responsibility and sustainability with JSE's 400 companies required to produce integrated annual reports, amidst concerns from auditors.

National:

* Indian Corporate Affairs Minister plans to reserve one director's seat for women in all companies with five or more directors through a provision in the proposed Companies Bill, 2008. Currently, there are barely 5% women directors in India's top 100 listed companies. This is against 15.7% in Fortune-500 companies; 14.5% in the US and 12.2% in the UK. There are worries, of course of this move for "reservation".

* The recent fraud involving the Indian subsidiary of a US financial conglomerate has drawn attention to white collar crime which can be a substantial financial, regulatory and reputational risk. This type of employee fraud is rather unique in the Indian context, though rogue traders have brought great companies to their knees elsewhere, on earlier occasions.

* Indian accounting standards have been converged with IFRS in pursuance of the G-20 commitment. Henceforth called IND AS, their implementation will be notified and implemented in due course.

* Responsible Investment Research Association (RIRA), a recently founded advocacy and research platform is all set to promote responsible investment in India and South Asia. It aims to facilitate dialogues, render education, training and applied research, and bring greater synergies between international initiatives and regional efforts. This is timely amidst the strong international reactions of ethical investors to ESG standards and practices in India.

* It is reported that about 35 firms in the SME segment are likely to raise money through initial public offers in 2011, in India. This would be higher than the 19 firms that raised less than 25 million USD in 2010. Start ups amongst these can go to the market without the three-year track record of profits by offering 60% to qualified institutional investors.

* There is a proposal once again of a separate exchange for SMEs with lower cost and with possibilities of raising smaller amounts from the primary market. Earlier attempts did not take-off well in the country compared to experiments in other countries.

* Following an approval of the Securities and Exchange Board of India (SEBI) Indian investors are soon to be allowed to trade in large indices of 24 international exchanges. These would be limited to trading in derivative contracts of the global indices spreading across the America's, Europe and Asia.

Social Impact of Global Financial Crisis – Review and Challenges

Following is the synopsis of the talk delivered by Y.R.K. Reddy to a joint session of Hyderabad Management Association, Federation of Andhra Pradesh Chamber of Commerce and Industry, National Institute of Personal Management and the Indian Society for Training and Development on 25th February 2011 at Hyderabad

Social Impact of Global Financial Crisis – Review and Challenges

Talk by

Y.R.K. Reddy

25th Feb 2011

For HMA / FAPCCI / NIPM / ISTD Joint Session



Is there a connection between Bouazizi & the Financial Crisis?



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- There are many apparent reasons – such as demand for bribes & public humiliation; insensitive bureaucracy - why Bouazizi, the 26 year old vegetable / fruit vendor supporting his parents & siblings, self-immolated himself in Tunisia and set ablaze a trend of social unrest in the entire region.
- Not so apparent is the fact: that tourist demand has nosedived post-financial crisis, that youth unemployment has climbed to 30% in that town, that purchasing power has crashed, that food prices have shot up steeply inducing mass hunger. (This, in an economy with three times per-capita income of India, less poverty & hunger).
- Consequent to the crises, commitments of G-8 made in Italy at a 2009 summit to channel \$3 billion for annum for boosting productivity among small African farmers has remained a rhetoric. Not even 1/10th was passed on. Connecting the North Africa – West Asia uprisings to hunger, Jeffrey Sachs said “this is about hunger, about poverty, about food production, about a change of world economy..... This is one large Swathe of 10,000 miles of potential instability”.

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■ Why should we bother about a lone Bouazizi?

- Because, it is the symptom of a man-made insidious disaster; of badly missing the modest and patient MDG's; of possible mindless repetition; of an impending widespread unrest that will pit the vulnerable against the rich.
- Because, we seem to be looking at apparent & politically convenient reasons such as “cry for democratic rights”, “overthrow of oppressive, corrupt regimes” aided by common language and culture.
- Because, the main culprit of the current global economic owes is beginning to reassert, control and be back to “business as usual”.
- Because, public seem to have disconnected the global financial crisis from the economic downturn, as if the latter were waiting to happen – a cyclical effect than induced?.....

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Is the Financial Crisis Passé?

- Some may want us to believe that it is dead and well buried; that the economic crisis and efforts at recovery are independent of GFC.
- Going also by the revival of salaries, bonuses, reassertion of bank chiefs and Wall Street.
 - Citi's top four with \$12m in a new profit sharing plan.
 - Lloyd Blankfein's opposition to base salary hikes in Wall Street followed within few months with a tripled salary of \$2m.
 - RBS, Lloyd's, Barclay's, HSBC chiefs reported GBP 3.5m, 2.04m, 8m, 9m bonuses. (one of them accepting a 3m bonus while the bank was paying a penalty of 2.8m).
 - Deutsche Banks chief Josef Ackerman to earn Euros 9 M for 2010.
 - Bob Diamond of Lloyd's and the interface with Treasury Select Committee (that the “period of remorse and apology” made to be over; that the liabilities of CEOs must be limited; that he has no idea of offshore subsidiaries that the bank has; that it may not matter what the hard working nurses and teachers may think of indecent salaries in the finance sector....)

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Despite indictment during the early phase.....

- *This crisis questions the considerable progress made these last ten years by many low-income countries that raised their economic growth, decreased poverty and reached greater political stability. (Dominique Strauss-Kahn, MD, IMF)*
- *The unprecedented global crisis – in the economic, financial, social, food and environmental fields, but also in the moral and ethical spheres – is threatening the achievement of the most important multilateral agenda of today – the millennium development goals – and is affecting the most vulnerable countries, particularly those in Africa. The crisis makes it imperative for us to act on an emergency basis (Irina Bokova, DG, UNESCO).*

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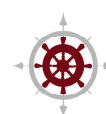


"While recently we have heard much in the US about how problems on Wall Street are affecting innocent people on Main Street, we need to think more about those people around the world with no streets"

- Ban Ki-moon

UN Secretary General

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The Report of the FCIC, USA, January 2011 is revealing

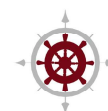
- “The profound events of 2007 and 2008 were neither bumps in the road nor an accentuated dip in the financial and business cycles we have come to expect in a free market economic system. This was a fundamental disruption – a financial upheaval, if you will – that wreaked havoc in communities and neighbourhoods”
- “There is much anger about what has transpired, and justifiably so. Many people who abided by all the rules now find themselves out of work and uncertain about their future prospects. The collateral damage of this crisis has been real people and real communities. The impacts of this crisis are likely to be felt for a generation.”

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- “Trillions of dollars in risky mortgages had become embedded throughout the financial system, as mortgage-related securities were packaged, repackaged, and sold to investors around the world.” “It was the equivalent of a small business with \$50,000 in equity borrowing \$1.6 million with \$296,750 of that due each and every day.”
- “The very nature of many Wall Street firms changed – from relatively staid private partnerships to publicly traded corporations taking greater and more diverse kinds of risks. Bu 2005, the ten largest U.S. commercial banks held 55% of the industry’s assets, more than double the level held in 1990. On the eve of the crisis in 2006, financial sector profits constituted 27% of all corporate profits in the United States, up from 15% in 1980.”

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- “From 1999 to 2008, the financial sector expended \$2.7 billion in reported federal lobbying expenses; individuals and political action committees in the sector made more than \$1 billion in campaign contributions.”

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John Cassidy’s article (November 2010 – “What Good is Wall Street?”) is insightful:

- Lending vs trading / speculation? (63% of revenue while corporate finance accounted for just 13% in GS).
- Lord Adair Turner, Chairman FSA: largely “socially useless activity”; extractive rents through some products. Financial sector grow by 50% in employment since 80’s. From 14% to 33% of total corporate profits. 60% higher wages than elsewhere; average pay in three banks increased by 27% amidst overall freeze.

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- Woolly Center for the Study of Capital Market Dysfunctionality: talks of rent capture / extraction, misallocation of labour and capital, transfer of wealth to bankers and financiers; systemic failures, “perfect storm for wealth destruction”.
- Proprietary trading too lucrative to be given up. Volcker Rule, a part of Dodd – Frank financial reform bill being questioned and diluted.

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The Main Transmission Mechanisms

- Economic impact has been estimated in trillions even as some explored the “\$ 100 billion question”.
- With reduced financial flows, demand recession impacting supply chains in developing countries, budgetary cuts, donor reluctance etc. The North Atlantic crisis cascaded to vulnerable economies and masses.
- For instance, Growth rates fell steeply throughout the world. For instance in sub-Saharan Africa and the Caribbean, Central Asian and South East Asian regions average growth fell from 7%, 5.6%, 6.3% to -7%, -.5%, -.3% in 2009. Excluding China and India growth was -1.6% among developing economies.
- The idea of “de-coupling” in respect of China and India appears short lived with significant falls in their growth rates.

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- Main transmission mechanisms recognized by ILO, AeA etc. are:

- **Official Development Assistance:** G-8 is expected to reduce the target of \$130 billion by over 20%. “European countries which had a target of .56% of GNI in 2012 and .7% in 2015 granted .4% (.34% on deflation). The gross amounts also fall with the fall in GNI due to the crisis – say, overall impact of about 30-40%..
- **Remittances:** Constitutes twice the ODA. After continuous growth since the 1940’s, declined sharply by \$21 billion in 2009& hasn’t picked up.
- **Exports:** Supply chain impacts - particularly high among export dependent / high-openness-to-trade-economies and especially those with high proportion of foreign ownership in financial sector. Sharp decline in South Asia in labour intensive sectors, .
- **FDI:** which were continuously growing 03-07 decreased by 14% in 2008 and further 30% in 2009. (India’s decline estimated at 40% during 2009 and roller-coaster thereafter.?)

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Select Social Impact

- Studies show adverse impact on all goals set for 2015 due to the transmitted effects of GFC. Ambitions of the 2000 summit increasingly a “mirage” an Aide-et-Action report states. Also,

“Experience shows that human development tends to deteriorate faster during slowdown phases than their improvement recorded during phases of acceleration”.

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Three interconnected impacts stand-out.

■ Poverty & Hunger.

- Food price hikes are expected to throw 44 million more into poverty this year as per a World Bank estimate.
- India is home to nearly half of world's poor – recall 2010 study that estimates 625million. 421 million concentrated in 8 states against 410million in the 26 poorest African nations.
- The Global Hunger Index – shows reduced position for India by 2 ranks. Now 67 out of 84 countries. Worse than Sudan, Pakistan and Nepal
- The Nomura Food Vulnerability Index – India at 21 out of 24. Incidentally, Tunisia is better placed.

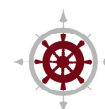
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■ Children:

- Particular impact noted on school enrolment, drop-out rates, girl child, aggravated malnutrition / under nourishment, child mortality.
- “Over 200 thousand to 400 thousand additional deaths could occur every year among children below one year.... Right up to 2015.
- For instance, undernourishment between 6-59 months of age contributes to 25-50% of mortality in India, which is extremely sensitive lower incomes and higher food prices.
- India accounts for the most malnourished children in the world!

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- **Youth Employment (15-24)** :There is a special concern relating to employment & youth as per ILO's Global Employment Trends 2011 – the challenge of a jobs recovery:
 - increased unemployment by about 13.5% in 2010 compared to 2007. In sharp contrast to the recovery in macro-economic indicators such as GDP, private consumption, gross fixed investment and world trade, unemployment stood at 6.2% in 2010 against 5.6% in 2007.
 - Youth unemployment at 12.6% in 2010 compared to 11.8% in 2007. “There are 1.7 million fewer youth in the labour market than expected on longer term trends, indicating that discouragement among youth has risen sharply. These discouraged youth are not counted among the unemployed because they are not actively seeking work”.
 - In South Asia the economies have withstood the impact of the crisis in several ways and are on the way for rapid growth. “Yet the region has the highest rate of vulnerable employment in the world at 78.5% of total employment in 2009.” In the case of Middle East, unemployment at 10.3% is the highest in the world with youth unemployment rate being four times the adult rate. In Northern Africa an alarming 23.6% of economically active young people were unemployed in 2010.

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- Those excited by signs of economic recovery must bear in mind that recovery of labour markets and wages will be far slower and lag by two years in some cases.
- It is possible that the poor in the world have just lost 5 years of their lives whose effect will last all life.

Demographic dividend can be a worse mirage than MDG's if malnutrition continues and youth unemployment aggravates. It may become a demographic dead-weight.

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Tentative Conclusion - what can we do?

- Do not forget yet, the Financial Crisis and its ripple. Keep a close oversight over financial intermediaries and their regulation. Encourage activist forces in markets to supplement regulation & discipline.
- Keep track of social indicators, that lag badly even if there are signs of economic recovery. Analyze closely, report loudly, discuss in high pitch,
- Hasten recovery in human terms thru direct intervention – look for adverse factors hidden behind the inflation dynamics which may not be limited to issues of supply-demand; reach directly to arrest hunger and malnutrition – especially among children and women; create short-term / developmental employment for youth; shore up medical attention to women / below-poverty, ensure enrolment to schools doesn't drop any further.....

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- Try to make up for the lost years of human capital – support micro strategies of livelihood projects, re-skilling.....
- Quicken the process by learning from success stories in:
 - Coalitions (examples of professional bodies and business associations)
 - Partnerships (sector bodies, associations, NGOs + Government)
 - Redirecting Strategic CSR (corporates to rethink quickly beyond just symbolic charity).

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