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CONTENTS

Foreign Institutional Investors and Corporate Governance

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Foreign capital flows have come to be acknowledged as one of the important sources of funds for economies that would like to grow at a rate higher than what their domestic savings can support. Foreign capital flows have particularly become prominent after the advent of globalization that has led to widespread implementation of liberalization programmes and financial reforms in various countries across the globe in 1990s. This resulted in the integration of global financial markets. As a result, capital started flowing freely across national borders seeking out the highest rate of return. The net capital flows to developing countries which were at US $ 86.6 billion in 1990 have seen a steady growth over time and are at US $ 228 billion in 2003 representing about 3.6% of the nominal gross domestic product of developing countries. (Global development finance 2004) Initially these capital flows were mainly in the form of syndicated bank loans. But, after the Latin American debt crisis, the debt flows have gradually been replaced with Foreign Direct Investment (FDI) flows and portfolio flows to a great extent.

Table 1 : Net capital flows to developing countries

(US $ billion)

	1970	1980	1990	2000	2001	2002	2003*
FDI	2.2	5.3	24.1	160.6	175.0	147.1	135.2
Portfolio equity flows	...	...	4.5	26.0	4.4	4.9	14.3
Debt	6.4	96.0	58.0	-1.0	-1.2	7.3	44.3

* Estimate

Source: Global development finance various issues

The portfolio flows were virtually non-existent till 1970s. They made a modest beginning in 1980s and assumed significant proportions only in 1990s. They reached a peak in the period prior to the East Asian crisis, but remained subdued thereafter. Though the portfolio flows towards developing countries have always been smaller than the FDI flows, they have always been positive from 1990. In fact, the portfolio flows have registered a substantial increase in the year 2003 and have gone up by more than four fold compared to the previous year.

Foreign capital flows to India

Till the beginning of 1991, India had a highly regulated financial system with a restrictive foreign exchange regime. The country had a closed capital account and the mobility of capital was restricted through administrative controls. In 1991 India suffered a balance of payment crisis and had to devalue the currency. Since it was also faced with the worldwide declining trend in the availability of official assistance, India embarked on economic reforms to transform the controlled economy into a market driven one. This included the financial liberalization strategies like dismantling of capital controls, reforms in trade and investment policies and so on to integrate the Indian financial markets with the global financial markets. All these reforms opened the floodgates to foreign capital flows into the country. The total net capital flows have risen to US $ 12.1 billion in 2002-03 from US $ 7.1 billion in 1990-91. The cross border flows are averaging around US $ 10 billion every year currently. Like elsewhere in the globe, the nature of capital flows has witnessed a transformation over time in India also. The non-debt creating capital flows has come to constitute a higher percentage of the total capital flows. The ratio of non-debt creating inflows to debt creating inflows was 1.5 to 83.3 in 1990-91 as against 44.6 to –6.6 in 2002-03.

Table 2 : Composition of capital flows to India

Year	Total net capital flow (US $ million) 1	FDI flows as a % of 1	Portfolio equity flows as a % of 1	Debt creating flows as a % of 1	Others* as a % of 1
1990-91	7056	1.4	0.1	83.3	15.2
1999-00	10444	20.7	29.0	23.1	27.2
2000-01	10018	40.2	27.6	59.4	-27.2
2001-02	10573	58.0	19.1	9.2	13.7
2002-03	12638	36.9	7.7	-6.6	62.0

* Includes lags and leans in exports, banking capital, loans to non-residents by residents, India's subscription to international institutions and quota payments to IMF.

Source: Reserve Bank of India Annual Report 2002-03

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The portfolio flows have been one of the major forces that has changed the quantum and nature of international capital flows to India. Portfolio flows include the investment in ADRs/GDRs and offshore funds in addition to investment by Foreign Institutional Investors (FIIs). Foreign portfolio investments have been allowed in India on the basis of the recommendations of the Narasimham committee which stated:

'The committee would also suggest that the capital markets should be gradually opened up to foreign portfolio investments and simultaneously efforts should be initiated to improve the depth of the market by facilitating the issue of new types of equities and innovative debt instruments.' (Narasimham committee report, p.121)

Prior to 1992, only non-resident Indians (NRIs) and Overseas corporate bodies (OCBs) were allowed to undertake portfolio investment in India. Only on September 14, 1992 the Government of India issued guidelines on FII investments in India which was followed by a notification by Securities and Exchange Board of India (SEBI) three years later in November 1995.

Ever since the opening up of the market for FIIs, the net investments by FIIs have always been positive every year except in the year 1998-99 where the net investment was negative primarily because of the uncertainty that prevailed after India tested a series of nuclear bombs in May 1998 and the imposition of the economic sanctions by the United States, Japan and other industrialized countries. On an average India has received cross border portfolio investment of around US $ 2.2 billion per year between 1992-93 and 2002-03 of which close to US $ 1.2 billion per year on an average is the share of FIIs. The cumulative FII investment in India is around US $ 19 billion and the FII investment in India account for over 10 per cent of the total market capitalization of the Indian stock market.

Table 3 : FII investment in India

(US $ million)

Year	Total Portfolio flows	FII investment @	GDRs/ ADRs*	Offshore funds
1992-93	244	1	240	3
1999-00	3026	2135	768	123
2000-01	2760	1847	831	82
2001-02	2021	1505	477	39
2002-03#	979	377	600	2

Provisional

@ Represents fresh inflow of funds by FIIs

* Represents the amount raised by Indian corporates through Global Depository Receipts (GDRs) and American Depository Receipts (ADRs)

Source: Reserve Bank of India Annual Report 2002-03.

The investments by FIIs have been registering a steady growth since the opening of the Indian capital markets in September 1992. That this trend has come to stay is evident from the fact that the FIIs investment in equity and debt markets amounted to Rs.130 billion in the first quarter of calendar 2004, nearly 447% higher than Rs.24 billion in the corresponding period of calendar 2003. Equity investments by FIIs amounted to Rs.112 billion between January and March 2004 as compared with Rs.17 billion in the corresponding period last year. The equity investments by FIIs in the first quarter of calendar 2004 are close to 50% of the total equity investments worth Rs.244 billion made in the year 2003.

Corporate governance problem

Corporate governance is the system of control mechanisms, through which the suppliers of finance to corporations assume themselves of getting a return on their investment. (Shleifer and Vishny 1997) The formulation of corporate governance problem rests on the divorce of ownership and control in the modern companies. In large companies if the shareholders are a disorganized body then it may not be beneficial for them to closely monitor the company given the cost and benefit of such a monitoring. This may result in managers pursuing their own goals that may be in partial or complete disregard of the objectives of the shareholders. In such a situation, the principal-agent problems arise, as shareholders cannot perfectly control managers. Literature on corporate governance offers two important solutions to this problem. One is the developed and disciplined capital market and the other being the institutional investors as shareholders.

The developed capital market is an efficient allocator of capital. The efficiency or otherwise of a company's management is immediately and perfectly reflected on how the company's shares are quoted in the stock market. If a company's managers neglect the interests of the shareholders and concentrate on maximizing their own benefits, then in a developed stock market the price of such a company's share would considerably decline. If the economic fundamentals of the company suggest a price higher than its current market price, which is only because of the fraudulent or negligent management, then such a company will become a target for hostile takeover. (Herzel 1994) Kreps (1990) argues that the desire of managers to maintain reputation in the market will help to protect shareholders.

The second solution to the problem of corporate governance rests on the economic changes in the structure of share ownership. (Black 1990) It suggests that the institutional investors as shareholders will be in a better position to monitor and control the managers. It is argued that the individual investors may find it difficult to enforce their rights owing to the difficulty in acting in a concerted

manner. It may be uneconomical for them to collect information and monitor management. But the institutional investors may easily overcome this problem given their size. The presence of institutional investors among the shareholders of a company may, therefore, offer a solution to the problem of corporate governance.

Institutional investors and the corporate governance models

As mentioned earlier, the development of institutional investors and their growing dominance as owners of companies is expected to have pervasive influence on corporate governance. Since these institutional investors are the custodians of the funds of a large number of individual investors, they can avoid the rational apathy of small shareholders. They can economically benefit from collecting information and monitoring the management of the company. The institutional investors may also choose to find it easier to enforce their rights in court. These arguments assume more weight in case of the FIIs portfolio investment. Since the companies compete for finance in capital market, they face demand for better information, both in terms of quality and quantity. Foreign portfolio investors, who do not have the advantage of access to information that an insider enjoys, may place high demands on information disclosure and transparency, thus forcing companies to adhere to better governance systems.

Though theory is more in favour of offering institutional shareholding as one of the important solutions to the problem of corporate governance, the researchers who have studied this phenomenon have come out with highly contradicting findings. While some observe that the institutional investors do emerge as an influential force on the corporate governance system of a company, others argue, on the basis of their observation, that the behaviour of institutional investors replicates that of small shareholders and they tend to pursue their own investment objectives.

Shleifer and Vishny (1986) observe that institutional investors, by virtue of their large shareholdings, can reduce the incidence of agency problems that arise because of the divergence of interests between managers and shareholders, by monitoring. The rise of globally diversified mutual funds seems to create 'pressure for the standardization of information on companies, according to Ibbotson and Brinson (1993, p.321) Useem (1994) argues that most financial money managers would prefer companies throughout the world to observe shareholder rights, maximize shareholder value and be transparent in their reporting of corporate activities and results. Aoki (1995) suggests that large shareholding is a necessary condition than a sufficient condition for monitoring services. Holderness and Sheehan (1991) accept that the large shareholders have a greater incentive to monitor. However, they argue that the firm value may not increase if they lack the relevant managerial skills. Sengupta (1998) has found a positive relationship between quality of corporate disclosure and bond ratings. The study by Ajinkya, Bhojraj and Sengupta (1999) has brought out a positive relationship between financial analysts' ratings of corporate disclosure practices and institutional stock ownership. Feldstein (2000) has noted that foreign capital flows can offer several other advantages in addition to allowing capital to seek out the highest rate of return. First, international flows of capital reduce the risk faced by owners of capital by allowing them to diversify their lending and investment. Second, the global integration of capital markets can contribute to the spread of best practices in corporate governance, accounting rules and legal traditions. Third, the global mobility of capital limits the ability of governments to pursue bad practices. Goswami (2000) has observed that FIIs have steadily raised their demands for better corporate governance, more transparency and greater disclosure.

Some argue that the presence of free rider problem will prevent the institutional investors from engaging in monitoring of management. (Levmore 1982, Black 1990, Coffee 1991 and Monks 1995) If a given institutional investor incurs the cost of monitoring the corporate management the benefits of which are going to be shared by other institutional investors and individual shareholders the problem of free rider emerges. As a result, none of the institutional investor will monitor the management. Hirschman (1970) has distinguished three possible reactions to bad performance on the part of firms or organisations: exit, voice and loyalty. Loyalty is a characteristic of large family investors and sometimes, individual investors, but not the institutional investors. The institutional investors' capacity to create 'voice' is greater than in the case of individual investors, but should not be overestimated. Marsh (1990) argues that the performance of fund managers is evaluated over a shorter time period. He says that the active monitoring by the institutional investors, therefore, works against the short-term performance measurement. This argument is supported by the evidence found in India by Mohanty(1998). The findings of other research works in India also support this argument. Khanna and Palepu(1999) and Verma (1997) have found that the institutional investors play a passive role in the corporate governance system of Indian companies. The finding of Sarkar and Sarkar (2000) has been similar in the case of development financial institutions as well when their combined holding is less than 25%. However they have found that when the debt holdings of the Development financial institutions are high, they play an active role in monitoring the performance of the companies. Charkham (1994) argues that most of the institutional investors manage a widely diversified portfolio

and as a result do not influence the corporate governance system. Empirical study by the Price Water House (1998) shows that the institutional investors only rarely attempt to influence management. Their corporate governance capacity lies in professionalizing information gathering and investment strategy (Exit). McKinsey (2000) has found that the institutional investors are willing to pay more for the stocks of a 'well governed company' than for a 'bad governed company', assuming equal financial performance.

Research on issues of corporate governance is more than a few decades old in United States and Europe, but it is of recent origin in India. Studies on corporate governance relating it to foreign institutional investors are particularly few as the FIIs are allowed to enter the Indian capital market only in September 1992. Hence this paper analyses the relationship between investment by FIIs and corporate governance in India.

Sample

To analyze the relationship between FIIs shareholding and corporate governance, the study has chosen the 42 companies that are rated by the Standard and Poor's survey on transparency and disclosure. The survey covers 1600 companies across the globe from 40 markets and representing about 70% of the world's tradable market capitalization. This survey included 42 Indian companies. The companies are evaluated on the basis of 98 possible information attributes grouped into three sub-categories: ownership structure and investor relations (28 attributes), financial transparency and information disclosure (35 attributes) and board and management structure and processes (35 attributes). The inclusion of each attribute is scored on a binary basis representing a 'yes' (included) or 'no' (not included) answer. The companies are rated on a scale of 1 to 10. On the basis of this rating the 42 companies are grouped into good governance companies and bad governance companies. The good governance companies are the companies that have scored a minimum of 5 on the corporate governance rating score and all other companies which have scored 4 and below are classified as bad governance companies. Accordingly, we have ended up with 17 good governance companies and 25 bad governance companies. One surprising observation of this survey is that the blue chip Indian companies are not necessarily rated high on disclosure and corporate governance. Companies like Hindustan lever, Reliance industries, and State bank of India, ITC. Dr. Reddy laboratories fall into the category of bad governance companies. Cipla, with a rating of 2 out of 10, is the worst governed company in our sample. The best-governed companies in our sample are Infosys and SSI with a ranking of 7 out of 10 each.

Data

Data for grouping the companies into good governance companies and bad governance companies has been sourced from the website of Standard and Poor. Though a few institutions in India like CRISIL and ICSI also rate companies, such ratings are not available for all the companies included in the sample. Hence no comparison of the results using the ratings done by different agencies is possible. The information on the shares held by the FIIs in the sample companies as of March 31, 2004 and March 31, 2003 is obtained from the website of the National Stock Exchange and Bombay Stock Exchange.

Methodology

The study compares the quantum of shares held by FIIs in the two groups of good governance and bad governance companies and infers from it.

FIIs investment in sample companies

Data on the shareholding pattern of the 42 sample companies reveals the following observations. As on March 31, 2004 FIIs hold shares in each of these companies. The company with the highest shareholding by the FIIs as on March 31, 2004 is Housing finance development corporation with 61.55% of the outstanding shares held by them followed by Satyam where it is 51.27%. BPL is the company, which has the most negligible shareholding by FIIs at 0.01%.

Table 4 : FIIs investment in sample companies

Category of shareholder	Shares held as on 31/03/04	Percentage of total outstanding shares as on 31/03/04	Shares held as on 31/3/03	Percentage of total outstanding shares as on 31/03/03
Promoters	4215697	37.10	3965560	36.18
Mutual funds	391675	3.45	576844	5.26
Banks/ Financial institutions/ Central govt./ state govt./ non-govt. institutions	1233012	10.85	1475251	13.46
FIIs	2227836	19.60	1648703	15.04
Private companies	433852	3.82	441737	4.03
Indian public	2009326	17.68	2017614	18.41
NRIs/OCBs	87537	0.77	103813	0.95
Others	765400	6.74	731469	6.67
Total	**11364338**	**100**	**10960991**	**100**

The total shares held by the FIIs in these 42 companies are 19.60% of the total outstanding shares issued by them. FIIs are the second largest shareholders of these companies next to only the promoters. The investment held by the domestic mutual funds, domestic financial institutions and the Indian public are less than that of the FIIs. A look at the comparable figures for March 31, 2003 shows that FIIs

have increased their shareholding over the period March 2003-04, whereas every other category of shareholder has brought down their investment. The FIIs, which were the third largest shareholder in March 2003 next to, the promoters and the Indian public, have come to occupy the second position because of their additional investment made during the period.

It can be expected that the FIIs can play a useful role in monitoring the company management because of the size of their shareholding. They may prevent the company from indulging in malpractices and taking decisions that are investor unfriendly. This argument has an inherent weakness in that the portfolio investment of the FIIs cannot remain held in the shares of a single company. They need to continuously churn their portfolio in order to maximize the return on their funds. But they are expected to exert pressure on the company management only by their selling and buying activity.

Results

The findings of the study, reported in table 5, suggest that the quantum of shares held by FIIs is not significantly different across good governance and bad governance companies. This suggests that the FIIs may not really be driven by the governance systems of the companies as the investments that are considered here are of portfolio in nature. The findings in case of the Domestic Financial Institutions (DFI) are similar. Their shareholding patterns are also not significantly different across the companies with good and bad governance systems.

Table 5 : T test results

		N	Mean	Standard deviation	T value
FIIs	Good governance companies	17	24.1624	18.3684	2.049*
	Bad governance companies	25	14.3240	8.9470	
DFIs	Good governance companies	17	10.1906	8.0948	0.463*
	Bad governance companies	25	9.1124	6.9097	

* p>.05

Discussion on the findings

In this paper an analysis of the shareholding patterns of the FIIs are done by grouping companies into good governance and bad governance companies. It is found that the investments by FIIs are not significantly different across the two groups of companies. This may be because of the fact that the investments considered here are the portfolio investments, which are highly liquid. The FIIs can shuffle their portfolio and exit from the stocks of companies in which they visualize a problem. The observations for the country as a whole bear similar trends. Though the monthly FII flows to India have been mostly positive, the flows have also been negative during the periods of external shock or a domestic political uncertainty. Gordon and Gupta (2003) have shown that there tends to be an immediate negative reaction by FIIs to adverse domestic or external events. For example, they have elaborate, the FII flows turned negative in September 2001 following the 9/11 terrorist attacks, though recovered after a month. As mentioned earlier the FIIs investment flows were negative when there was an uncertainty that followed the India' nuclear tests in May 1998. This suggests that the FIIs, like other institutional investors, may only evaluate the performance of the company when they decide to include its stock in their portfolio rather than go by their governance system. Mohanty (1998) concludes, on the basis of the findings of his study of mutual funds and development financial institutions, that, 'however we find that there is no effect of equity investment of institutional investors on the corporate governance records of the companies. Rather the institutional investors as a group have invested in companies with good financial performance'. Drucker (1976) has rightly put it as ' ... it is their job to invest the beneficiaries' money in the most profitable investment. They have no business to manage. It they do not like a company or its management, their duty is to sell the stock ...' One more reason for the current finding could be that the study considers the investment of all the FIIs in a company for its analysis, where a large number of such FIIs may collectively hold the investment. It can be noticed that at least in some of the 42 companies included in the sample only a small number of FIIs hold more than 1% of the shares which may mean the FIIs may not attach much of importance to the governance system in the company as its shareholding is minimal.

That there is no difference in the shareholding pattern of domestic financial institutions across the companies grouped into good governance and bad governance companies is supported by the results of various prior researches on corporate governance. Khanna and Palepu (1999) have found that the domestic financial institutions in India are ineffective monitors. They argue that the domestic financial institutions in India are insufficiently oriented, if at all, toward the task of monitoring managers, and are thus unlikely to exercise effective governance. Many researchers have brought out that the domestic financial institutions lack the requisite monitoring skills in the emerging markets. Qian (1995) has brought to light the creation of a monitoring vacuum in China following the withdrawal of the state from monitoring its enterprises. The commercial banks in Russia have no experience with

market accounting and governance and are therefore in no position to control managers. (Frydman et al. 1993) In Eastern Europe, according to Rapaczynski (1996), the various supervisory bodies are incapable of genuine monitoring. The observation by Berglof (1995) in Czech Republic is similar. He points out that the investment privatization funds that hold concentrated blocks of capital are not active in corporate governance.

Conclusion

This study analyses the quantum of investment by FIIs across companies grouping them into good governance and bad governance companies. It does not find any significant relationship between the investment by FIIs and the governance of the companies. However, more insights we could have by studying the quantum of investment of individual FIIs and the governance systems of the companies.

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S&P governance ranking for the selected companies

Good governance companies

Serial Number	Company	Comprehensive ranking
1	B P L Ltd.	5
2	B S E S Ltd.	6
3	Digital Globalsoft Ltd.	5
4	G T L Ltd.	5
5	Grasim Industries Ltd.	6
6	Gujarat Ambuja Cements Ltd.	5
7	Himachal Futuristic Communications Ltd.	6
8	Housing Development Finance Ltd.	6
9	I C I C I Ltd.	5
10	Infosys Technologies Ltd.	7
11	Larsen & Toubro Ltd.	5
12	N I I T Ltd.	6
13	Ranbaxy Laboratories Ltd.	6
14	S S I Ltd.	7
15	Satyam Computer Services Ltd.	5
16	Tata Tea Ltd.	5
17	Videsh Sanchar Nigam Ltd.	5

Bad governance companies

Serial Number	Company	Comprehensive ranking
1	Associated Cement Cos. Ltd.	4
2	Bajaj Auto Ltd.	4
3	Bharat Heavy Electricals Ltd.	4
4	Cipla Ltd.	2
5	D S Q Software Ltd.	3
6	Dr. Reddy's Laboratories Ltd.	4
7	H C L Infosystems Ltd.	4
8	Hindalco Industries Ltd.	4
9	Hindustan Lever Ltd.	4
10	Hindustan Petroleum Ltd.	4
11	I T C Ltd.	4
12	Indian Petrochemicals Corporation Ltd.	4
13	Mahanagar Telephone Nigam Ltd.	3
14	Mahindra & Mahindra Ltd.	4
15	Pentamedia Graphics Ltd.	4
16	Raymond Ltd.	3
17	Reliance Capital Ltd.	3
18	Reliance Industries Ltd.	4
19	Rolta India Ltd.	4
20	Silverline Technologies Ltd.	3
21	State Bank of India	4
22	Sterilite Industries (India) Ltd.	3
23	Tata Iron & Steel Ltd.	4
24	Tata Motors Ltd.	4
25	Zee Telefilms Ltd.	4

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