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2019 challenged India's corporate governance practices

Companies with institutionalized governance practices were better able to withstand the onslaught of 2019. Both equity and debt markets were affected by governance practices in 2019, which is expected to renew focus on responsible investing going forward.

For Corporate India, the past 12 to 18 months have been difficult. With economic growth slowing, achieving business targets has been stretching managements with a few opting for short-term fixes.

The meltdown of two large non-banking finance companies (NBFCs) impacted the flow of funds. With stretched liquidity and a weakened real estate sector, the asset quality of several NBFCs came under scrutiny. One large NBFC was referred to Insolvency and Bankruptcy Code (IBC) within a week of the code being notified for finance companies.

Divergences on asset quality recognition continued to plague the banking sector and the continued weakening of asset quality further deteriorated capital adequacy levels in what is referred to the twin balance sheet problem. The government merged several public sector banks in an attempt to create larger banks (that can better serve a growing corporate India), but whether this creates stronger banks remains to be seen. Meanwhile, the failure of two co-operative banks resulted in anxious deposit holders turning to the Reserve Bank of India (RBI) for help and brought to the forefront the debate on the extent of RBI's oversight over the financial sector.

Developments over the past one year have demonstrated the impact of corporate governance practices for credit markets. The almost USD 20 bn of debt held in companies under the IBC, while being set to clear up, is lesson enough for credit markets on the importance of assessing not just credit ratios, but governance practices before they lend. Other disruptions too affected bond holders during the year. The big issue concerning the Indian credit markets was promoter shareholding being pledged to raise debt. Mutual funds that invested in loan-against-shares products in their Fixed Maturity Plan schemes, rolled over the redemption on maturity date in the hope that a stake sale would result in the bonds being paid up, even as promoters of one bank, one media house, and one industrial solutions company lost control of their businesses because lenders called in the pledge and sold down the equity. Although SEBI introduced side-pocketing to deal with such instances, and tightened disclosure

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requirements, this brought focus on the governance practices of various investment institutions.

Whistle blowers once again came to the fore in raising governance issues. While whistle-blower mechanisms in India work for the most part, today there seems to be a dangerous trend of whistle-blowers using media to get attention. Even so, while whistle-blowers get protection under law, the use of media to raise questions on management has severe repercussions. In a regime where defamation laws are weak, an event of this nature is essentially out of boards' control. Boards can only react, and not pre-empt this. Regulations must consider removing protection afforded to whistle-blowers that directly access media, a practice followed in other geographies.

All these issues tested the governance practices of corporate India in 2019. Companies that had institutionalized their governance practices were better able to navigate the onslaught the myriad issues. In 2019, Institutional Investor Advisory Services (IiAS) evaluated the governance practices of 150 companies - S&P BSE 100 index constituents (BSE 100) + 50 companies listed between April 2015 and March 2017 (IPO companies) - on the Indian Corporate Governance Scorecard framework[1]. This scorecard has been developed jointly by International Finance Corporation (member of the World Bank Group), BSE, and IiAS.

The 2019 study, "Stability despite headwinds" showed that the larger companies have taken their governance practices seriously, resulting in median scores of S&P BSE SENSEX constituents (SENSEX companies) increasing to 61 from 60 in 2018. BSE 100 companies maintained median scores at 58. Yet, at the higher end, the scores of most companies had increased, just as much as at the lower end, the scores had decreased over the previous year. The institutionalization of governance practices led to greater stability of scores for the larger listed companies. IPO companies were not been able to hold ground – median scores for IPO companies declined to 54 from 55 last year, with the lowest company scoring a mere 29.

The study shows that markets have rewarded the more stable and better governed companies. At a portfolio level, well-governed companies (those with a score of 60% or more) outperformed the rest of the pool over a two and three-year period. The analysis holds true for stock Beta too; stock Beta signifies the volatility in stock price movement. Well-governed companies tend to, at a portfolio level, be less volatile than the residual

[1] As all evaluation frameworks do, the methodology of the Indian Corporate Governance Scorecard also has its own limitation. A high score on the scorecard is not an indicator of current or future financial performance, or stock price performance. The scores also do not indicate the permanency of governance practices: a company's governance practices may improve or deteriorate from the date of the scoring. The scorecard is based on publicly available information, which has its limitations and cannot predict corporate behaviour – especially during contentious or divisive situations.

pool of companies. This analysis is not a back-testing of current scores, but an assessment of companies scored in IiAS' earlier studies. Therefore, the assessment on the Indian Corporate Governance Scorecard framework has predictive value.

At a company-specific level, there will be exceptions. Stock-prices of well-governed companies may not outperform the index and vice-versa. Even so, at a portfolio level, the argument of a direct correlation between price performance and stock beta vis-à-vis corporate governance standards holds true.

Investors have a strong role to play in improving the corporate governance practices of companies. This is reflected in the correlation between institutional holding and governance scores: median shareholding of institutional investors is higher for BSE 100 companies at 34%, compared to IPO companies at 24%. 2019 also witnessed an increase in investor engagement levels. With the growing number of issues that companies faced during the year, investors from both the debt and equity side increased their interaction with companies. Lenders took unique positions – some ruthlessly calling in pledges and selling down the equity, others taking on board seats and establishing control. In one instance, lenders refused to accept the promoter's resignation, ensuring that the promoter continues to shoulder the responsibility of finding a resolution for the company instead of walking away.

With both equity markets and credit markets being affected by corporate governance practices in 2019, responsible investing is likely to see renewed focus in 2020.

Exhibit 1: Top 10 performers on the BSE 100 (in alphabetical order)

Cipla

Dr.Reddy's

HDFC BANK

Hindustan Unilever Limited

HDFC

Infosys

marico

TATA MOTORS

TATA POWER

wipro

Notes and Disclosures:

1. *Based on the scores effective 30-Sep-2019; assessment based on the Indian Corporate Governance Scorecard*
2. *HDFC, through its subsidiary HDFC Investments Limited, is one of IiAS' shareholders.*
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