



REPUBLIC OF INDIA

Corporate Governance of Central Public Sector Enterprises

JUNE 2010



Contents

| Ack | knowledgements | V |
|-----|---|----------------|
| Glo | ossary | vi |
| Exe | ecutive Summary | 1 |
| 01. | Objectives and Methodology | 5 |
| 02. | Context for CPSE Governance | 7 9 |
| 03. | Imposing Market Discipline | 20 |
| 04. | Improving the State's Ownership Role | 26 |
| 05. | Professionalizing CPSE Boards A. Strengthening Board Composition and Structure B. Empowering CPSE Boards C. Strengthening Audit Committees D. Introducing Board Remuneration and Evaluation Systems | 42 45 48 |
| | Enhancing Disclosure and Transparency A. Enhancing Disclosure | 52 55 |
| | Next Steps | 5/ |
| | nex 1: Understanding the Impact of Policy Measures on the formance of CPSEs | 59 63 64 |
| | F. The MOU System and Performance | 68 |

Tables and Figures

| Table 1: Main Recommendations | 3 |
|--|----|
| Table 2: Top Ten Companies by Income | 10 |
| Table 3: Top Ten Profit-Making CPSEs | 10 |
| Table 4: Brief History of Public Sector Reforms in India since Liberalization in 1991 | 11 |
| Table 5: Top Ten Loss Making CPSEs | 12 |
| Table 6: Breakdown of CPSEs by Ministry | 16 |
| Table 7: Board Selection and Appointment Process | 37 |
| Table 8: Coverage of MOU System | 39 |
| Table 9: Brief history of Memoranda of Understanding System | 40 |
| Table 10: CPSEs in the Sample of 25 Companies used in Figures Below | 60 |
| Table 11: Companies by Ownership in the Dataset | 65 |
| Figure 1: Structure of CPSE Oversight | |
| Figure 2: Distribution of SOEs by Sector | |
| Figure 3: Sales to National GDP: 1997-2005 | |
| Figure 4: Annual Sales Growth Rate of all SOEs: 1998-2005 | |
| Figure 5: Profit of CPSEs to National GDP: 1997-2005 | 61 |
| Figure 6: Loss of CPSEs to National GDP: 1997-2005 | 61 |
| Figure 7: Business Costs of Private Companies, 1992-2005 | 61 |
| Figure 8: Business Costs of CPSEs, Sample of 25, 1992-2005 | 61 |
| Figure 9: Business Costs of Private Companies, 1992-2005 | 62 |
| Figure 10: Business Costs of CPSEs, 1992-2005 | |
| Figure 11: Return on Assets of Private Firms and SOEs, 1992-2005 | |
| Figure 12: Efficiency of Private Firms and SOEs, 1992-2005 | 62 |
| Figure 13: Return on Sales of Private Firms and SOEs, 1992-2005 | 62 |

ACKNOWLEDGEMENTS

This report was prepared by David Robinett, Varsha Marathe, and Sunita Kikeri of the World Bank. The report is based on a template/ questionnaire completed by Sumant Batra, and additional inputs provided by Pavithra Suryanarayan, and Pratip Kar, consultants.

The Review reflects technical discussions with the Ministry of Heavy Industries and Public Enterprises, Ministry of Chemicals & Fertilizers, Comptroller and Auditor General, Standing Committee on Public Enterprises, Bombay Stock Exchange, Confederation of India Industry, Public Enterprise Selection Board, Board for Reconstruction of Public Sector Enterprises, and CMDs, directors, and company secretaries of central public sector enterprises. Alexander Berg, Parminder Brar, Manoj Jain, Dhruba Purkayastha, Vijay Tata/Yesha Yadav, and Chunlin Zhang provided advice and comments.

The report incorporates comments received at the "Workshop on Developing an Agenda for Corporate Governance" organized by the Department of Public Enterprises (DPE) in Delhi, February 15-16, 2010. It has been updated to reflect all changes through June 2010. The report has been discussed with the Government of India but does not necessarily bear their approval for all its contents, especially where the Bank has stated its judgment/opinion/policy recommendations.

GLOSSARY

ACC: Appointments Committee of Cabinet

BIFR: Board for Industrial and Financial Reconstruction

BPE: Bureau of Public Enterprises

BRPSE: Board for Reconstruction of Public

Sector Enterprises

CA: Companies Act

C&AG: Comptroller and Auditor General

of India

CBI: Central Bureau of Investigation

CG Guidelines: Corporate Governance

Guidelines issued by the DPE

CPSE: Central Public Sector Enterprise

CVC: Central Vigilance Commissioner

DPE: Department of Public Enterprises

FCI: Food Corporation of India

Gol: Government of India

GRI: Global Reporting Initiative

HPC: High Power Committee

ICAI: Institute of Chartered Accountants

of India

IFRS: International Financial Reporting

Standards

IPO: Initial Public Offering

MCA: Ministry of Company Affairs

MHI&PE: Ministry of Heavy Industry and

Public Enterprises

MoF: Ministry of Finance

MoU: Memorandum of Understanding

NCMP: National Common Minimum

Programme

NIF: National Investment Fund

PESB: Public Enterprises Selection Board

PIB: Public Investment Board

PMA: Permanent Machinery of Arbitration

PSU: Public Sector Undertaking

RIA: Right to Information Act

SCOPE: Standing Conference of Public

Enterprises

SC/ST: Scheduled casts/scheduled tribes

SEBI: Securities Exchange Board of India

SICA: Sick Industrial Companies (Special

Provisions) Act, 1985

CPSE: State Owned Enterprise

UNGC: United Nations Global Compact

VRS: Voluntary Retirement Scheme

Corporate Governance of Central Public Sector Enterprises

EXECUTIVE SUMMARY

The Government of India (GOI) has taken a number of steps over the years to improve the efficiency and performance of its Central Public Sector Enterprises (CPSEs). Corporate governance has been an important part of GOI's broader CPSE and economic reforms, aimed at improving the performance and competitiveness of some of India's most important national assets, allowing companies easier access to the capital markets, and making companies more transparent and accountable. The underlying goal is to reorient the state's role away from a market player to a market regulator and away from day-to-day management of CPSEs towards exercising its core ownership rights based on sound corporate governance principles.

To this end, the Department of Economic Analysis (Ministry of Finance) and the Department of Public Enterprises (Ministry of Heavy Industry and Public Enterprises) requested World Bank support in assessing CPSE corporate governance in light of good practice based on the OECD Guidelines on Corporate Governance of State-Owned Enterprises, and in light of India's own Guidelines on Corporate Governance of State-Owned Enterprises issued in 2007. This report carries out the review and offers recommendations for improving CPSE governance. It is based on a review of the legal and regulatory framework, the findings and reports carried out by various government commissions and expert groups on CPSEs, background research on CPSE performance, discussions with key stakeholders, and case studies of two leading CPSEs—the Oil and Natural Gas Corporation and the National Thermal Power Corporation.

The governance framework for CPSEs is consistent with several aspects of international good practice. Substantial progress has been made in removing barriers to competition, reducing government financial support, and listing of CPSEs on the capital markets. Almost all CPSEs are corporatized and come under the same laws as private sector companies. Key decision making powers have been delegated to leading enterprises and other profitable CPSEs. Memorandums of Understanding (MOUs) have been signed by most CPSEs and have emerged as a key tool in monitoring and motivating performance. Clause 49 of the Listing Agreement has helped put listed CPSEs on the same footing as private companies and the 2007 Corporate Governance Guidelines have helped to extend these practices to non-listed CPSEs. CPSE boards are required to have independent members and are now bringing in directors with private sector experience. Extensive information is provided on CPSEs to the public, at both the sector and enterprise level.

Yet governance challenges still remain and further reforms are needed to build on the substantial gains that have already been achieved. There are still critical differences with the private sector that distort competition and market incentives. These include certain legal and financial privileges that favor CPSEs on the one hand and social obligations and human resource rules that constrain them on the other. A complex ownership framework combines the conflicting roles of policy-making and ownership in some ministries, allows political interference in board appointments and commercial decision-making to continue, and weakens board powers. CPSE boards continue to be oriented to the public sector and are rarely if ever evaluated on their performance. Implementing disclosure requirements is a challenge

for many CPSEs, particularly in light of relatively weak internal audit and control functions, lack of guidance on disclosure for non-listed firms, and potential duplication and delays in the various CPSE audits. This report addresses these challenges. The main findings and recommendations of the report are summarized below.

First, corporate governance reforms are and should be seen as part and parcel of the broader CPSE reform program rather than as a stand-alone or substitute reform. Reforms aimed at improving governance and increasing CPSE autonomy—such as board appointment and empowerment, separation of ownership from policy functions—can facilitate broader policy reforms aimed at increasing market discipline through exposure to competition, tightening of budget constraints, listing of CPSEs on the stock exchange, and bringing in private sector participation. Market discipline in turn puts pressure on CPSE to adopt further governance reforms and ensure transparency and accountability. It also helps maximize—and sustain—the gains from improved governance.

Second, GOI should target corporate governance efforts at Navratnas, Miniratnas, and other profitable companies. In tandem with other policy reforms, this would help achieve even higher levels of performance of some of India's most important companies. It would allow companies to graduate to higher categories, giving them greater delegation of powers and more autonomy while requiring higher levels of transparency and accountability. It would also help facilitate listing of such companies on the capital markets. For consistently loss-making or unviable companies, the focus should be on restructuring through freeing up land for more productive use elsewhere in the economy, implementation of VRS and retraining programs, and closure or liquidation.

Third, expanding and deepening corporate governance reforms requires action on three main fronts. These are as follows (detailed recommendations are provided in Table 1):

- Strengthening the state's ownership role: How the state organizes and exercises its ownership rights is central to improving CPSE governance. The main challenge lies in making a complex and controloriented ownership framework more effective in striking the right balance between CPSE autonomy and accountability. This can be achieved by: (i) reforming ownership arrangements with a view to focusing the role of administrative ministries on policy-making and limiting their day-to-day role in commercial decision-making, giving boards greater decision-making powers in practice, and considering moving to a more centralized ownership model in the longer-term; (ii) improving the ways in which GOI exercises its key ownership functions, in particular enhancing transparency in the board appointment process and improving performance monitoring; (iii) enhancing the role and capacity of the Department of Public Enterprises as a nodal agency to make it a more active promoter of the governance agenda; and (iv) improving the Corporate Governance Guidelines so that they become a more effective governance tool.
- Professionalizing CPSE boards: While boards have come a long way in becoming more professional over the years, there is still substantial room for improvement. Particularly in the case of Navratnas, Miniratnas, and other profit-making companies, boards could be made more effective by bringing in independent directors from the private sector, empowering boards with greater decision-making authority while ensuring fair and responsible behavior through integrity and accountability mechanisms, strengthening audit committees, introducing performance-based board evaluation and remuneration practices, and making board development and leadership programs mandatory.

• Enhancing transparency and disclosure: CPSE disclosure standards are comparable to many OECD countries while the Right to Information Act has pushed the frontier even further on transparency and accountability. Implementation is the main challenge. These requires improving company reporting and disclosure, strengthening internal audit functions, and continue to streamline the audit system to avoid duplication and ensure timeliness.

TABLE 1: Main Recommendations

A. IMPOSE MARKET DISCIPLINE

- Tighten budget constraints and establish market relations with state owned banks
- Advance CPSE listings on the capital markets
- Identify and finance non-commercial obligations directly from the government budget
- Make human resource policies more marketbased
- Allow unviable companies to exit the market

C. PROFESSIONALIZE CPSE BOARDS

- Bring in more private sector candidates as independent directors
- Reduce board size
- Separate the roles of board chairman and managing director
- Make board leadership/development programs mandatory
- Empower CPSE boards with greater decisionmaking authority
- Strengthen the audit committee of the board
- Introduce a professional board evaluation and remuneration process

B. STRENGTHEN THE STATE'S OWNERSHIP ROLE

- Consider moving to a centralized model as a medium to long-term option
- Target corporate governance efforts on Navratnas, Miniratnas, and profitable companies
- Focus the ministries role on core ownership functions and limit their day-to-day role
- Enhance the role and capacity of the Department of Public Enterprises
- Improve the Corporate Governance Guidelines to make them more effective
- Enhance transparency in the board appointment process
- Improve the performance monitoring or MOU system

D. ENHANCE TRANSPARENCY AND DISCLOSURE

- Mandate disclosure of non-commercial obligations and related party transactions
- Provide implementation support to CPSEs
- Monitor and disclose compliance with disclosure requirements
- Strengthen internal controls and audit
- Make supplementary audits timely and carry out compliance audits on a selective basis

Fourth, successful implementation requires careful management of the corporate governance reform process. A number of commissions and expert groups have studied CPSE governance in depth and have offered recommendations for improvement. Indeed, much of this report draws from and reflects on the findings of these studies. In short, the policy and technical solutions are known. The challenge going forward is instead one of implementation. Entrenched groups may oppose or find other ways to resist governance reforms. Implementation requires fundamental changes in organization, incentives, and behavior that can be difficult to achieve. And governance reforms are ongoing processes that evolve and unfold over time. Managing these challenges will therefore require attention to the reform process itself, in particular to the need for: (i) political leadership and commitment; (ii) phasing or sequencing of reforms based on the political and institutional feasibility of reform; (iii) creation of strong institutions with dedicated reform teams to manage and sustain the process; (iv) building of public support to overcome stakeholder resistance to reform; and (v) development of monitoring systems early in the process to evaluate impacts, ensure transparency and accountability, and provide a feedback loop to adjust course as needed.

Fifth, the following steps are suggested for taking the CPSE corporate governance agenda forward. These include:

- Development of a strategy for implementing the CPSE reform agenda: A sequenced or phased strategy could be considered, based on political and institutional feasibility. Based on further political economy analysis, recommendations and actions can be categorized into two groups: (i) "low-hanging fruit" or a set of recommendations that are not particularly controversial and can be relatively easily done—for example, bringing in more independent directors from the private sector, improving MOU indicators, enhancing disclosure; and (ii) the more difficult set of recommendations that may require time and a change in mindset, for example, development of a more centralized approach to managing the state's ownership functions, disinvestment of state shares, and exit of unviable companies.
- Revision of the CG Guidelines: As discussed in the report, the current Guidelines are too narrow in scope and may also require making certain provisions mandatory in order to give it teeth and enforce implementation. DPE should take stock of CPSE compliance with the Guidelines to date and based on the findings the Guidelines should be revised with a view to also making them more comprehensive.
- *Monitoring of compliance with the CG Guidelines:* In developing such a monitoring system, DPE could draw from the monitoring requirements established for listed companies and from international experience with performance monitoring systems in general.
- Implementation of company-level governance reforms in 2-3 pilot cases of Miniratnas and profitable companies. A pilot exercise along these lines may help upgrade their status and facilitate listing on the stock exchange. It would also provide tangible improvements and benefits that could create momentum for more widespread implementation across CPSEs.
- Enhance DPE's capacity to carry out the above steps. Some of the above activities (e.g. development of the strategy, revision of the Code, monitoring indicators) may require inputs from specialized experts or consultants to help with design and implementation and/or exposure of DPE staff to training and international good practice. Donor agencies could help support this process.

01. Objectives and Methodology

Central public sector enterprises (CPSEs) and other public sector undertakings have long played an important role in the Indian economy. Post-independence, they were created as vehicles for industrial and regional development, creation of basic infrastructure networks, and employment generation. A large number of CPSEs were initially set up as green field projects. Others, mainly sick companies, were taken over from the private sector. CPSEs and other public sector undertakings remain important contributors to the economy, contributing nearly a quarter of India's national GDP in terms of gross sales and around 2 percent of the GDP in terms of profits in 2005-06. Through CPSEs, the government owns or controls significant interests in key sectors with significant economic impact, including infrastructure, oil and gas and mining, and manufacturing.

Over the decades, the Government of India (GOI) has taken a number of steps to improve CPSE performance, including through better corporate governance. Reforms during the 1990s focused on liberalization and deregulation of most sectors, disinvestment of government shares, greater autonomy through delegation of decision-making powers to leading companies, and the development of a performance monitoring system to ensure accountability. These and other steps to strengthen CPSE boards and enhance transparency evolved into a more comprehensive governance approach, culminating with the Guidelines on Corporate Governance of State-Owned Enterprises issued in 2007. Governance reforms gained prominence for several reasons: increased pressures on CPSEs to improve further their competitiveness as a result of exposure to competition and hard budget constraints; listing of CPSEs on the capital markets; and a slowdown in disinvestment. Underlying all of these factors is a desire to shift the government's role from a market player to a market regulator and to reorient it away from day-to-day management of CPSEs towards exercising its core ownership or shareholder rights based on sound corporate governance principles.

In this context, the Department of Economic Analysis (Ministry of Finance) and the Department of Public Enterprises (Ministry of Heavy Industry and Public Enterprises) requested World Bank support to carry out a review of CPSE corporate governance. This report summarizes the main findings of the review. Its mains goals are to: (i) examine current CPSE governance frameworks and practice in light of good practice based on the OECD Guidelines on Corporate Governance of State-Owned Enterprises, and in light of the 2007 Guidelines on Corporate Governance of State-Owned Enterprises issued in 2007; and (ii) offer recommendations for improving governance. In doing so, the report is expected to help instill greater market discipline and achieve higher levels of CPSE performance, allow CPSEs access to financing from the capital markets, and bring higher levels of transparency and accountability to the sector as a whole. A better functioning CPSE sector in turn should help improve enterprise efficiency, enhance investment, ensure delivery of key public services, and boost economic growth.

The report's scope is limited to CPSEs which are defined as non-financial enterprises with a corporate form in which the national government holds, directly or through other CPSEs, 51 percent or more of ownership. It does not include other state-owned enterprises such as departmental enterprises (e.g. railways, post and telegraph), state-owned financial institutions (banks and insurance companies), and companies in which the central government has less than 51 percent ownership. While these are presently excluded, many of the report's findings and recommendations may apply to these enterprises—as well as to the many state-owned enterprises at the state level. They may also help catalyze support for improving governance of the broader state-owned sector as a whole.

The report is based on: (i) a diagnostic review of the legal and regulatory framework for CPSE governance; (ii) the findings and recommendations of various commissions and expert groups appointed by GOI on CPSE governance; (iii) background research on the financial performance of CPSEs; (iv) discussions with key stakeholders such as the ministries, government advisory bodies, companies, Securities and Exchange Board of India, Standing Conference of Public Enterprises, the Bombay Stock Exchange, the Confederation of Indian Industry; and (v) an analysis of corporate governance practices in two specific CPSEs, the Oil and Natural Gas Corporation of India (ONGC) and National Thermal Power Corporation (NTPC), two of India's largest and best performing CPSEs. Any review of corporate governance has its limits without assessing the qualitative aspects of how governance reforms work in practice. While such a review is difficult to do on a large and representative scale and was not part of this exercise, these two cases may begin to help fill in the gaps in understanding practice.

The report is organized into six main sections. Section II provides the overall rationale and context for CPSE corporate governance, including a brief history of CPSE reform, an overview of the role and performance of CPSEs, and the challenges and benefits of reforming the existing governance framework. Section III focuses on broader market discipline forces that help drive and sustain governance reforms. Section IV covers the role of the state as an owner, in particular the way in which the state organizes ownership arrangements and exercises its key ownership functions. Section V covers the board of directors, focusing on their structure and composition, delegation ofpowers, and board remuneration and evaluation policies. Section VI looks at issues of transparency and disclosure. Section VII concludes with next steps in taking the CPSE corporate governance agenda forward.

02. Context for CPSE Governance

A. Brief History of CPSE Reform

CPSE reform has been a critical component of India's broader economic policy for more than five decades. As early as 1956 the Industrial Policy Resolution called for CPSEs to be given greater autonomy and be organized on business lines. In 1965 the Bureau of Public Enterprises, later the Department of Public Enterprises (DPE), was established to report on CPSE performance. And in the mid 1980s the Memorandum of Understanding (MOU) system was introduced to increase enterprise accountability.

The 1991 New Industrial Policy cemented and expanded the reforms of the previous decades. It envisioned a greater role for the private sector, opened up sectors to competition, and highlighted the need for CPSEs to innovate and lead in areas of "strategic" importance. To raise resources and encourage public participation, the policy also called for the partial sale of shares of CPSEs and other state-owned enterprises to financial institutions and the public through the disinvestment program. Boards were to become more professional, and emphasis was placed on the MOU system to give managers greater autonomy while holding them accountable. The policy called for the restructuring of poorly performing or sick enterprises while developing social security mechanisms to protect affected workers.

Various policy measures were implemented over the next several years (*Table 2*). Phase 1, from the early to mid-1990s, focused on deregulation and liberalization which aimed to reduce the number of strategic sectors reserved for CPSEs. Over time the number of reserved sectors was reduced to just three: military equipment; atomic energy; and railway transport. Disinvestment also began, albeit slowly, with the sale of minority shares on the stock exchanges (*Box 1*).

BOX 1: Disinvestment in India

Disinvestment of GOI equity in CPSEs began in 1991-92. Initially the disinvestment was primarily through sale of minority shares in small lots. Later, the emphasis of disinvestment changed in favor of strategic sale. At present, the emphasis is to list large and profitable CPSEs on domestic stock exchanges and to selectively sell small portions of equity in listed, profitable CPSEs (other than the Navratna). It has been decided not to privatize profit-making CPSEs; make all efforts to modernize and restructure sick public sector companies and revive sick industry; sell or close the chronically loss-making companies, after all the workers have got their legitimate dues and compensation; and induct private industry to turn around companies that have potential for revival. A "National Investment Fund" was set up in 2005 into which the proceeds from disinvestment of government equity in CPSEs are to be channelized. The fund is maintained outside the Consolidated Fund of India and managed by selected public sector mutual funds for providing sustainable returns without depleting the corpus. As much as 75 per cent of the annual income of the fund is to be used to finance selected social sector schemes to promote education, health and employment. The residual 25 per cent is to be used to meet the capital investment requirements of profitable and revivable CPSEs. The proceeds from disinvestment from April 1991 to November 2005 amounted to Rs.47, 671.62 crore (US\$ 10.5 billion).

Phase 2, in the mid to late 1990s, focused on the delegation of substantial decision-making powers to the boards of leading CPSEs, starting with the "nine gems" or Navratna companies. The 1997 DPE guidelines gave large and important companies special status and greater functional autonomy in decisions about investments, capital expenditures, joint ventures, mergers and acquisitions, and the raising of debt from the capital markets. Important preconditions were established for the delegation of powers, in particular that: (i) the boards be restructured to include at least four non-official or independent directors; and (ii) there be no financial support or contingent liability involved on the part of the government. The concept of Miniratnas was subsequently introduced for smaller enterprises that met certain performance criteria. Their main delegated powers relate to joint ventures and subsidiaries, development of human resources, business tours abroad, technology joint ventures, and creation/disinvestment in subsidiaries. At present there are a total of 45 Miniratnas. The number of Navratna companies increased from the original nine to 18 as of March 2008, resulting from upgradation of Miniratnas to Navratna status.²

Phase 3, from the late 1990s to 2004, focused on disinvestment and privatization. While minority share sales via the stock market continued, GOI also supported a more open privatization program involving strategic sales via open tender. The Voluntary Retirement Scheme (VRS) that had been initiated in the first phase for loss-making companies was extended to profitable companies undergoing privatization. During this period, GOI raised proceeds worth Rs. 51.9 billion through sales and divestments.³ Listing of CPSEs on the stock exchanges continued, which required that companies comply with the corporate governance and other provisions of Clause 49 of the Listing Agreement, issued by the Securities and Exchange Board of India (SEBI) in 2000 and subsequently modified in 2003-04.

Phase 4, from 2004 to the present, derived from the National Common Minimum Program (NCMP) of the then newly elected coalition government which reaffirmed GOI's commitment to the state owned sector and adopted a more cautious approach to privatization. The NCMP: (i) pledged that profitable CPSEs would not be privatized and that any privatization would be considered on a transparent and consultative case-by-case basis with the objective of increasing competition, protecting workers, and meeting social needs; (ii) encouraged CPSEs to raise resources through the capital markets, and called for GOI to devolve full managerial and commercial autonomy to profit making companies in competitive sectors; and (iii) committed the government to make every effort to revive sick enterprises. The focus shifted to restructuring and modernizing sick companies while furthering the delegation of powers to companies. Profit making companies (other than Navratna and Miniratna) were also empowered to make certain investments and other decisions without GOI approval. As this report was being finalized, a new "Maharatna" category was introduced to allow for further delegation of powers in leading CPSEs.

To further advance the governance efforts, in July 2007 the DPE issued the Guidelines on Corporate Governance for CPSEs. Patterned on Clause 49, the Guidelines aim to improve board practices and other elements of corporate governance in all CPSEs, including non-listed enterprises.: The Guidelines are voluntary in nature, although compliance is monitored.

¹ Other preconditions included the need for: unanimous or majority approval of the board for proposals, the presence of government and functional directors in board meetings, and preparation of proposals for investment and capital expenditure by experts.

² The Miniratna I, Schedule 'A' CPSEs which have obtained 'excellent' or 'very good' rating under MoU system in three of the last five years become eligible to be upgraded to Navratna status.

³ A National Investment Fund for disinvestment proceeds was constituted in 2005, with 75 percent of its annual income used for financial social schemes and the remaining 25 percent for capital investment requirements of profitable and revivable companies.

In short, over the decades, and especially since 1991, a number of initiatives have been undertaken to improve CPSE governance with a view to bringing about higher levels of CPSE efficiency, investment, and economic growth. Regardless of the political parties in power, reforms continued over the years, though some governments emphasized certain reform policies over others. In recent years reform has moved from the past focus on privatization and liberalization to include broader initiatives such as corporate governance and continued support for performance monitoring and restructuring, while maintaining a commitment to a prominent role for the state in the Indian economy as both owner and regulator of CPSEs.

Today, corporate governance is squarely on the CPSE reform agenda. Interest in corporate governance is driven by recognition of:

- ► The important role that CPSEs continue to play in the Indian economy and the significant room for further improvements in performance;
- ► The need to tackle the substantial governance challenges that still remain; and
- ► The benefits of improved governance in terms of achieving higher levels of performance, greater access to capital markets, and increased transparency and accountability.

B. Role and Performance of CPSEs

CPSEs continue to play an active role in the Indian economy. As of March 2009, there were 246 CPSEs, of which 213 were in operation and 33 under construction. Operating across 22 sectors, they dominate key sectors such as public utilities, transportation, and coal and oil and gas. CPSEs are also significant players in the production of steel, fertilizer, aluminum, copper and electrical machinery. They produced just over 8 percent of GDP on a value added basis in 2007, and 6.5 percent in 2008 (available data suggests a slight rebound in 2009). Financial investment amounted to Rs. 528951 crore (US\$ 117 billion), a 14 percent increase over the previous year. CPSEs employed 1.53 million full time employees (excluding casual and contract workers), a decline from 1.9 million in 2001-02. Nearly one fourth of employees comprised managerial and supervisory cadres.

CPSEs are important capital market players. 40 CPSES are listed and traded on the various stock exchanges and include some of the largest listed companies. Their total market capitalization in March 2009 was Rs. 813530 crore (US\$ 180 billion) and accounted for over 25 percent of the market capitalization of the Bombay Stock Exchange.

Overall CPSE performance improved over the years as a result of various reform measures and general improvements in the economy. As a group they grew their sales at double digit rates for most of the past decade and contributed nearly a quarter of the country's national GDP in terms of gross sales. The top ten companies by income are given in Table 3. Total turnover in 2008-09 grew by 15.4 percent, after increasing by 12 percent the previous year. Profit of profit making companies grew 7.7 percent in 2008-2009 to Rs. 98652 (US\$ 22 billion).

TABLE 2: Top Ten Companies by Income (March 2008)

| Name of Companies | Average Income (Rs. Cr.) | Average Income US\$ million | Number of Employees |
|--|-----------------------------|--------------------------------|------------------------|
| Coal India Ltd. | 330,228 | 73,384 | 438,103 |
| Indian Oil Corporation Ltd. | 205,508 | 45,668 | 35,314 |
| Bharat Petroleum Corporation Ltd. | 84,790 | 18,842 | 14,690 |
| Oil & Natural Gas Corporation Ltd. | 79,916 | 17,759 | 34,929 |
| Food Corporation of India | 45,308 | 10,068 | 41,358 |
| Bharat Sanchar Nigam Ltd. | 38,661 | 8,591 | 320,506 |
| Steel Authority of India Ltd. | 2,186 | 7,152 | 132,973 |
| NTPC Ltd. | 30,792 | 6,843 | 24,162 |
| Mangalore Refinery & Petrochemicals Ltd. | 24,382 | 5,418 | 1,046 |
| Chennai Petroleum Corporation Ltd. | 20,488 | 4,553 | 1,651 |

The number of profitable companies reached 158 in 2009. But just ten companies accounted for nearly two thirds of the total profits (Table 4). The same ten companies also accounted for around 40 percent of annual turnover over the previous five years. The companies were predominantly in extractive industries such as petroleum, minerals and metals and steel, industries that continue to be heavily regulated. Other large players included power generation and telecommunications firms.

TABLE 3: Top Ten Profit-Making CPSEs (March 2009)

| Name of the CPSEs | Net profit (Rs. Cr.) | Net Profit US\$ Million | % age share |
|------------------------------------|-------------------------|----------------------------|-------------|
| Oil & Natural Gas Corporation Ltd. | 16041.00 | 3564.67 | 19.2 |
| NTPC Ltd. | 8309.62 | 1846.58 | 9.9 |
| Steel Authority of India Ltd. | 6171.03 | 1371.34 | 7.4 |
| NMDC Ltd. | 4371.86 | 971.52 | 5.2 |
| Coal India Ltd. | 3290.03 | 731.12 | 3.9 |
| Bharat Heavy Electricals Ltd. | 3126.32 | 694.74 | 3.7 |
| GAIL(India) Ltd | 2814.09 | 625.35 | 3.3 |
| Indian Oil Corporation Ltd. | 2569.89 | 571.09 | 3.0 |
| Oil India Ltd | 2166.31 | 481.40 | 2.6 |
| South Eastern Coalfields | 2014.81 | 447.74 | 2.4 |
| TOTAL | 50874.96 | 11305.55 | 61.0 |

TABLE 4: Brief History of Public Sector Reformsin India since Liberalization in 1991

| Public Enterprise Reforms Process | Time Period | Key Reforms | Results |
|---|--------------------------|--|---|
| PHASE 1: New Industrial Policy | July 1991- May 1996 | "De-reservation" involving liberalization of hitherto closed sectors dominated by state monopolies "Disinvestment" involving limited and partial sale of government shares "Memoranda of understanding", a performance evaluation system, expanded "Sick" CPSEs referred to the Board for Industrial and Financial Reconstruction | Number of state monopolies decreased from 17 to six within a couple of years State raised Rs195bn between Dec 1991 to Nov 1995 through disinvestment Failed to improve performance significantly and generated lukewarm response from private sector and general public |
| PHASE 2: Empowerment of Enterprises | June 1996- March 1998 | Operational autonomy granted to very large CPSEs Professionalisation of the "Board of Directors" in PSEs "Disinvestment Commission" set up Dramatic reduction in state compliance guidelines and requirements | "Navaratna package" for 11 CPSEs and "Miniratna package" for 97 PSEs created Government abolished 695 guidelines governing CPSEs, retained 105 and modified 25 |
| PHASE 3: Open Privatization | April 1998- May 2004 | More open privatization policies made apparent through: The buy-back and cross holding of some shares Downsizing, restructuring and professionalisation of PSEs and governing boards Shutting-down selected sick CPSEs | Open mention of privatization in government policy documents and budget papers Indian government raises Rs51.90bn through the dales of shares of PSEs. Volunteer Retirement Scheme initiated in the first phase extended beyond sick enterprises to marginally profitable companies Eight chronically sick companies shutdown Attempt to privatize Indian Airlines but shut down by presidential decree |
| PHASE 4 | May 2004- Present | Cautious attitude to privatization driven by political considerations including the government's dependence on communist parties for support Corporate Guidelines for CPSEs introduced | Restructuring and modernizing sick companies Devolving commercial autonomy to successful companies Induction of the private sector in turning around sick companies Less reliance on ownership changes and more on internal governance and management reform to improve performance |

While there were 54 loss making firms, compared to 63 in 2005-06 and over 100 at the start of the decade, their losses grew from Rs. 6845 crore (US\$ 1.5 billion) in 2005-06 to Rs. 14424 crore (US\$ 3.2 billion) in 2008-09. Ten loss-makers accounted for over three quarters of the total net loss of all lossmaking enterprises (Table 5). Some of these have been losing money for a number of years.

TABLE 5: Top Ten Loss Making CPSEs (March 2009)

| Name of CPSEs | Net Loss (Rs. Cr.) | Net Loss US\$ Million | % Age Share |
|--|-----------------------|--------------------------|-------------|
| National Aviation Co. of India Ltd. | (-) 5442.58 | (-)1209.46 | 37.7 |
| Eastern Coalfields Ltd. | (-) 2106.31 | (-) 468.07 | 14.6 |
| Hindustan Photo Films Manufacturing Co. Ltd. | (–) 875.61 | (–) 194.58 | 6.0 |
| Fertilizer Corp. of India Ltd. | (–) 752.58 | (-) 167.24 | 5.2 |
| ITI Ltd. | (–) 645.65 | (-) 143.48 | 4.4 |
| National jute Manufactures Ltd. | (–) 551.77 | (–) 122.62 | 3.8 |
| Bharat Coking Coal Ltd. | (–) 527.99 | (–) 117.3 | 3.6 |
| Hindustan Fertilizer Corpn. Ltd. | (–) 516.01 | (–) 114.67 | 3.5 |
| Hindustan Cables Ltd. | (–) 444.75 | (-) 98.83 | 3.0 |
| Chennai Petroleum Corporation Ltd. | (-) 406.05 | (–) 90.23 | 2.8 |
| TOTAL | (-) 12269.3 | (-) 2726.51 | 85% |

A range of factors affect the performance of CPSEs. Annex 1 examines CPSE performance in greater detail. Based on an analysis of aggregate CPSE performance in the 1997-2005 period, it shows that profitable and loss-making firms were clustered in a few industries, revealing strong linkages between performance and sector characteristics such as competition, level of regulation and nature of the business activity. Firm level factors also played a role, ranging from obsolete technology, high input and overhead cost, low capacity utilization and managerial decision-making, as did management and governance constraints. In addition, unlike private firms, CPSEs are also saddled with non-commercial goals, including employment generation, assisting laggard industries, technology development, and price controls that compete with profit maximization goals and affect their financial performance.

Notwithstanding recent improvements in the performance of the CPSE sector as a whole, addressing these constraints through improved governance and other measures could help raise the levels of performance even higher in the case of Navratnas, Miniratnas and profitable firms while reducing the losses of lossmaking firms.

C. Overview of Corporate Governance Framework

CPSEs are governed by a complex legal and institutional framework. This framework is described below, followed in the next section by a discussion of the main challenges that it creates for CPSE governance.

Legal Framework

CPSEs generally fall under the same legal framework as the private sector, although some laws contain special provisions or exemptions for state-owned companies.⁴ They are mainly governed by the Companies Act, Clause 49 of the Listing Agreement, and various DPE guidelines issued over the years. In addition CPSEs are subject to various other laws and regulations. The main laws include:

- Companies Act 1956 (CA): CPSEs and other companies in which the government, directly or indirectly, holds 51 percent or more of the paid-up share capital are incorporated under section 617 of the CA as "government companies". Their governance form and structure are prescribed by the Act and the companies' articles of association. The principal difference between private firms and CPSEs is that in the latter the auditor is appointed by the Comptroller and Auditor General (CAG) instead of the government as shareholder. All other processes are more or less the same except for mergers and amalgamations of CPSEs where the same procedures are followed but where the power of the High Court is exercised by the government.⁵
- Securities regulation/Clause 49 of the Listing Agreement: Listed CPSEs fall under securities regulation and the listing agreement issued by the Securities and Exchange Board of India (SEBI). This includes basic disclosure requirements and Clause 49, which contains important corporate governance norms. Introduced in 2000 and revised in 2003-04, Clause 49 has both mandatory and voluntary provisions. Mandatory provisions relate to board composition, audit committees, board procedures, management discussion and analysis in the annual reports, certification of financial statements and internal controls, and corporate governance reporting.
- ▶ DPE guidelines: In addition to the 1997 Circular on delegation of powers, DPE guidelines determine many of the practices and procedures of CPSEs, including those related to finance, human resource development, operation of CPSEs, functioning of boards of directors, and the performance monitoring system. Hundreds of such guidelines have been issued over the years. In the mid to late-1990s, with a view to streamlining, GOI abolished nearly 700 guidelines, while retaining 105 and modifying another 25. Some guidelines are binding, while others are voluntary.

⁴ The founding acts of the three statutory corporations provide for governance structures that are somewhat different from the CA. Their rules and regulations are framed with the sanction of Parliament and cannot be easily changed. Directors are immune from any law suits or legal proceeding for loss or damage caused by any act done in good faith and in pursuance of the objects of the founding statute. Statutory corporations can only be liquidated by the passage of a law by Parliament. SICA does not apply to such corporations.

⁵ The CA contains some special modifications for government companies that make them distinct from other companies (for example, more flexibility on time and venue of the AGM and on certain accounting provisions), or exemptions from certain sections of the Act (e.g. declaration of benami share holdings, requirement for board sanction of contracts entered into with other government companies). A new company bill has been introduced to parliament which might scale back or eliminate these and other such provisions.

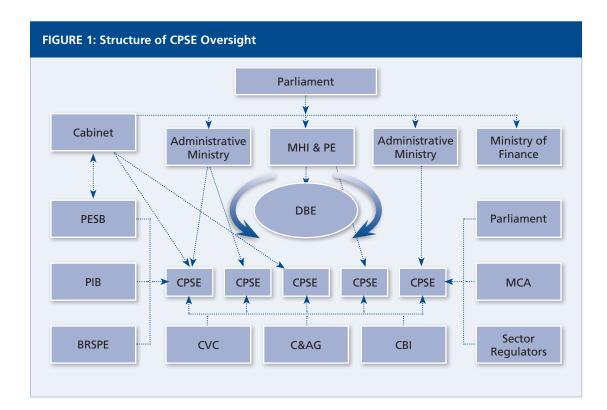
- Guidelines on Corporate Governance for State-Owned Enterprises (CG Guidelines): Issued by DPE in 2007, these guidelines are voluntary and are applicable to all CPSEs (it is not clear whether and how statutory corporations can adopt them given their special legal form). The main focus of the CG Guidelines is on the board of directors and audit committees but they also touch on disclosure and subsidiary companies. While the CG Guidelines are voluntary, CPSEs are expected to note their compliance and explain areas of non-compliance (comply or explain).
- Other laws and regulations: Various other laws and regulations impinge on CPSE governance. Main among these are:
 - Right to Information (RTI) Act 2005: RTI is a landmark initiative for enhancing transparency and governance of the public sector as a whole. The Act requires that various CPSE reports and statements be made available to the public. In practice, many CPSEs have established websites linked to that of their administrative ministry to meet the law's requirements. Documents that are not regularly disclosed to the public may also be demanded from CPSEs.
- Labor laws: Most of the Acts related to employee relations and protection apply to CPSEs, though there are some special provisions and exemptions.⁶ Supreme Court decisions govern employee relations, giving CPSE employees the formal status of GOI employees, but more recently denying that they had full civil service status.
- Insolvency laws: CPSEs fall under the same insolvency and liquidation laws as other companies, including: the Sick Industrial Companies Act which governs restructuring for all industrial companies (public and private);⁷ the CA which covers liquidation; and the general civil procedure law which contains provisions for the appointment of receivers.
- Other acts and regulations: The Competition Act 2002 applies to CPSEs, but exempts those carrying out sovereign functions or activities necessary for the discharge of these functions. CPSEs are also subject to other laws and regulations, such as sector regulation and environmental law.

Institutional Framework

Institutional arrangements for exercising the state's ownership rights are complex compared to international practice. GOI shareholding in CPSEs is held by the President of India, ex-officio. His powers as a shareholder are delegated to 38 administrative ministries, each with its own portfolio of CPSEs. DPE serves as the nodal agency. In addition, a number of other governmental bodies have oversight, regulatory, and recommendatory roles. Figure 1 below highlights the complexity of the CPSE ownership arrangements.

⁶ The Factories Act 1948, Apprentices Act 1961, Equal Remuneration Act 1976, Industrial Disputes Act 1947, and the Industrial Employment (Standing Orders) Act 1946 all contain special provisions for SOEs. Certain SOEs are exempted from provisions of the Employment Provident Funds and Miscellaneous Provisions Act 1952 and the Employees State Insurance Act 1948.

⁷ SICA does not apply to statutory corporations.



The specific roles of the major bodies are as follows:

- Administrative ministries: As delegated owners, administrative ministries represent GOI in the AGM, participate in board selection, approve major decisions, monitor performance, and restructure sick or loss-making units. Currently 38 ministries and departments administer the 244 operational CPSEs (Table 6). They consult other ministries and departments on various matters and obtain Cabinet approval as needed.
- DPE: Located in the Ministry of Heavy Industries and Public Enterprises, DPE is the nodal agency for all CPSEs. Established in 1965 as the Bureau of Public Enterprises, it became a department in 1990 and is headed by a secretary reporting to the Cabinet Minister and Minister of State. DPE has five divisions—financial policy, management policy, MOU division, administration and coordination, and the permanent machinery of arbitration (PMA)—with 121 positions, of which 90 are filled. DPE sets policies and guidelines for CPSEs and acts as an interface between administrative ministries and CPSEs. It also manages the MOU system, supports the board appointment process, conducts an annual survey of CPSEs, and provides reports to parliament and the public.
- Cabinet: The Cabinet approves a range of major decisions through the High-Powered Committee chaired by the Prime Minister, and finalizes the choice of CPSE board directors through the Appointment Committee of Cabinet (ACC).
- ► Ministry of Finance (MOF): It reviews many CPSE finance and investment decisions, as does the Public Investment Board (PIB) for investment plans over Rs. 100 crores (US\$2.3 million).

TABLE 6: Breakdown of CPSEs by Ministry

| Administrative Ministry | No. of Companies | No. of Employees | Income US\$ million | Income (Rs. Cr.) |
|---|---------------------|---------------------|------------------------|---------------------|
| Ministry of Agriculture | 2 | 2,695 | 4 | 185 |
| Ministry of Chemicals & Fertilizers • Department of Chemicals & Petrochemicals • Department of Fertilizer | 11 10 | 6,540 15,807 | 225 2,184 | 1,012 9,828 |
| Ministry of Civil Aviation | 9 | 37,850 | 3,558 | 16,012 |
| Ministry of Coal | 10 | 457,218 | 7587 | 34143 |
| Ministry of Commerce & Industry | 8 | 4,950 | 7,903 | 35,564 |
| Ministry of Communications & IT Department of Telecommunications Department of Information Technology | 5 1 | 383,587 39 | 10,418 10 | 46,880 43 |
| Ministry of Consumer Affairs | 3 | 47,671 | 10,205 | 45,921 |
| Ministry of Defence | 10 | 74,802 | 3,547 | 15,962 |
| Ministry of Development of NE Region | 2 | 179 | 4 | 19 |
| Ministry of Environment & Forests | 1 | 1,607 | 1 | 5 |
| Ministry of Finance • Department of Economic Affairs | 2 | 17,690 | 362 | 1,629 |
| Ministry of Health & Family WelfareDepartment of AyushDepartment of Health & Family Welfare | 1 2 | 346 2,050 | 4 59 | 16 264 |
| Ministry of H. Industries & PE • Department of Heavy Industries | 42 | 121,048 | 5,221 | 23,495 |
| Ministry of Housing & Urban Poverty | 2 | 1,515 | 572 | 2,576 |
| Ministry of Human Resource Dev. | 1 | 84 | 8 | 35 |

| Administrative Ministry | No. of Companies | No. of Employees | Income US\$ million | Income (Rs. Cr.) |
|---|---------------------|---------------------|------------------------|---------------------|
| Ministry of Information & Broadcasting | 2 | 229 | 14 | 62 |
| Ministry of Micro & SMEs | 1 | 860 | 83 | 372 |
| Ministry of Mines | 3 | 14,998 | 1,428 | 6,428 |
| Ministry of Minorities Affairs | 1 | 34 | 1 | 3 |
| Ministry of New and Renewable Energy | 1 | 111 | 51 | 230 |
| Ministry of Petroleum & Natural Gas | 21 | 116,197 | 129,134 | 581,106 |
| Ministry of Power | 38 | 68,452 | 11,504 | 51,768 |
| Ministry of Science and Technology Department of Biotechnology Department of Scientific & Industrial Research | 2 | 135 778 | 6 36 | 26 163 |
| Ministry of Shipping, Road Transport | 8 | 13,383 | 1,299 | 5,844 |
| Ministry of Social Justice | 5 | 660 | 34 | 153 |
| Ministry of Steel | 13 | 170,936 | 11,270 | 50,715 |
| Ministry of Textiles | 10 | 26,036 | 932 | 4,194 |
| Ministry of Tourism | 9 | 3,767 | 104 | 470 |
| Ministry of Tribal Affairs | 1 | 60 | 2 | 11 |
| Ministry of Urban Development | 1 | 2,444 | 269 | 1,210 |
| Ministry of Water Resources | 2 | 2,838 | 146 | 658 |
| Department of Atomic Energy | 5 | 23,798 | 1,227 | 5,521 |
| Department of Space | 1 | 12 | 107 | 482 |

- Oversight and control bodies: CPSEs are accountable to a number of different bodies, including:
 - Parliament: As the main oversight body, a number of parliamentary committees routinely review CPSE performance and related issues.
 - Comptroller and Auditor General (CAG): CPSEs with more than 50 percent of ownership are subject to CAG oversight. An independent body established by the Constitution of India, CAG: (i) appoints the statutory auditor and oversees and supplements their work; (ii) conducts regular transaction audits of CPSEs; (iii) conducts performance audits of CPSEs that focus on particular topics and sectors; and (iv) reports the findings to parliament.
 - Central Vigilance Commission (CVC): CVC has a mandate to deter corruption and malpractice in CPSEs through observance of procurement matters and clearance for all board positions.
 - Judiciary: CPSEs are subject to judicial review by the Supreme Court of India and the High Courts.
- Regulatory bodies: These bodies oversee CPSEs in much the same way they oversee private sector companies. They include: (i) SEBI, which enforces securities rules for listed CPSEs; (ii) Ministry of Company Affairs (MCA), which oversees compliance with the Companies Act; and (iii) sector regulators, like the Telecom Regulatory Authority, which regulate pricing and other sector specific issues for relevant CPSEs.
- Recommendatory bodies: These include: (i) the Public Enterprises Selection Board (PESB), which manages the process for selecting board members, including tenders and advertising, interview panels, and preparation of short-lists. The PESB is overseen by an independent board and supported by the Ministry of Personnel. ACC approves the final selection; (ii) BRPSE, which was set up in 2004 as an independent body that advises the government on the restructuring and revival of poorly performing CPSEs; and (iii) SCOPE, a membership body for CPSEs and other state companies. It acts as an interface between GOI and CPSEs, and organizes conferences and training, including on corporate governance, for its members.

D. Challenges and Benefits of Governance Reform

The above governance framework follows several aspects of international good practice. Aside from the statutory corporations, CPSEs are corporatized and fall under the provisions of the CA. DPE guidelines have delegated decision making powers to the leading firms and other profitable companies and improved CPSE governance through the induction of independent directors and improvements to the performance monitoring system. Clause 49 of the Listing Agreement has been instrumental in putting listed CPSEs on the same footing as private companies. The 2007 CG Guidelines are geared to raising further awareness and compliance with board, disclosure and other governance practices.

Yet, governance challenges still remain and further reforms are needed to build on the substantial gains that have already been achieved. The nature and extent of these challenges are bound to vary by type of CPSE—for example by size and importance of firm, delegation of powers, and listed vs. non-listed firms. Four general observations can still be made:

- First, corporate governance reforms are part and parcel of the broader CPSE reform program rather than a stand-alone or substitute reform. In this regard, broader policy reforms aimed at imposing market discipline are essential to bringing pressure on companies to improve governance—and to maximizing and sustaining the gains from such improvements. Substantial progress has been made in removing barriers to competition, reducing government financial support, and listing of CPSEs on the capital markets. But further market-based reforms are needed to cement these achievements and further enhance the competitiveness of CPSEs. These issues are covered in Section III of the report.
- Second, how the state organizes and exercises its ownership rights is central to improving the governance of some of India's most important companies. The main challenge for GOI lies in making a complex ownership framework more effective in striking the right balance between CPSE autonomy and accountability. The present arrangements combine the conflicting roles of policy-making and ownership in some ministries, allow political interference in board appointments and commercial decision-making to continue, and weaken board powers. Strengthening the ownership arrangements to minimize these problems while further improving the MOU system to enhance accountability is thus a key challenge going forward and is discussed in Section IV of the report.
- ▶ Third, despite the advances that have been made, CPSE boards continue to be state-dominated, still lack sufficient decision-making authority in practice, and are rarely if ever evaluated on their performance. Professionalizing and empowering CPSE boards is thus a second major challenge and is discussed in Section V of the report.
- Fourth, CPSE disclosure standards are comparable to many OECD countries and the RTI Act has pushed the frontier even further on transparency and accountability. Implementing these disclosure requirements however can be a major challenge for many CPSEs, particularly in light of relatively weak internal audit and control functions, lack of guidance on disclosure (particularly for non-listed firms), and potential duplication and delays in the various CPSE audits. Enhancing transparency and disclosure is thus the third main challenge and is discussed in Section VI of the report.

Addressing the above challenges and improving CPSE governance would make the state a more effective owner of CPSEs, achieve higher levels of CPSE performance and increase the value of important national assets, bring capital market discipline, and achieve higher levels of transparency and accountability. As an integral part of business strategy and ethical value creation, improved corporate governance should help improve economic efficiency, increase investments, and achieve economic growth.

03. Imposing Market Discipline

OECD GUIDELINE: The legal and regulatory framework for state-owned enterprises should ensure a level-playing field in markets where state-owned enterprises and private sector companies compete in order to avoid market distortions. The framework should build on and be fully compatible with the OECD Principles of Corporate Governance."

Corporate governance reforms are best seen as part and parcel of a broader policy reform program aimed at imposing market discipline on CPSEs, rather than as a stand alone reform or substitute for other reforms. Such a policy program typically aims to ensure that CPSEs compete fairly with the private sector through hard budget constraints, listing of companies on the stock exchange and other forms of private sector participation, and removal of entry and exit barriers. These reforms are essential to creating the right incentive structures or pressures for companies to improve governance—and to maximizing and sustaining the gains from governance reforms.

Since liberalization began in the early 1990s, GOI has taken a number of steps to bring market discipline to state companies. CPSEs have faced direct competition from the private sector through the opening up of sectors to new private entry. Direct budgetary support to firms has been significantly reduced. Indeed through the payment of taxes and dividends, the CPSE sector as a whole has become a major net contributor to the national budget. GOI shareholding in the companies has been reduced through listing of companies on the stock markets. Legal distinctions between CPSEs and private sector companies have been gradually eroded. And procurement preferences that once favored CPSEs, and that had been in place since 1971 and subsequently modified over the years, were finally removed in March 2008.8 Taken together, these steps have led CPSEs to compete more fairly with the private sector and have helped bring greater market discipline to the companies.

But continued reforms are needed to build on the progress that has already been made with the goal of making CPSEs even more commercially oriented. This would require continued efforts to:

- ► Tighten budget constraints and establish market relations with state-owned banks;
- Advance CPSE listings on the capital markets and bring in private sector participation through other means;
- Identify and finance non-commercial obligations directly from the government budget;
- Make human resource policies more market-based;
- Allow unviable companies to exit the market.

Tighten budget constraints and establish market relations with state-owned banks.

Many countries require their state-owned companies to borrow on commercial terms and limit explicit and implicit government guarantees for such borrowing. Similarly, in India, the nature of public financing

⁸ However, under DPE guidelines, administrative ministries still have leeway to develop purchasing policies for CPSEs under their supervision, and some have done so, giving CPSEs a competitive edge in terms of a level playing field.

to CPSEs has undergone a significant transformation from dependence on the central government in the form of grants to budgetary support on the basis of project justification. Moreover, as CPSEs increasingly turned to the capital markets to mobilize resources, budgetary support to CPSEs declined from a high of 50.6 percent of the total resource mobilization and plan investments of CPSEs in 1985-86 to 12.8 percent in 2004-05. These factors have helped make CPSEs more disciplined in their borrowings.

Yet CPSEs continue to benefit from less visible forms of government financial support. Public sector banks remain major lenders to CPSEs, which in turn can borrow more easily from state banks than other companies as banks may have higher comfort in lending to companies that are state-owned. While CPSEs are free to approach private banks for finance, in practice they are encouraged to maintain their accounts with public sector banks. (Indeed, MOF recently directed CPSEs to deposit at least 60 percent of their surplus funds in state banks to shore up banks during the crisis, irrespective of any adverse financial implications for CPSEs.) Moreover, in some, albeit fewer, cases, CPSE borrowings are still explicitly guaranteed by GOI (based on the public purpose to be served, the credit worthiness of the company and terms of borrowing), while GOI also provides both loans and equity finance through the administrative ministries. And, in cases where there is no explicit government guarantee, investors and lenders believe that an implicit guarantee exists.

Ending these forms of support can be difficult given the public sector nature of CPSEs, but reducing and eliminating them over time would help put CPSEs on an equal footing with the private sector, force them to become more aggressive in tapping alternative sources of financing through capital markets (see below), and consequently require them to undertake the necessary governance reforms. In particular:

- ► CPSEs should be free to engage in banking relationships that are fully market-based;
- ► Investments by the ministries in equity and loans should be based on clear criteria and a clear policy on when such investments are appropriate, and be subject to MOF and Cabinet scrutiny as required;
- ► Such investments should only be used as a last resort when other options are unavailable, or to maintain the state's target level of ownership, for example in conjunction with selling shares to non-state shareholders; and
- A thorough review of the GOI investment approval process may be in order to ensure that any investments result in optimal outcomes.

Advance CPSE listings on the stock markets.

As per the 2004 NCMP, non-listed profitable CPSEs (other than Navratnas) can go for listing on the stock market to raise funds, and listed CPSEs can issue new equity to the market as long as they receive the approval of the administrative ministry and maintain the public sector character of the enterprise (51 percent or more public sector ownership). However, in 2006, GOI put all such new listings and sale of government equity on hold, to be reviewed on a case by case basis. Since then, just one CPSE (Power

⁹ DPE guidelines stipulate that a CPSE in need of a guarantee must first approach a bank to provide it. If the bank is unable to provide such guarantee, then the GoI may be approached. Consultation with the administrative ministry is required and it in turn must consult the MoF. GoI guarantees may be given for repayment of loans or share capital, payment of minimum annual dividends, and contracted payments to suppliers.

¹⁰ Listing may not always raise significant funds for the enterprise: new listings are usually divided between shares sold by the by GoI, with the revenue going to the budget and NIF, and fresh equity, which finances the CPSE.

Finance Corporation) was able to list and raise fresh equity, in 2007. A number of CPSEs have received tentative approval to do the same, but have not yet come to the market.

Advancing the listing of CPSEs should help raise capital, require corporate governance improvements, and bring greater scrutiny and transparency to CPSEs by involving other shareholders and placing the companies under SEBI oversight. New listings of CPSEs should also help further expand and deepen the capital markets. As such:

- GOI's plans for listings should advance and CPSEs should be given greater freedom to tap the capital markets and issue shares to the public;
- GOI should initiate the process of discussion and consensus building on allowing its shareholding to go below 51 percent while exercising specific ownership rights on a selective basis through other mechanisms. Carrying out further analysis and case studies of companies in which GOI shareholding is less than 51 percent would be helpful in carrying out this discussion;
- Over time, other forms of private sector participation may also be considered, including strategic sales, management contracts, concessions, and other forms of public-private partnerships. Improving the governance of companies would help facilitate private participation, which in turn would allow for access to investment capital and improvements in efficiency and service delivery.

Identify and finance non-commercial obligations directly from the budget.

Twenty-five CPSEs, including the statutory corporations and those incorporated under Section 25 of the Companies Act, are explicitly charged with implementing GOI programs in specific sectors or servicing specific GOI departments and thus do not operate on strict commercial lines. 11 But CPSEs incorporated as companies that should be operating as commercial entities may in addition have social or policy obligations which are, as per DPE guidelines, specified in the memorandum of association or in the company statute. Some social responsibilities may also be assigned through Presidential directives or orders by the administrative ministry. These can be opaque and informal or non-explicit in nature, and decided in an ad hoc manner. (A distinction needs to be made between non-commercial or social obligations and the corporate social responsibility or CSR programs carried out by many CPSEs.¹²) Managing these multiple objectives is difficult and poses a direct challenge to efficient management and accountability.

One of the main social obligations for many CPSEs is to sell their output at a price fixed by GOI. Prices are controlled to limit market power, provide certain products at or below cost, and limit the impact that commodity price increases have on the overall cost of living. For many years, the Administered Pricing Mechanism (APM) was used to set prices for a range of CPSEs. This system has been gradually

¹ For example, the Food Corporation of India provides price support for farmers, operates a nationwide public distribution system for food grains, and maintains sufficient buffer stocks to ensure food security. It also provides subsidized food. The difference is paid by the concerned ministry, which also reimburses the carrying charges of the buffer stocks of the corporation. State Farms Corporation Ltd has been established to manage mechanized farms; National Informatics Centre Services Incorporated to provide network backbone and e-governance support to GOI; and the Tamil Nadu Trade Promotion Organization has been incorporated to pro mote, organize and participate in industrial trade fairs and enhance the global competitiveness of Indian industry and trade.

¹² Awareness of CSR is relatively high in India, and many large and/or listed CPSEs have CSR programs. These frequently include health, education, and housing programs for employees and others in the communities where the CPSE is most active. 47 CPSEs have joined the UN's Global Compact (UNGC), 23 of which are considered active members. UNGC signatories commit to honoring the 10 principles of the compact—which cover human rights, employee rights, the environment, and anti-corruption, and provide regular reports on their compliance.

dismantled, but price controls remain important in certain sectors, for example coal, electrical power, petroleum products, fertilizer, and pharmaceuticals. The means by which prices are set varies across the relevant sectors and CPSEs.¹³ In recent years prices have also been fixed below cost for other petroleum products, sometimes at a substantial loss to the CPSE. These CPSEs have been compensated with "oil bonds", off-budget government debt that the enterprise can then hold or sell to third parties. While steel and coal were removed from the APM mechanism years ago, coal prices remain fixed, and steel prices have been strongly influenced by the Ministry of Steel.

Non-commercial obligations can put CPSEs at a serious disadvantage compared to the private sector. DPE guidelines themselves recognize that the capabilities of CPSEs to undertake—and finance—such obligations will vary and that "it is for the individual CPSE to identify and implement social responsibilities keeping in view its financial ability to sustain such activities, operating environment and provisions in its (articles)". Yet there is no explicit policy for identifying and financing the costs of the obligations. Instead, when the company is expected to provide social services or offer a subsidy, part of the cost may be borne out of the government budget but much of the cost is often borne by the CPSEs' own resources, which affects their performance and contributes to inefficiencies and losses. In short, non-commercial obligations are not always transparent and they impose high, and variable, costs on the CPSEs.

While it cannot be expected that CPSEs will be free from the social objectives of their principal shareholder, such objectives should be managed with a view to leveling the playing field, bringing about greater transparency and efficiency, and making it easier for GOI to assess the true financial performance of CPSEs. This would require:

- ► Identifying specific obligations and mandating them through clear directives and regulations;
- Determining the cost of the obligations and any subsidies, giving due consideration to the volatility of that cost. This is especially relevant for price controls, which can lead to large and varying losses;
- Financing the costs through direct government support that is confined and targeted; and
- Disclosing any social obligations as part of CPSE disclosure requirements (discussed in further detail in Section VI).

Make human resource policies more market-based.

CPSE employee status remains ambiguous. While court rules have confirmed that CPSEs and their employees are part of the public sector, a 2003 Supreme Court decision rejected the notion that CPSE employees are civil servants and should automatically enjoy comparable benefits. For all practical purposes, however, CPSE employees are treated as public sector employees, and as such enjoy a number of rights and benefits, including job security and social benefits. This once made, and still makes, CPSE employment highly desirable, but rapid growth of the private sector has created new opportunities for skilled workers and managers. Attracting and retaining talent in CPSEs could become a major challenge.

¹³ In electrical power and pharmaceuticals, for example, sector regulators set prices for both private and public enterprises based on national policies. For fertilizers, kerosene and cooking gas, GOI has long fixed the price below cost and provided subsidies, which may not cover the full cost of production.

Human resource policies hinder CPSEs and reduce their competitiveness. Set by GOI through DPE guidelines, policies generally follow civil service norms. Detailed guidance is provided on pay and benefits for senior and supervisory employees. Delegation of powers to Navratnas and Miniratnas has provided some flexibility, but delegation does not extend to rules for pay and benefits and in practice tends to be limited by the administrative ministries and DPE. DPE guidelines set the salary for the CMD and functional directors based on the category of the company, with directors in Category A companies making the most and Category D companies the least, while pay scales for executives and non-unionized supervisors are the same for all categories of companies. Pay compression remains a problem: the pay of junior staff is considered competitive with and in some cases even better than the private sector, while employees at mid-management and above lag significantly. The value of perquisites and allowances is limited to 50 percent of base pay. Performance-based pay is capped at 5 percent of profits. Most CPSEs do not yet have performance management systems that would allow for effective performance-based pay at the team or individual level.

The Second Pay Committee Report recognizes the need to modernize human resource policies in order to enhance CPSE competitiveness. It makes a number of recommendations, including greater flexibility in pay to narrow the gap with the private sector and greater use of performance-based pay while developing and implementing performance evaluation and benchmarking systems at the company level. As this report was being finalized, key report recommendations were being implemented, including greater scope for performance based pay and some flexibility in pay and benefits. However, the overall structure of the system remains largely in place.

In the longer term, consideration should be given to allowing CPSEs the flexibility to determine compensation and other human resource policies for employees below the level of director or top management. This would further enhance the competitiveness of CPSEs and bring them in line with countries that have phased out special rules on SOE compensation and human resource policy.

Allow unviable loss-making companies to exit the market.

SICA provides for the rehabilitation of sick (potentially bankrupt or insolvent) industrial companies in both the private and public sector and refers companies to the Board for Industrial and Financial Restructuring (BIFR). But SICA contains special provisions for CPSEs (statutory corporations may only be shut down by an act of parliament). A sick CPSE requires prior GOI approval to approach BIFR with a revival plan, and GOI, as an unsecured creditor, also has the right to vote on the revival plan. Thus GOI's position as both an owner and, in many cases, a significant creditor, gives it leeway to restructure CPSEs before going to the BIFR or the courts. BRPSE was also set up as a shorter and more informal adjudicating forum for this purpose. According to the law, continuation of operations while revival measures are being considered depends on the discretion of the courts and on the facts of each case. In the case of CPSEs, the position taken by the government is usually seen to be the determining factor, and where GOI expresses support for rehabilitation it appears the courts generally do not resort to closure of the companies.

For viable companies, restructuring can be a solution and BRPSE, which was set up as a special forum for this purpose, ¹⁴ should focus on such cases. But unviable loss-making companies are a different case. Many such companies appear to have been through several cycles of restructuring and have made large annual losses from the time they were incorporated around 50 years ago. As such companies are fundamentally uneconomic units; the decision to keep them going is a political one, not an economic one. Keeping alive companies which employ a small percentage of the formal labor force and where the main values lies in real estate comes at a high economic cost. As such, the focus should be on freeing up the assets for more productive use elsewhere in the economy through:

- ► VRS and retraining/redeployment programs to minimize the social impact;
- Asset sales via a transparent process;
- Mergers and consolidations with other companies where appropriate; and
- ► Closures and liquidation.

¹⁴ Through 2007, it had made recommendations on 47 CPSEs, with GoI approval of 28 proposals, including two for closure. The total restructuring cost amounted to Rs. 8285 crore (1.8 billion USD), including cash assistance of Rs. 1955 crore (434 million USD) and non-cash assistance, primarily debt forgiveness, of Rs. 6330 crore (1.4 billion USD).

04. Improving the State's Ownership Role

How the state organizes and exercises its ownership rights is central to improving CPSE governance. The main challenge lies in making a complex ownership framework more effective in striking the right balance between CPSE autonomy and accountability. This can be achieved by: (i) reforming ownership arrangements to limit the day-to-day role of ministries while moving to a more centralized model in the longer-term; and (ii) improving the ways in which GOI exercises its key ownership functions, particularly in terms of board appointments and performance monitoring.

A. Strengthening Ownership Arrangements

OECD Guideline: "The state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of state owned enterprises is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness."

International experience suggests that the way in which the state organizes and exercises its ownership rights is central to improving state enterprise governance. There is no one model for doing so. Ownership arrangements can generally be categorized into three broad models:

- The "dual" system, where ownership and policy-making functions are usually exercised by line ministries but where a specialized body or nodal agency has been created to set the rules for both how the state acts as owner and how companies should behave. Countries such as the UK, Brazil, and South Africa use variations of the dual system, with either the ministry of finance or a specialized body serving as the nodal agency;
- The "centralized" system, where policy-making and ownership functions have been explicitly separated and a single entity—a holding company, ministry, or specialized body—has been created to carry out the ownership role, while policy functions are left to the respective ministries. Many OECD and emerging market countries such as Singapore, Chile and Indonesia use such a system; and
- The "decentralized" system, where different ministries each have a portfolio of state enterprises and act as owners and policy makers for the companies. Widely used in the past, decentralized systems have slowly evolved toward the dual or centralized models.

India's approach to organizing the state's ownership arrangements is closer to the dual model, reflecting its political system of checks and balances, a strong administrative and institutional culture, and a large and diverse state enterprise portfolio. As described in Section II above, ownership rights are delegated to the administrative ministries while DPE serves as a nodal agency for preparing guidelines, facilitating the MOU process and serving as a source of information to parliament and the public. By international standards, though, it is even more complicated than the typical dual model, in that a plethora of other agencies also play important roles: investment decisions may have to be approved by PIB and Cabinet, which also approves certain board level appointments; CAG appoints the auditor and also conducts various additional audits; CVC oversees the conduct of CPSE employees and has related powers; and bodies such as the PESB and BRSPE provide advice on various matters.

This system has its advantages, in that it does not concentrate undue power in any one agency(ies) and brings the sectoral expertise of ministries to bear. But it also has its drawbacks (as discussed in greater detail in paras 59 below). It does not allow for the separation of ownership and policy functions which may create conflicts of interest. Having 38 different ministries in charge makes it difficult to drive, manage and monitor governance improvements. Dispersion of CPSEs may also enhance the scope for political interference. Moreover, to be effective, the nodal agency or coordinating body, DPE in this case, must possess the necessary skills, resources, and political backing to deal with the ministries, companies, and various other institutions involved.

The challenge therefore is how to make the ownership arrangements more effective so that they achieve an appropriate balance between CPSE autonomy and accountability. The predominant view appears to be that, at present, the balance tilts heavily towards overregulation of CPSEs through the involvement of administrative ministries in day-to-day matters and through other checks and balances which together strangle the companies and minimize entrepreneurial or commercial decision-making.

Consider moving to a centralized model in the medium to long-term.

The OECD Guidelines tend to favor the centralized model where a single high-powered ownership entity (or group of entities) is created to carry out the state's ownership functions. Countries have created such an entity to: (i) separate policy making and regulation from ownership, thereby avoiding any potential conflicts between these two functions; (ii) make it easier for the entity(ies) to professionalize the ownership function and develop sufficient capacity and consistency as an owner versus spreading responsibilities among many different ministries; and (iii) insulate better CPSEs from political interference. In a centralized arrangement, the role of the ministries is to focus on sectoral policy-making, while the ownership entity(ies) exercises the state's core ownership rights, including: participating in the AGM, appointing directors, and monitoring performance (these functions are discussed separately in Section C below).

While organizational details differ from one country to the next, such entities share certain common features:

- They are incorporated under the Companies Act, thereby putting them on a level playing field with the private sector;
- Their portfolio typically includes commercial or for-profit SOEs that are large and operate in important or strategic sectors of the economy;
- As shareholders their main role is to manage the State's share in the portfolio through oversight/ monitoring of the companies, rather than day-to-day management of the companies. Investment and business decisions are taken by the boards and management of the companies based on commercial considerations, with minimal involvement of the government as shareholder;
- ► The state's shareholder role is exercised through annual shareholder meetings, board appointments, and monitoring the performance of SOEs. It usually has sole authority to vote the State's shares at the AGM;
- ► Their boards consist largely of independent directors with requisite competencies and skills;

- Many operate with a strong commercial or private sector culture, with a full-time professional staff and advisors paid at market rates to attract and retain the necessary skills and expertise;
- A major goal of the entities is to promote good corporate governance of the portfolio companies, including through the use of performance contracts, strengthening of boards and management, and stakeholder management;
- ► They operate with broad authority and autonomy to perform the ownership functions based on targets and guidelines set by the State;
- They report directly to the Prime Minister or in some instances to the Minister in charge of the portfolio, which in turn have access to independent experts to exercise oversight of the entities. Transparency and accountability of the ownership entity is also managed through oversight by Parliament, audit institutions, public disclosure, and annual review.

Moving to such a model in the Indian context may be a radical change and a complex endeavor in the short-term, entailing significant political, institutional and legal ramifications that would need to be more closely assessed. Concentrating power in such an entity(ies), especially given a large and important CPSE sector, may raise opposition. Concerns about its transparency and accountability would need to be considered. For these and other reasons, centralization, though it resolves many of the problems associated with the existing arrangements, may not be a workable or feasible option for Indian CPSEs in the near-term. It can and should, however, be considered as a medium or longer-term option as and when more companies are listed, as and when they become more independent with exposure to capital market discipline and SEBI oversight, and as and when the size of the CPSE sector is reduced.

In the interim, existing arrangements can be made more effective by taking the following steps which should also help put reform on a path towards centralization. These include steps to:

- ► Target governance efforts on Navratnas, Miniratnas, and profitable companies;
- Focus administrative ministries on exercising core ownership functions (see Section C below) while drastically curtailing day-to-day interference in the companies and moving to a board-managed model;
- ► Enhance DPE's role and capacity to make it a more effective nodal agency;
- ► Improve the CG Guidelines to make them a more effective governance tool.

Target governance efforts on Navratnas, Miniratnas, and profitable companies.

Implementing governance reforms across a group of 244 companies spread across 38 ministries is a demanding task and is likely to lead to a slow and uneven process. Instead, priority should be given to improving the governance of Navratnas, Miniratnas and profitable companies. In tandem with market discipline reforms, this would help achieve even higher levels of performance and allow companies to graduate from one category to the next, with greater delegation of powers and more autonomy accompanied by transparency and accountability. It would also help facilitate new and further listings of such companies on the capital markets, and also prepare for other forms of private sector participation

as and when opportunities arise. In the case of loss-making or unviable companies, the focus should be on restructuring through BRPSE, including restructuring of the balance sheet, freeing up land for more productive use elsewhere in the economy, implementation of VRS and retraining programs, and closure or liquidation.

Focus the role of the administrative ministries and curtail day-to-day interference.

Administrative ministries are responsible for both setting sector policies and regulation and, as delegated owners, for exercising shareholder rights. In a few sectors, these two functions have been separated and independent regulators have been established to regulate both the public and private sectors, as for example in electricity, telecoms, and petroleum.¹⁵ In other sectors, administrative ministries continue to be involved in both policy-making and ownership functions. The Ministry of Chemicals and Fertilizers, for example, decides the fertilizer policy for all firms, public and private, while at the same time owning a number of CPSEs operating in the sector. In such cases, while ministries have a legitimate role in policymaking, combining this function with the ownership function can create conflicts of interest and also serve to dilute the ownership role.

As delegated owners, administrative ministries should be responsible for exercising key ownership functions. These include: voting at AGM meetings; overseeing board appointments; and monitoring CPSE performance (these ownership functions are discussed in detail in Section C below). Formally, the ministries are expected to exercise their role in these areas in much the same way any owner would under the CA, that is through the participation of their representatives in the AGM and through the two nominee directors that serve on CPSE boards (boards are discussed in greater detail in section IV below). To ensure compliance with the CA, the ministries also derive certain powers found in most CPSE articles, in particular an article requiring a Presidential directive for allowing the GOI to make an extraordinary request of the CPSE. DPE guidelines, however, give boards a de jure right to reject certain requests by the GOI, while also delegating certain powers to Navratna, Miniratna, and other profit making CPSEs (Box 2).

In practice, however, the most frequently cited concern relates to the pervasive and informal day-to-day interventions by ministries in the commercial domain which severely limits CPSE autonomy in decisionmaking. Such interventions are less in the case of Navratnas and Miniratnas which have been delegated significant decision-making powers. But even in such companies, DPE guidelines—for example on investment, use of surplus funds, dividends, compliance and internal controls, land acquisition and use, and human resource related issues—appear to provide scope for involvement. In other CPSEs, ministries exert direct and indirect influence on the management, making management dependant on the ministries for taking most decisions. While ministries have certain rights as owners, their interventions are not always transparent and may not always be consistent with the CA or with statements by the GOI on the need to increase management autonomy and board power. Entrenched interests and opportunities for rent-seeking may also work to perpetuate the status quo and reduce incentives for pulling back or letting go. Interventions also come from various other ministries, departments and institutions such as MOF, PIB, CVC and others. The net result is bypassing and weakening of CPSE boards (discussed in greater detail in Section IV below).

¹⁵ Issues related to the independence or corporate governance of the regulatory bodies are outside the scope of this particular report.

BOX 2: Delegation of Powers

DPE guidelines formally delegate certain powers to Navratnas, Miniratnas, and profit making CPSEs, and have tended to increase delegated powers in recent years. Delegation is contingent on the CPSE not receiving financial support from the government and having at least 4 "nonofficial" directors (though until recently this included government directors). Decisions made by the board regarding delegated powers should include the government directors and relevant functional director, and should, if possible, be made unanimously.

| Category | Threshold | |
|--|--|--|
| CAPITAL EXPENDITURES | | |
| Navratna | No limit | |
| Miniratna (Category I) | Rs 500 Crore (USD 110 million) or 100% net worth | |
| Miniratna (Category II) | Rs 250 Crore (USD 55 million) or 50% net worth | |
| Other profit making CPSE | Rs 150 Crore (USD 33 million) or 50% net worth | |
| Other CPSEs | No specific delegation | |
| JOINT VENTURES, SUBSIDIARIES, AND MERGERS & ACQUISITIONS | | |
| Navratna | Rs 1000 Crore (USD 220 million)or 15% of net worth | |
| Miniratna (Category I) | Rs 500 Crore (USD 110 million) or 15% net worth | |
| Miniratna (Category II) | Rs 250 Crore (USD 55 million) or 15% net worth | |
| Other profit making CPSE | No specific delegation | |
| Other CPSEs | No specific delegation | |

Investment: Depending on the category of the enterprise, capital expenditures can be made without GoI approval up to limits set in DPE guidelines as provided below. These must be included in the annual and 5 year plans of the enterprise.

Investments that exceed the limit must be approved by the administrative ministry and, if they are large enough, the Public Investment Board and the Economic Affairs Committee of Cabinet (which is chaired by the Prime Minister). In practice, non-navratnas that wish to undertake major investments may need to wait months for final approval.

Finance: Profit making CPSEs are generally free to borrow from private and state-owned banks. As discussed in IIA, there is preference for using state-owned banks, and equity finance from non-state sources is limited.

Joint Ventures and Subsidiaries: Navratnas and miniratnas have also been delegated the power to create joint ventures and subsidiaries in India, subject to prescribed limits (table). The combined value of such ventures cannot exceed 30 percent of the net worth of the CPSE. Navratnas may also create foreign joint ventures, but must inform the Economic Affairs Committee of Cabinet.

ventures and subsidiaries.

Navratnas and miniratnas may also transfer assets, issue new equity, and divest shareholdings in these subsidiaries, as long as the "public sector character" (51 percent or more state ownership) of the CPSE or subsidiary is not affected. The rules for navratna and miniratna mergers and acquisitions are similar, with the same thresholds and the requirement that the "public sector character" of the enterprise is not affected. Non-ratnas have not been delegated the ability

Dividends: Delegation does not extend to dividends. Under MoF guidelines, all profit making CPSEs are required to pay a minimum dividend of 20 percent of equity or 20 percent of after-tax profits, whichever is higher. Companies in the oil, petroleum, chemical, and other infrastructure sectors are required to pay at least 30 percent of post-tax profits in dividends. Dividends are paid to the central exchequer, they are not retained by the administrative ministry or department. In practice, while some CPSEs do exceed the required minimums, others may find that the requirement limits their ability to reinvest, and increases dependence on external debt.

to enter such arrangements, and there is some ambiguity on the approval process for joint

Human Resources: There are currently 250 DPE guidelines dealing with pay and other HR matters. Navratnas and miniratnas have been delegated some powers in this area, but certain controls still remain.

Maharatnas: As this report was being finalized, a new category, "Maharatna" had been introduced to allow for greater delegation to leading CPSEs. These will be delegated somewhat more power than Navratnas, including a Rs. 5000 Crore (vs. 1000 Crore) limit on joint ventures and subsidiaries.

Limiting administrative ministries to performing key ownership functions is challenging but critical to reducing the scope for discretionary influence and increasing CPSE autonomy in commercial decision-making. The main objective should be to bring greater clarity to the state's ownership role, in particular to distinguish between commercial decisions which should be left to the board and management and policy decisions which require governmental intervention. Achieving this objective would require efforts to:

- ► Focus and strengthen the role of the ministries on policy-making and establish independent regulatory authorities where required;
- ► Limit the ownership role of ministries to core ownership functions: participation in the AGM; appointment of directors, and monitoring performance (discussed in Section C below);
- Ensure that, in all other matters, ministries exercise their ownership rights through the government nominees on the board of directors;
- Enforce the requirements for Presidential directives to limit informal intervention in day to day affairs;
- Keep developing corporate governance systems and processes at the company level to reduce the scope for political interference;

- Move towards a fully board-managed model as the role of the ministries becomes more limited, starting with the more important listed companies that have already begun moving in that direction (discussed in greater detail in Section IV). Giving boards greater autonomy will in turn require high levels of accountability through exposure of CPSEs to market discipline and implementation of the other corporate governance recommendations mentioned in this report; and
- Develop a system to monitor and benchmark the performance of ministries as owners.

Enhance the role and capacity of DPE.

As the nodal agency, DPE has played and continues to play an important role in CPSEs. In consultation with various other ministries and advisory bodies such as SCOPE, one of its main roles is to issue policy guidelines for different categories of CPSEs. Its other main role is to facilitate the MOU system and prepare an annual survey and report on CPSE performance. In addition, DPE is involved in the process for appointing CPSE directors (see Section C below). Its other roles are to help settle disputes between CPSEs through the Permanent Machinery for Arbitration and to provide training opportunities for members of scheduled castes and tribes. Most of DPE's core functions are typical of those carried out by nodal agencies elsewhere.

DPE has issued a large number of guidelines over the years in a wide range of areas covering all aspects of CPSE operations (see para 24 above). These guidelines helped set policies and made service conditions similar across CPSEs. They played a strong role in earlier years when CPSEs were less exposed to competition, disinvestment, delegation of powers, and listing. But these reforms and the categorization of companies may have reduced the role—and the need—for such guidelines. Companies complain that there are too many guidelines. While some 700 guidelines were cancelled between 1997 and 2002, around 350 still remain in force. Many of these may have been partially or fully overridden by subsequent ones, without a clear indication of what remains relevant. Companies also complain that, in view of exposure to market forces, many of the guidelines are overly prescriptive and serve to reduce, rather than enhance, the competitiveness of the firms. Cleaning up the guidelines and focusing DPE's role on the most important policy areas (e.g. performance-based compensation) is one issue going forward.

DPE's central role in facilitating the MOU process is widely acknowledged and appreciated. It provides logistical support to the MOU process, acts as buffer between the Task Forces that approve and evaluate the MOUs and the signatories (the CPSEs and the ministries), develops an information database, monitors the progress of MOUs, provides counsel to the signatories, and coordinates research and training on various aspects of the MOU mechanism. Based on a review that was carried out last year, DPE has begun to strengthen the process of negotiating and setting targets, refining performance indicators, and of evaluating performance. Its role in these areas may require specialized technical and financial knowledge and skills that DPE currently lacks.

DPE has so far taken modest steps to actively disseminate, promote, and monitor compliance with the CG Guidelines. The Guidelines were issued just two years ago and DPE is still in the initial stages of this process. However, promotion of good corporate governance practices is a key function of nodal agencies and DPE's role and profile in promoting and monitoring governance compliance needs to be substantially elevated.

Going forward, therefore, DPE's role and capacity need to be enhanced with a view to transforming it into a more professional and activist body aimed at promoting and following up on the governance agenda. This would require:

- Consolidating existing DPE guidelines into a more accessible and user-friendly document. Redundant
 and outdated guidelines need to be removed. Certain guidelines, especially those that may be overly
 prescriptive, may also need to be revisited;
- Hiring technical and financial experts capable of improving and overseeing the MOU system, instead of relying solely on Task Force outsiders. Greater exposure of DPE to international trends in performance measurement practices through the development of a forum for the regular exchange of experience and training/study tours for DPE staff would also be helpful;
- Enhancing DPE's role in promoting and following up on the governance agenda, by working with the administrative ministries to implement and monitor compliance with the CG Guidelines (discussed in greater detail below). Enhancing its role in this area may also require specialized skills and knowledge about governance practices. Donor technical assistance and cooperation with ownership entities or nodal agencies in other countries may be useful in building the needed skills and capacity.

Improve the CG Guidelines to make them a more effective tool.

India is one of the few developing countries to have issued a corporate governance code for its CPSEs and in doing so has taken a big step forward in promoting the governance agenda. The CG Guidelines were issued in June 2007 as voluntary guidelines, modeled largely along the lines of Clause 49. Though voluntary in nature, compliance with the Guidelines is required to be reflected in the Director's report, in the annual report, and in the Chairman's speech at the AGM. DPE would also grade CPSEs on compliance. The Guidelines were issued for a one year experimental phase in which all CPSEs—listed and non-listed—would implement the Guidelines and submit progress reports to DPE. In light of the experience, suitable improvements would be made. The Guidelines cover the key areas of boards of directors, audit committees, and disclosure. Seven detailed annexes go into greater depth in each of these areas and also provide model codes of conduct.

Now that two years have passed, sufficient experience should have been gained for DPE to carry out a systematic assessment of compliance with the CG Guidelines and assess what specific changes or improvements may be required. Such an assessment could start with listed companies and eventually cover non-listed companies. Comparisons between these and other groups of companies (e.g Navratnas, Miniratnas, other profit-making companies) would also be of use. In the absence of such an evaluation it is difficult to have an informed view about compliance (especially of non-listed CPSEs) or the specific changes that may be needed.

Nevertheless, a few initial observations are offered for strengthening the Guidelines to make them a more effective tool for promoting the governance agenda. First, the scope and coverage of the CG Guidelines could be expanded to make it a stand-alone document that covers all aspects of corporate governance within the context of GOI's broader policy framework for CPSEs. This would entail:

- Expanding the introductory section to include the main elements of GOI's policies toward CPSEs and lay out the broader context and rationale for CPSE governance and the Guidelines;
- Adding a discussion of the role of the administrative ministries as owners, and the principles governing the relationship between the ministries, other key bodies, and CPSEs; and
- Adding sections on two other important governance areas: minority shareholder protection, which is likely to grow in importance as CPSEs are listed on the stock exchange (Box 3), and stakeholder protection.

Second, the Guidelines should clearly distinguish and clarify what is mandatory and what is voluntary. The CG Guidelines are voluntary in nature, yet they contain specific directives "requiring" all companies including non-listed companies—to comply with the stated governance practices, while also calling on DPE to monitor compliance. Compliance with the Guidelines is less of an issue for listed companies governed by Clause 49, and more of a challenge for non-listed companies where administrative ministries and companies themselves may not face pressures or feel obliged to comply, especially since monitoring is yet to take place and compliance is not yet factored into the MOU system. Making certain core requirements mandatory and distinguishing these from the voluntary aspects would serve to ensure compliance, especially in the case of non-listed companies.

Third, and related to the above, DPE should develop and put into place a system to monitor compliance with the Guidelines and ensure that the minimum mandatory requirements, or compliance with the Guidelines in general, is included as a parameter in the MOU system (see Section C below). This should help give CPSEs a strong incentive to comply. In the same vein, consideration should also be given to developing a monitoring and benchmarking system to evaluate the administrative ministries against adoption and implementation of the CG Guidelines.

B. Exercising Key Shareholder Functions

As the sole or dominant shareholder of CPSEs, GOI—through the administrative ministries as delegated owners—is, like any other shareholder, expected to carry out three key shareholder functions: (i) participation in the AGM; (ii) appointment of CPSE directors; and (iii) performance monitoring. While the first of these functions is covered in various parts of this report, the latter two are discussed separately in greater detail below, aimed at enhancing transparency in the board selection process and at improving the MOU performance monitoring system.

Enhance transparency in the board appointment process.

Appointing CPSE boards is a key ownership function given the central role of boards in achieving good corporate governance. Unlike many other countries, India has a well established process for doing so for the different categories of directors. As per the provisions of DPE guidelines and Clause 49, boards typically consist of a full-time Chairman-cum-Managing Director (CMD) and three categories of directors:

• Government directors: Representing GOI as the shareholder, these posts are restricted to a maximum of two and are generally filled by the Additional or Joint Secretary of the concerned ministry, or by their designees. Finance ministry representatives may be appointed to major CPSEs (companies with no finance representatives must send agenda papers and minutes of board meetings to the ministry);

BOX 3: Including Minority Shareholder Protection in the CG Guidelines

The 44 listed CPSEs have large numbers of minority shareholders, some more than 100,000 each. These shareholders are protected by the relevant provisions in the CA and SEBI regulation, including disclosure requirements, the right to receive notice of and participate in the general shareholders meeting, and transfer their shares and receive dividends. Like other shareholders, they can appeal to the MCA or SEBI if their rights are violated.

While the CA, Clause 49 and other regulations cover protection of minority shareholders, the special status of CPSEs limits the role that outside investors play in the governance of the company. DPE guidelines and 51+ percent state ownership ensure that key decisions, including board selection and major transactions, are made by GOI or the directors. In many cases direct and indirect state ownership is greater than 76 percent, so that changes to the articles and other decisions requiring qualified majorities can be made without the consent of other shareholders. Special provisions in the CA for government companies further limit non-state shareholders and reinforce the role of the GOI. This includes a prohibition on proportional representation, which would allow non-state shareholders to be represented on the board, and other provisions that make it easier for GOI to choose the entire slate of directors. This contrasts with the OECD Guidelines, which call for equal treatment of all shareholders and consultation with and participation of minority shareholders in the AGM and board elections. A growing number of countries allow for minority shareholders to be represented on the board and provide other rights to minority shareholders.

DPE guidelines should cover the participation of minority shareholders in listed companies. The CG Guidelines should encourage CPSEs to nominate at least one representative of minority shareholders to the board of directors. Minority shareholders should be consulted on major transactions, even when the government has enough votes to ensure passage. In addition, the CG Guidelines should elaborate on duty of the CPSE and its board to act in the interest of shareholders, including minority shareholders, and treat all shareholders equally. A number of other recommendations in this report would also serve to protect the interest of minority shareholders, including floating larger stakes in CPSEs and improving CPSE reporting.

- Full-time functional directors: Comprising a maximum of 50 percent of the board, they are typically senior management of the company (e.g. directors of finance, marketing, human resources) who serve for a five year term or until the age of superannuation, whichever comes earlier, and on a contract basis with the option for government to terminate services with three months notice. A performance review is conducted after the first year prior to confirmation; and
- Part-time non-official or independent directors: They must be independent from the company and meet the criteria laid out in DPE guidelines¹⁶ Independent directors must comprise at least one-third of

¹⁶ An independent director is defined as someone who has no pecuniary relationships or transactions with the company, its directors or senior management, or holding companies and subsidiaries; is not related to persons occupying management positions at the board level or one level below; has not been a senior executive or manager of the company in the prior three years; is not a partner or an executive in the previous three years of the statutory audit, internal audit or tax firm or legal or consulting firms that have a material association with the company; is not a material supplier, service provider or customer or lessee of the company; is not a substantial shareholder of the company owning two percent or more of the block of voting shares. Candidates must be between 45-65 years of age (eminent persons can be up to 70 years), have a graduate degree from a recognized university, and have at least ten years experience at a senior level (joint secretary or above in the government, CMD or MD in the corporate or public sector, in academia, or in the field of chartered accountancy).

total board strength in non-listed companies and in listed companies with a non-executive chairman; and at least half of the board of listed companies with an executive chairman. Navratna and Miniratna boards must have at least four and three independent directors respectively in order to exercise their delegated powers.

In all companies, government directors are appointed by the concerned minister. For the other two categories, the appointment process is complex, varying by category of director and by type of CPSE (Table 7). Functional directors are short-listed (based on predetermined eligibility criteria) by the Public Enterprise Selection Board (PESB) and interviewed by the PESB board in consultation with the concerned secretary (or joint/additional secretary) and CEO of the company. The shortlist is sent to the ministry and to CVC for vigilance clearance. For the more important companies, the final selection is made by the Appointments Committee of Cabinet (ACC). For smaller companies, appointment powers are delegated to the concerned minister, with any deviations from the recommendations submitted to ACC for approval. For independent director positions, the concerned ministry proposes the names of three candidates to PESB, drawing from the DPE databank of candidates. For Navratnas and Miniratnas, the selection is made by a Search Committee chaired by the PESB chairman and consisting of the DPE secretary, the secretary of the concerned ministry, the CEO of the concerned company, and four nonofficial members. For other CPSEs, the selection is made by PESB. In both cases, the final list is sent to the ministry and then to ACC for final approval.

The board appointment process is relatively independent and professional compared to many other countries, managed largely by PESB whose board comprises independent or non-official members. Independent members are also included in the Search Committee for independent directors. The process of selecting functional directors begins well in advance (about two years) as known vacancies are identified. Unlike in the past, these posts are now open to external candidates, a big step forward towards opening up the process and bringing in outsiders with the necessary skills, experience, and independence. DPE has set up a databank with nearly 350 candidates for independent director positions. And greater efforts are being made to bring in such directors with private sector backgrounds.

Yet there is room for further improvement. The process for selecting functional directors still openly gives preference to candidates from within the company (with the objective of developing a cadre of management professionals), from other CPSEs, or from other parts of the public sector. Thus candidates for these positions are still likely to come mainly from senior management ranks within the CPSE sector or the public sector more broadly. In the case of independent directors, the current practice of allowing administrative ministries to propose candidates and then nominate the final list for ACC approval may allow their self-interests to come into play and risk jeopardizing the independence of the process. Reportedly, ministries have sometimes disagreed with the Search Committee/PESB list and have added their own names before sending it to ACC for approval. Retired civil servants and other insiders reportedly are frequently appointed to independent director positions. Perceptions of political influence exist. Moreover, the process of obtaining ACC approval itself can be time-consuming, reportedly taking anywhere from six months to one year. Vigilance clearance can also be a long drawn out and complex process. Having too many players involved in the process has exacerbated these problems. As discussed in greater detail in Section IV on CPSE boards below, these factors in turn have contributed to delays in hiring the requisite number of independent directors on CPSE boards. By appointing directors still beholden to GOI, both as the appointing authority and through previous connections, board independence and board effectiveness may also be constrained.

TABLE 7: Board Selection and Appointment Process

| | | Government Directors | CMD/Functional Directors | Independent Directors |
|----------------------|---------------------------|-------------------------|--|--|
| Required Composition | | Maximum two: | "Adequate" number Not more than half of board 5 year term | Non-listed companies and listed companies with non-executive chairman: one third of board Listed companies with executive chairman: half of board Navratnas: at least 4 Miniratnas: at least 3 Three year renewable term |
| | Proposed by | Concerned minister | • PESB | Concerned minister |
| | Shortlisted by | | • PESB | Navratnas and Miniratnas: search committeeOther companies: PESB |
| Appointment Process | Interviewed by | | PESB board A companies: concerned secretary B, C, D companies: joint/additional secretary Concerned CEO | Navratnas and Miniratnas: searchcommittee Other companies: PESB |
| ₹ | Cleared by | | Concerned ministryCVC | Concerned ministryCVC |
| | Selected/ appointed by | Concerned minister | A and B companies: ACCC and D companies: concerned ministry | • ACC |

Streamlining the board appointment process would serve to minimize the scope for political influence, expedite the process, and enhance transparency—and in so doing would lead to more professional and effective boards. More specifically:

- ► ACC's role should focus on appointing the CMDs of Navratnas and other important or strategic companies. CMDs should come from a strong corporate background rather than from the civil service;
- Any explicit preferences for hiring internal candidates to functional director posts should be removed. PESB/DPE should proactively seek out qualified candidates from outside the public sector in order to diversify CPSE boards and bring in the requisite competencies and skills;

- The process for appointing independent directors should be streamlined with a view to reducing the role of ACC and the ministries while giving CPSE boards a greater role as per private sector and good practice. Such a board managed process would still allow government directors on the board to represent GOI's interests in the selection of directors. Under such a system:
 - Boards would set up nomination committees comprised of independent directors to manage the selection process;
 - These committees would nominate a panel of 2-3 candidates with PESB support and using the DPE databank of candidates;
 - The administrative ministry (as the delegated owner) would select and appoint the final candidate drawing from the above list;
 - n selecting directors, it should be ascertained that candidates are committed and willing to attend and actively participate in board meetings (attendance is reportedly a problem in some cases);
 - The new director should participate in a quality induction program to familiarize them with their responsibilities, the business, the board, and recent issues;
 - Such a process could initially be applied on a pilot basis to boards of large listed companies which already have or are considering creating nomination committees comprised of independent directors. Based on an evaluation of the experience, this process could be expanded eventually to other CPSEs as and when they set up nomination committees.

Improve the MOU performance monitoring system.

Compared to most other countries, India has one of the more sophisticated state enterprise performance monitoring systems in place. CPSEs are monitored and evaluated through the Memorandum of Understanding or MOU process, which is an annual performance agreement negotiated and signed between the CPSE and administrative ministry. Established in 1986, the main goal was to improve CPSE performance by providing greater autonomy to the enterprises while holding them accountable for results through the MOU, which set out objectives, targets, and incentive-based rewards. The MOU system started with four companies in 1986-87, increased to over 100 after the 1991 IPR, which reemphasized the importance of the system, and reached 143 companies in 2007-08 (Table 8). Beginning in 2007, DPE mandated that all CPSEs have MOUs, either directly with the administrative ministry, or in the case of subsidiaries, with the parent CPSE.

MOU negotiations are arranged by DPE and facilitated by eleven "Task Force Syndicates", organized by sector. Each CPSE is assigned to a particular Task Force, which approves the MOU and also evaluates how well the enterprise did in meeting the targets. Each Task Force consists of the convener, six members, and the Task Force members. The six members consist of retired civil servants, executives of public sector, management professionals, and independent members with experience. Task Forces were formed to bring technical expertise that was considered lacking in the government and the CPSE, and to bring independence to the process (no current government member can serve on the Task Force). Final MOUs must be approved by the High Powered Committee (HPC), which also assesses the performance of both

TABLE 8: Coverage of MOU System

| Year | MoUs signed | Year | MoUs signed |
|---------|-------------|---------|-------------|
| 1987-88 | 4 | 1998-99 | 108 |
| 1988-89 | 11 | 1999-00 | 108 |
| 1989-90 | 18 | 2000-01 | 107 |
| 1990-91 | 23 | 2001-02 | 104 |
| 1991-92 | 72 | 2002-03 | 100 |
| 1992-93 | 98 | 2003-04 | 96 |
| 1993-94 | 101 | 2004-05 | 99 |
| 1994-95 | 100 | 2005-06 | 102 |
| 1995-96 | 104 | 2006-07 | 113 |
| 1996-97 | 110 | 2007-08 | 143* |
| 1997-98 | 108 | | |

^{*} These are all 'holding' or independent companies. Almost all CPSEs are to be covered under the MoU system in 2007-08, since the subsidiary CPSEs sign MoUs separately with their holding companies.

CPSEs and administrative ministries in meeting their commitments. The HPC is chaired by the Cabinet Secretary and consists of other key cabinet secretaries, PESB chairman, Tariff Commission chairman, Chief Economic Adviser, and the DPE Secretary. The MOU division in DPE acts as the permanent secretariat to the HPC and task forces.

The MOU's contents are set by DPE guidelines, and include: (i) a mission statement; (ii) the objectives of the CPSE; (iii) areas where power has been delegated to the CPSE; (iv) performance targets; and (v) commitments from the government to the CPSE. In practice it is the performance targets, and the resulting composite score, that seems to be the primary focus of system participants. DPE guidelines specify particular financial and non-financial or dynamic targets, with different weights assigned to each, based on the broad sector the CPSE operates in (loss-making companies and those under construction have their own formats). A balanced scorecard approach is used, with 50 percent of the weight given to financial targets, and 50 percent to non-financial.¹⁷

Performance is evaluated based on a comparison between actual achievements and the agreed annual targets. It is measured on a five point scale, ranging from excellent (1) to poor (5) for each target area. Based on audited accounts and other data provided by the CPSE, the relevant task force grades the targets at the end of the year, which in turn is aggregated to give the composite score for the CPSE. Typically, a majority of CPSEs receives scores between 1 and 2, indicating that they are top performers. Performance incentives are monetary and non-monetary. Monetary payments are based on MOU scores.

¹⁷ The latter is broken down into 'dynamic' targets (30 percent), 'enterprise specific' targets (10 percent), and 'sector specific' targets (10 percent). For example, based on DPE Guidelines, the dynamic targets of manufacturing and mining CPSEs should include quality (4 percent), customer satisfaction (4 percent), human resource development (3 percent), R&D (4 percent), project implementation (7 percent), investment (4 percent), and extent of globalization (4 percent). Sector specific and enterprise specific targets are not given in DPE guidelines, but it is suggested that the former include economy-wide factors like changes in supply and demand, and the latter safety, environment, and similar issues.

Non-monetary incentives include Excellence Awards for the best performing CPSEs, and Excellence Certificates for CPSE with a final rank of 1.5 or better. In recent years the Prime Minister has presented these awards. The score is also taken into account in the evaluation and bonuses for managing directors and other senior officers.

In December 2009, the DPE issued new guidelines for MOUs. These added corporate social responsibility (CSR) as an additional component to be included and provide some additional clarity on setting both financial and non-financial targets. They also reaffirm the importance of including the CPSEs mission and objectives, and GOI commitments and assistance.

TABLE 9: Brief history of Memoranda of Understanding System

| MOU Guidelines | Time Period | Key Guidelines Implemented |
|---|---------------------|--|
| PHASE 1 The French Contract | 1987-1989 | Based on the recommendations of the Arjun Sengupta Committee set up in 1985 to review policy for public enterprises, the government introduced the MOU system in 1987-88. The system was modeled after the French "Performance Contract". 4 CPSEs signed MOUs that year and 11 CPSEs signed in 1988-89. The MOU is a freely negotiated document between the government and the CPSE that specifies intentions, obligations and mutual responsibilities. These first set of guidelines were focused on achieving a balance between autonomy and accountability and to improving CPSE performance and "emphasis was on negotiated and agreed objectives rather than interfering with day to day affairs. An independent High Level Committee is instituted under the chairmanship of the Cabinet Secretary members from other government departments to ensure fairness in the process. |
| PHASE 2 The Korean Signaling System | 1989- Mid 90s | The MOU system underwent a qualitative change the year after it's implementation in four distinct ways- Efficiency expanded from merely focusing on "static operational efficiency" to include "qualitative efficiency" that focused on customers-satisfaction, on-time performance etc. and "dynamic efficiency" focused on future growth through human resources development, corporate planning etc. Weights were assigned to the various criteria used to gauge the performance of CPSEs. The extent of deviations from targets would specify what kind of scores the CPSEs received for their performance Grades were assigned to CPSEs based on composite scores on a five point scale – Excellent (A), Very Good (B), Good (C), Fair (D) and Poor (E). |
| PHASE 3 | Mid 90s- Present | The MOU system grew steadily from 4 CPSEs in 1987-88 to over 150 CPSEs in recent years. The emphasis of the system has also enabled companies to gain autonomy threw results. |

The MOU system has steadily evolved and improved over the past 20 plus years, and has become a key tool for ensuring accountability of CPSEs and their directors (Table 9). It provides powerful incentives for companies to improve performance: if Navratna and Miniratna companies, for example, do not show consistent performance three consecutive years they stand to lose their status. Yet there is room for further improvement and continuous development of the system. This would involve steps to:

- Ensure that Task Forces have sufficient capabilities. The system places high demands on the Task Forces and gives them a central role in the process. DPE should ensure that in addition to sector-specific technical capacities the Task Forces also have the requisite financial and management skills;
- Evaluate how social objectives and service delivery targets can be factored in. The "non-performance" elements of the MOU, in particular social objectives/obligations and government commitments, can have a significant impact on performance but are seen as secondary by the system, making it difficult to hold managers accountable for targets because of external factors. Sector and enterprise specific targets should thus find a way to take into account such obligations;
- ▶ Revisit the targeting process. Targets should not be so generous that a great majority of CPSEs are rated very good or excellent. Once established, various target areas and objectives need not change on an annual basis, with only specific thresholds being adjusted to reflect the growth of the CPSEs and changing market conditions;
- Include compliance with corporate governance as a criterion for evaluating and rewarding performance. Compliance with the CG Guidelines should become a criterion for consideration of the Excellence Awards:
- ▶ Be more specific about what the ministries' obligations are. At present, the MOUs appear to provide more specifics on what the company will do compared to what the ministries will do. While interministerial decision-making may make this difficult to do, the specific obligations will need to be clear to evaluate the ministries' performance.
- ▶ Disclose more on MOUs. MOUs are not easily accessible to the public but contain the basis for company evaluation and hence important information for Parliament, other shareholders, and the public. Other countries have moved to disclose more on their performance management systems. While specific targets do not have to be disclosed, things like social objectives and the target areas for measuring performance can and should be disclosed.

05. Professionalizing CPSE Boards

OECD GUIDELINES: The boards of state-owned enterprises should have the necessary authority, competencies and objectivity to carry out their functions of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.

GOI has taken a number of steps to professionalize and empower CPSE boards. Starting in1992 and progressing over the years, the emphasis has been on improving the composition of boards, inducting independent directors to bring greater balance and expertise and reduce the scope for political interference, and delegating decision-making powers to the boards of Navratna, Miniratna, and profitable companies. Since 2002-03, listed CPSEs have had to comply with corporate governance requirements introduced by SEBI through Clause 49 of the listing agreement. More recently, the 2007 CG Guidelines endorsed SEBI's requirement on independence of boards and has stipulated that, for listed CPSEs, at least half the board needs to be independent and for unlisted CPSEs at least a third needs to be independent. The Guidelines also call on companies to develop a code of conduct for board members and senior management and a formal board charter to clarify roles and responsibilities. After some initial hiccups in implementing these requirements, listed CPSEs are now gradually improving compliance with corporate governance norms. Training of existing and potential directors is getting underway.

These are all steps in the right direction, and have led CPSE boards to become more serious in adhering to corporate governance norms. The detailed case studies of ONGC and NTPC, for example, indicate that board procedures have become more transparent and board documents are prepared and circulated well in advance. The number of agenda items has been on the decline, leading to more serious consideration of important issues. And independent directors are beginning to express their views and often call for more information and discussion on agenda items. All this augurs well for improved board performance.

Yet further improvements can and should be made with a view to further professionalizing CPSE boards. As discussed in greater detail below, and especially for Navratnas, Miniratnas, and other profitable companies, strengthening CPSE boards will require actions in four broad areas, including actions to:

- Strengthen board composition and structure;
- ► Empower boards with greater decision-making authority;
- Strengthen the Audit Committee of the board; and
- ► Introduce performance-based evaluation and remuneration practices.

A. Strengthening Board Composition and Structure

DPE guidelines and Clause 49 have led to steady improvements in board composition and structure over time. Board composition, on paper at least, is comparable to many countries. The level of state representation through the two nominee directors is in line with countries such as Sweden, Germany, and Finland which also have one or two such directors (unlike in countries with a centralized ownership model such as Denmark, Norway, the Netherlands, the UK, and Australia which have no state representative on the boards). DPE guidelines and Clause 49 on independent director requirements are also similar to the requirements in such OECD countries as Greece, France, and Korea (unlike in Scandinavia, Germany and Australia where most if not all SOE board members are independent).

In practice, however, boards still lack the requisite number of independent directors. Full-time or functional directors reportedly comprise more than half the board in many CPSEs, while many independent director posts remain vacant. The March 2007 CAG performance report reviewed compliance with independent director requirements in both listed and unlisted companies. It found that:

- 30 of the 44 listed CPSEs had not constituted their boards as per Clause 49. The bulk or 70 percent of these companies (21 in all) did not have the required 50 percent of independent directors, while the remaining nine companies had no independent directors at all. The lack of independent directors also resulted in non-compliance with Clause 49 requirements for independent directors in the Audit Committee, independence of the Chairman of the Audit Committee, and requirement of quorum of meeting of the Committee; and
- ▶ The board of 64 unlisted companies had not been constituted as per the DPE guidelines requiring at least one third of the board to be comprised of independent directors. In three quarters or 48 of the companies, there were no independent directors on the boards at all, while the remaining 16 companies did not have the requisite one third independent directors.

As such, there is still scope for further reform of CPSE boards. In this regard, GOI should take steps to:

- ▶ Bring in more private sector participation;
- ► Reduce the size of some boards;
- Separate the roles of Chairman and Managing Director in large companies; and
- ► Make board leadership and development programs mandatory.

Bring more private sector candidates onto CPSE boards.

Bringing more external candidates from the private sector—that are independent not only of the executive management of the company but also of the government as owner and appointing authority—should be the main goal. Candidates with strong business and commercial backgrounds would help bring greater commercial orientation and independent decision-making to the board, reorient its role towards a more strategic view, and promote the interests of the company rather than the government. Attracting good candidates from the private sector can be difficult due to government dominance of boards and low remuneration. Remuneration may need to be increased and made more performance based (and recent changes move in this direction, as discussed in D). In the larger and more important CPSEs the honor and prestige of public service can also be motivating factors. Reform of the board appointment process (as discussed in Section III) and change of mindset are fundamental to changing board composition.

Reduce board size.

In unlisted companies there is no upper limit on the number of board directors as no such limit is prescribed by the Companies Act.¹⁸ Some companies however, have stipulated a limit on the maximum

number of directors in their articles.¹⁹ Boards of listed companies are structured as per the Listing Agreement where the board size is limited to a maximum of 15 members, which is similar to countries such as Greece, Korea, and Mexico. In practice, CPSE boards are generally said to range between three and 15 members. But many companies are reported to have boards with 12 to 20 members and a few even larger, compared to an average of 7 in such OECD countries as New Zealand and Sweden. In the case of statutory corporations that have a board of directors, the number of board directors is prescribed in the statute establishing the corporation.²⁰ Large boards can make decision-making less effective and board management more complicated, while also exacerbating the difficulties in finding the requisite number of independent directors. The large size of some boards has also contributed to difficulties in meeting independent director requirements.

Reducing board size should help reduce the problems of finding independent directors, and improve board effectiveness. Some companies are already taking steps in this direction. The Steel Authority of India Limited (SAIL), for example, has proposed reducing its board strength from 24 to 16 while maintaining the requisite number of independent directors as per Clause 49. Similar efforts should be carried out in other companies with very large boards.

Consider separating the roles of chairman and managing director in large and complex companies.

The most common practice among CPSEs is to have an Executive Chairman with the designation of Chairman-cum-Managing Director (CMD).²¹ Nearly two-thirds of CPSEs have a CMD, while the remaining third or so have a part-time chairman with a separate full-time MD.²² Some six to eight large multi-unit companies (e.g. SAIL, Coal India, and India Oil Corporation) have a separate fulltime chairman with two to three MDs. The posts of Chairman and MD were separated in the past but were subsequently combined to minimize the government's scope for nominating political appointees as chairmen and to thereby professionalize and insulate the company from direct political interference. However, in large complex companies, combining the roles may not achieve an important objective of good corporate governance, which is to ensure that the board does its job of overseeing management.

Separating the roles would help bring a system of checks and balances and establish the board's oversight powers. These objectives have led to a growing international trend towards separation, with the objective of differentiating the board's role in strategy development and oversight from management's role in implementation. Experience suggests that separating the roles is not an easy process and is influenced by a range of variables including the "personal psychology" and compatibility of the two persons chosen for the positions. It is, therefore, suggested that separation be considered mainly for large and complex companies on a case-by-case basis. In such cases the Chairman should ideally be an experienced nonexecutive chairman with proven leadership skills and the ability to manage different constituencies of the board.

¹⁹ For example, NTPC Hydro Limited has provided that "the number of directors of the company shall not be less than 3 and not more than 12." Tamil Nadu Trade Organization has provided that "the company shall have not less than four and not more than twelve directors". FCI Aravali Gypsum & Minerals (India) Limited provides that "the director of the company shall be not less than two and not more than 12 subject to provisions of guidelines

²⁰ FCI and CWC can have up to 12 directors. Airport Authority of India can have between 10 to 16 members.

²¹ The Companies Act provides for the role of chairman in various situations, Clause 49 does so for listed companies, and the founding statute and regulations for

²² The role and responsibilities of a part time chairman are specified in the articles of association and by-laws of the companies (DPE guidelines provide for the powers of an interim part-time chairman until a regular chairman is appointed). The part-time Chairman cannot issue directives as the management of the company is vested under the Companies Act with its board of directors.

Make board leadership and development programs mandatory.

International practice and DPE's own CG Guidelines call for board training. Navratna companies have begun to offer director training in collaboration with SCOPE which has provided training to about 200 directors in the last two years through six programs of two types: (i) a director's conclave for CMD and directors (in addition, SCOPE and DPE jointly hold a CEO conference once a year; and (ii) a director's certification program for new and potential directors. These programs are a good start and have helped raise awareness and capacity of directors to function effectively. However, the vast majority of CPSE board members do not appear to have participated in any training at all, due in part to insufficient awareness of the importance of training as well as to lengthy approval processes and the high cost of training (especially for training abroad).

International experience suggests that board leadership/development training programs are critical in helping directors to understand their role on the board and form an independent and critical mindset. Board training is important for all categories of directors, including independent directors and eminent persons. Training would help directors learn how to address strategy and policy making rather than focus on detailed operational matters, and how to operate in the company's best interest rather than in the government's interest. Being an independent director in a state dominated board may not be an easy task; training would help such directors learn how to how to voice their positions effectively in situations where full-time directors are mostly in control. Other tools such as a director's handbook or checklist of questions could also help strengthen the hands of independent directors.

Consistent with good practice in other countries and in some leading Indian CPSEs, training should not be optional: directors should be required to participate in board training programs, starting with the most important companies. This would require substantial ramping up of existing training programs with the goal of eventually training directors in all CPSEs. Reviewing and simplifying the processes for paying and approving training would also help encourage and spread training more widely.

B. Empowering CPSE Boards

Delegation of decision-making powers through DPE guidelines has helped empower the boards of CPSEs, particularly of Navratna and Miniratna companies. In practice, however, anecdotal evidence and stakeholder discussions suggest that there are several areas where CPSE boards have little or no say. This includes the appointment and removal of the CEO and directors and, to a lesser extent, strategy formulation, both being legitimate and fundamental board functions.²³ It also includes day-to-day commercial decision-making. Except for investments, government is said to intervene in most matters:

Navratna and Miniratna boards, for instance, reportedly have little or no flexibility to create posts or to revise pay scales and reward people according to performance, while any flexibility they may have on paper is difficult to carry out because of DPE guidelines and procedures that must be followed. Social and political considerations also lead to government influence in pricing and marketing decisions. And some complain that they have little flexibility to retain a larger share of profits for investment and control dividends.

²³ Board appointment powers are exercised by the government through PESB and ACC, although the CEO of the company plays a role in the appointment of functional directors through representation on the selection committee formed by PESB.

In other CPSEs, delegation of board powers does not appear to be explicitly defined, leading to ambiguity about who has decision-making powers. In practice, most decisions—about investments, capital expenditures, human resources, restructuring—are referred by the board and management to the concerned ministry for approval. Informal and direct interactions with management—by the ministries and a range of other government institutions—also lead to the bypassing of the board at times.

Government intervention is facilitated by its dominance of CPSE boards and by the numerous DPE guidelines on the composition and functioning of boards and on operational, financial and personnel matters. In turn, elaborate mechanisms for accountability have made management boards reluctant to take decisions without consulting with the administrative ministries. They also appear to have made management reluctant to take basic operational decisions, pushing all such decisions up to the board beyond what is common for well governed companies in the private sector. As a consequence the frequency and duration of board meetings may be higher than warranted, with boards spending more time on operational details than on strategy formulation and other higher level matters.

Especially in Navratnas, Miniratnas and profitable companies, commercial decision-making—intrinsic to the governance process of any enterprise—can and should be left to the boards, based on existing guidelines and the development of a performance management system with benchmarking and competency requirements (as discussed in greater detail in Section C below). Indeed, the Report of the Ad Hoc Group of Experts (AGE) on Empowerment of CPSEs (2005) has already recommended that the boards of Navratna, Miniratna and listed companies be responsible for decision-making and for the control and supervision of the management of the company. More specifically, it recommended that:

- ▶ Boards should be responsible for placement and promotion of senior personnel, formulation of the company's policy for creation/abolition/upgradation of posts, rewards and incentives for performance and out-of-turn performance, and on all matters relating to human resource development; and
- · Subject to statutory requirements, government policy and RBI guidelines, boards should have the powers to pursue new lines of business, acquire companies, set up JVs/subsidiaries, exit a line of business, and make capital expenditure up to a certain level without prior approval of the government.

The fact that the AGE had to reiterate these recommendations—which are fundamental to any business enterprise—suggests that many if not most CPSEs still have some distance to travel on real autonomy. These recommendations should be implemented to empower boards to become real decision-making bodies where government directors can look after the interests of GOI as the majority shareholder.

Ensure empowered boards are accountable and act with integrity.

At the same time, empowerment should be accompanied by proper accountability and integrity mechanisms (Box 4). This requires fair and responsible behavior on the part of boards towards shareholders and stakeholders. Codes of conduct and whistleblower policies should be developed and implemented by CPSE boards as vital accountability mechanisms in the empowerment process, while probity and integrity of CPSEs should be ensured without sacrificing efficiency. Codes of conduct and the CG Guidelines or other DPE guidelines should address the proper handling of conflicts of interest, which will become of increasing return as independent directors play a greater role in CPSEs. At a bare minimum, these should require potentially conflicted board members to declare conflicts to other board members and recues themselves from voting on related decisions.

BOX 4: Battling Corruption in CPSES Through Accountability and Integrity Mechanisms

Battling CPSE corruption requires that accountability mechanisms be put in place to ensure fair and responsible behavior towards shareholders and stakeholders through proper conduct by board members and managers. CPSE codes of conduct and whistle blower policies both play an important role in reinforcing proper behavior. Clause 49 and the CG Guidelines require CPSEs to have a code of conduct for directors and senior management. The code is to be posted on the website and all board members and senior managers must affirm compliance with the code on an annual basis. The annual report is required to include a declaration signed by the CEO (MD) and Chief Operating Officer to this effect. Annex 5 of the CG Guidelines includes a number of points to be included in the code and a sample code that CPSEs can use. A majority of listed CPSEs do have codes posted on their websites, as do some non-listed CPSEs. Clause 49 and the CG Guidelines also require companies to allow "whistleblowers" (employees that report wrongdoing) access to the audit committee and recommend that companies develop whistleblower policies and promulgate the policies throughout the enterprise so that employees are aware of their rights. Some CPSEs have developed such policies, but it is not clear if a majority have. Whistleblowers often face the threat of serious retaliation. There is little legal protection for whistleblowers, in spite of Supreme Court requests that such protection be enacted. A draft bill to protect whistleblowers has been pending for a number of years. As part of DPE's monitoring of corporate governance compliance, it should ensure that codes of conduct, whistleblower policies, and adequate internal controls are in place and implemented. Comprehensive legal protection for whistle blowers also needs to be introduced into law.

It also requires that the probity and integrity of CPSEs be ensured without sacrificing efficiency. CVC is charged with ensuring probity and fighting corruption in CPSEs. Functional directors and senior managers fall under the authority of the CVC, and together with the Department of Personnel and Training, CVC has issued a special Chapter on Vigilance Management in CPSEs. CVC vets potential directors and the administrative ministry can suspend directors and senior managers if the CVC finds evidence of improper conduct. More serious wrongdoing is referred to the Central Bureau of Investigation (CBI) or other relevant authorities. CPSEs are also required to have a Central Vigilance Officer (CVO), either a full time employee or a senior manager who fulfills the CVO function along with his or her other duties. Larger CPSEs may also have other vigilance officers. The CVO acts as the link between the company and CVC, advises the CMD on vigilance matters, and participates in investigations.

Various reports commissioned by the Gol have noted the potential for the CVOs and CVC to hinder legitimate risk-taking, their limited effectiveness with respect to complicated commercial decisions, and their tendency to duplicate the internal controls that should be developed by CPSEs.²⁴ These reports have suggested that vigilance officers in CPSEs should have sufficient knowledge of audit and accounting and modern business practices, and should see their role in adding value to the CPSE. CVC should focus its efforts on clear cases of bribery and abuse of power, not broader issues of underperformance, which are best handled through other mechanisms. A decision to suspend a director of a CPSE should be consistent with the CA and involve the concurrence of the board of directors.

Awareness of corruption in CPSEs is high. Corruption remains a serious problem in India. Transparency International's perception index ranks India at number 85 worldwide. Corruption in CPSEs can influence the financial strength and valuations of the companies, negatively affect investor perceptions, leads to the misallocation of scarce government resources, and hampers overall economic growth. Positive steps are being taken to directly address corruption. Twenty-one CPSEs have signed integrity pacts launched by Transparency International (the Integrity Pact was designed and launched by TI in the 1990s to safeguard public procurement from corruption. It can be used by any procurement body in its procurement and contracting.) Other CPSEs should be encouraged to do the same.

C. Strengthening Audit Committees

The role of the audit committee is well recognized in the CPSE governance framework. Listed companies are required to set up an audit committee whose status, composition and responsibility are defined as per Clause 49.25 The audit committee is also mandated by the Companies Act in case of public companies with prescribed paid-up capital of not less than Rs. 5 crores. DPE's CG Guidelines also requires unlisted companies to set up an independent and qualified audit committee, and spells out their role and powers in detail. Statutory corporations do not have provisions for constituting audit committees but may establish advisory committees as seen fit.

Significant progress has been made in setting up audit committees although, in practice, many are still not composed as per the requirements or guidelines on independent directors. CAG carried out a limited review of compliance with Clause 49 and the CA requirements. While it found that an audit committee existed in all listed companies as of June 2007, companies were non-compliant with respect to the composition of the committee: (i) in seven companies the committee did not consist of the required number of independent directors; and (ii) in nine companies there was no independent director in the committees. The same review also covered unlisted companies. It showed that in five companies no audit committee was formed, and that the committee of one company consisted of two directors rather than three, and did not meet the requirement for two-thirds of independent directors. At the same time, 30 unlisted companies that were not required to set up a committee as per the CA had formed audit committees as per good governance practice.

An independent and effective audit committee is one of the most important tools to ensure sound financial reporting and risk management and to strengthen accountability. The CAG review highlighted a number of steps to improve effectiveness which should be implemented, including:

- Filling vacant posts for independent directors, starting with the bigger and more important companies;
- Putting in place an evaluation procedure to assess the performance of the audit committee;
- Including in the board report a section on self evaluation by the audit committee in promoting corporate objectives; and

²⁵ he committee has a minimum of three directors and two-thirds independent directors. The chairman is an independent director. All members should be financially literate and at least one member must have accounting or financial management expertise. The committee meets four times a year, with a quorum of either two members or one third of the members of the audit committee whichever is greater; a minimum of two independent members must be present.

 Considering making it mandatory for statutory corporations to form audit committees to improve risk management and internal controls.

D. Introducing Board Remuneration and Evaluation Systems

Like in many other countries, both OECD and non-OECD, board remuneration and evaluation practices fall short of good governance practices. Board remuneration is not competitive with the private sector, and incentive-based pay is lacking. There is also no systematic process for evaluating CPSE boards and, as such, board evaluations are rarely if ever done. Going forward, it is suggested that steps be taken to:

- Reform board remuneration practices to make them more competitive and incentive-based; and
- ▶ Put in place a structured and professional process for evaluating board performance.

Make board remuneration competitive and performance-based.

Pay scales of the CEO and full-time functional directors of CPSEs are fixed by GOI every five years based on the size and status of the companies (the compensation package for all other executive levels is uniform). Fees and compensation for part-time directors are fixed by the board according to DPE guidelines and the Companies Act, with previous approval of shareholders in the case of listed companies. Part-time chairmen (who are not serving government officers) are paid either a fixed monthly honorarium or sitting fee and incidentals. They are also entitled to travelling allowance and a range of benefits (accommodation, medical benefits, company car, telephone and secretarial assistance). Remuneration of board members of statutory corporations is fixed by the regulations framed under their founding statute.

Systematic comparisons between CPSE and private sector board remuneration are not available but anecdotal evidence suggests that remuneration of the CMD and functional directors in CPSEs is low compared to private firms. CEOs of private companies are said to draw an average incentive up to 65 percent of the basic salary, while CPSE executives lack such incentives. Sundry allowances in the private sector reportedly amount to nearly 55 percent of basic salary, compared to roughly 15 percent in the case of CPSEs. The annual increase in private sector compensation is reportedly around 30 to 35 percent, compared to 8 to 9 percent for CPSEs. Especially in large companies operating in highly competitive markets, these discrepancies are reportedly leading to difficulties in attracting and retaining talent on CPSE boards.

As this report was being finalized, the GOI accepted many of the recommendations of the Second Pay Revision Commission, allowing more increased flexibility in pay and greater performance based pay tied to more sophisticated measures of performance measured through the MOU system. This will reduce the gap with the private sector, but it does leave in place the same basic structure.

Revamping board remuneration practices would help attract and retain professional board members and improve board performance. The Second Pay Revision Committee Report has made detailed recommendations in this regard based on a proposed reclassification of CPSEs into different schedules and sectors. More specifically it recommends that:

► The compensation of executives be independent of the civil service;

- ► The difference between lowest and highest paid executives be increased;
- ► Variable or performance related pay (PRP) become a major component of executive compensation, with PRP linked to profits and physical and financial performance (existing DPE guidelines permits allocation of up to 5 percent of pre-tax profits only to employees); and
- PRP be determined only by the remuneration committee of the board, headed by an independent director and based on guidelines for how such committees should determine pay. Since remuneration is decided by the Government, only a few large companies such as NTPC reportedly have such committees.²⁶

Migrating to private sector levels practices would help reduce the disparity and encourage and reward high performance. The Pay Revision report emphasizes that pay related recommendations should be accompanied by the development of a robust performance management system linked to the MOU and benchmarked with the private sector. Implementation will also require that appropriate mechanisms be put in place to ensure transparency and credibility of the system, and to ensure that incentives are properly aligned with risk. This is particularly important in the case of CPSEs given the potential moral hazard created by comparatively easier access to funding through state-owned banks.

Put in place a structured and professional process for board evaluation.

There is no systematic process for evaluating CPSE boards. At present the only requirement is that the performance of directors be reviewed by the administrative ministries at the end of the first year before confirming the remaining part of the tenure. A board member who fails to perform satisfactorily in the performance review can be removed by GOI.²⁷ There is no system for evaluating the performance of full-time directors or of independent directors. However, Clause 49 in its non-mandatory requirements provides for the evaluation of non-executive directors by a peer group comprising the entire board of directors, excluding the directors being evaluated. Such evaluations are rarely, if ever, done.

A systematic process for evaluating board performance on a regular basis is needed to accompany any changes to board remuneration practices as suggested above. Such a process should aim to:

- Develop a proper appraisal system for performance review of functional and independent directors (as per the 2005 AGE report). For the latter, performance indicators could include meeting attendance, participation in the audit committee, and participation in board deliberations;
- Assess the structure and composition of the board as a whole, including the performance of board committees, relations with management, board remuneration, the timeliness and quality of information received by the board, and other board processes. OECD countries such as New Zealand, Poland and Sweden have such systems in place.

²⁶ The Committee also made a number of broader recommendations, including the need for: including all benefits and perks in determining cost-to-company; dealing with excess employment by carrying out manpower requirements and instituting compulsory retirement schemes; withdrawing sick PSEs from BIFR and linking PRP to turnaround targets; not increasing the retirement age to 65; taking out non-commercial companies from the proposed recommendations; and government withdrawal from Schedule D companies that are mostly small or sick companies.

²⁷ A director can also be removed for disciplinary actions or for disqualifications provided under the Companies Act. Generally, the articles of most PSEs give absolute powers to the President of India to remove the board members at his discretion. The power is exercised by the ownership entity. In case of statutory PSEs, the government may at any time, in consultation with the PSE, remove the managing director from the office after giving reasonable opportunity for showing cause against the proposed removal. The board of statutory companies has the powers to remove any director on grounds stated therein.

A good board evaluation process should help lead to continuous improvements of board performance and capability. Evaluations of all three categories of directors should ideally be carried out by the board as a whole or by an external facilitator hired for this purpose. Concerned ministries should not be evaluating any board members.

06. Enhancing Disclosure and Transparency

OECD Guidelines: State owned enterprises should observe high standards of transparency in accordance with the OECD Principles of Corporate Governance.

A. Enhancing Disclosure

Overall, India provides a level of disclosure comparable to the more advanced OECD economies. At the aggregate level, both CAG and DPE submit comprehensive annual performance reports to Parliament and the public. The former contains information on government loans and equity, market capitalization of listed companies, returns on investment, profits and dividends, and net worth and accumulated losses. It also includes qualifications from external audits, the findings of various CAG audits, and special topics like environmental and sustainability reporting. The DPE report focuses mainly on CPSEs. It presents data on investment, revenue, profitability, and contributions to the budget and foreign exchange. Information is also provided on productivity, research and development, and GOI policy areas such as the MOU system, delegation of powers, human resources, privatization and restructuring. Balance sheets and profit and loss accounts, by sector and enterprise, are in companion volumes.

Both reports cover corporate governance. The CAG report reviews compliance with regulatory requirements and guidelines for audit committees and independent directors, and some issues specific to statutory corporations. The DPE report provides a descriptive summary of its CG Guidelines and the process for choosing non-official directors. DPE has not yet reviewed governance compliance of CPSEs. Both reports can be freely accessed from the websites by policy makers, the press, and the public. The inclusion of aggregate, sector, and firm level data makes them particularly useful in understanding the nature, size, and performance trends of the state owned sector.

At the company level, various laws, regulations, and guidelines govern disclosure of financial and non-financial information, including the CA, Clause 49, various DPE guidelines, CAG guidelines, Accounting Standards; and the CG Guidelines for CPSEs (Box 5). The recent RTI Act—which covers the transparency and accountability of the public sector as a whole—has had a major impact. It requires administrative ministries to disclose a range of information about CPSEs on their websites (ministry websites normally link to the websites of the CPSEs). In addition to basic company data, this includes: the name and contact details of the CMD; directory of officers and employees; organization chart of the company; channels of supervision and accountability; compensation policy and monthly remuneration; budget allocations; company rules, regulations and manuals; public consultation channels; and whether board meetings and minutes are open to the public.

CPSEs and directors are liable for meeting basic disclosure requirements. MCA may take action against CPSEs that fail to produce and file their financial statements, while SEBI may also take disciplinary action against listed CPSEs that fail to comply. Neither has taken action against CPSEs on disclosure. Problems, if any, are usually referred to the administrative ministry. In addition, CAG monitors compliance with various disclosure norms, and reports on compliance in its report to the parliament and public. However there is limited monitoring of non-listed companies and their compliance with all disclosure requirements.

BOX 5: Disclosure requirements for CPSEs

CA requirements for Government Companies: Government companies—including CPSEs are required to submit annual audited accounts to Parliament, to the Registrar of Companies (ROC), and to the administrative ministries. Ministries are required to submit annual reports to Parliament within nine months of the close of the accounting year. (Statutory corporations have similar rules in their articles.).

Annual Reports: Annual reports contain the balance sheet, profit and loss account, cash flow statement, statement of changes in equity, notes to the financial statements, and the audit report. Like other Indian companies, financial statements are prepared using the format prescribed in the CA and in adherence with Indian Accounting Standards (IAS) issued by the Institute of Chartered Accountants India (ICAI). The ICAI has sought to bring IAS closer to International Financial Reporting Standards (IFRS), and many standards have international equivalents, although certain differences remain. Securities regulations require listed CPSEs to provide consolidated statements and include segment reporting. Non-listed CPSEs are also required to do the same as per the CA, IAS, and CG Guidelines.

Quarterly reporting: SEBI regulations also mandate listed CPSEs to issue half-yearly and quarterly financial reports. These reports, as well as the annual report, are submitted to SEBI, MCA, ROC, and the stock exchanges. Key elements of the reports are published in national newspapers and on the company's websites.

Non-financial information: Listing requirements mandate disclosure of related party transactions. This includes transactions with directors, and remuneration of directors, but in practice excludes transactions with other CPSEs, except transactions between subsidiaries and parent companies. Clause 49 also mandates, and the CG Guidelines strongly encourage, the inclusion of directors' reports and management discussion, including issues related to foreseeable risk factors and risk management policies, internal controls, and corporate social responsibility. However, CPSEs are not required to disclose potential material information such as non-commercial objectives, social obligations, ministerial requests or directions, MOU targets or target areas.

Corporate Governance: Both Clause 49 and the CG Guidelines require CPSEs to include a section on compliance with mandatory and non mandatory corporate governance requirements, based on a certificate from the auditors or the company secretary (listed CPSEs are also required to make quarterly compliance reports to the stock exchange(s) on which they are traded but not to the public). Listed companies must disclose their major shareholders.

The great majority of CPSEs meet basic filing requirements. Listed CPSEs provide a high level of disclosure of financial and non-financial information, consistent with securities regulation. Many nonlisted CPSEs also disclose a range of information via their websites. Indeed, CPSEs complain that disclosure requirements are far higher for CPSEs than for the private sector and if anything they pose an unfair burden or cost on the companies.

But disclosure is not always in conformity with the CG Guidelines or other requirements. The level and quality of information varies across the companies; in some cases the information may be outdated. One area where CPSEs have had difficulty is in submitting their accounts in a timely manner. In 2007, CAG found that over 40 CPSEs had accounts in arrears. CPSEs maintain that the supplementary or test audit of CAG, as noted below, leads to delays in finalization of audited accounts. The quality of accounts may also be a problem. For accounts filed in 2007, CAG found that accounts of 12 CPSEs had to be restated and over 30 had qualifications from auditors. Over 20 did not comply with all required accounting standards.

In practice, key material information is also rarely disclosed by CPSEs. This includes most related party transactions, non-commercial objectives, social obligations, ministerial requests or directions, MOU targets or target areas. This is due to broad interpretation of existing requirements and insufficient standards in these areas.

Implementing disclosure requirements and complying with the RTI Act directly improves corporate governance, but implementation can be challenging. Meeting these challenges involves steps to:

Mandate disclosure of non-commercial obligations and related party transactions with other CPSEs under the same administrative ministry.

OECD Guidelines note that state enterprises should make a "clear statement to the public of the company's objectives and their fulfillment" as well as "any commitments made on behalf of the state" and that "(public service) obligations should be disclosed to the general public". Many countries are beginning to require disclosure of such objectives in the interest of transparency and accountability. GOI should consider doing the same. Transactions between CPSEs under the same administrative ministry, and with their administrative ministry, should be considered related party transactions and disclosed as such. This would be a key step to reducing the possibility of abusive or politically motivated transactions and making the role of the administrative ministry more transparent.

Provide implementation support to CPSEs.

DPE in conjunction with the administrative ministries should consider how best to help companies implement disclosure requirements. Pilot projects could be developed in a small of number of CPSEs to improve both IT and accounting capabilities. These could then become the basis for standards and reforms in other CPSEs. Donor assistance could be considered to help in implementing these projects and to support wider capacity building.

Monitor and disclose compliance.

In many countries monitoring disclosure compliance is routine, including listed companies in India. DPE and the administrative ministries should actively monitor compliance, explain areas of noncompliance, and make the reports publicly available.

B. Strengthening CPSE Audits

CPSEs have a three tier audit system, including: (i) statutory audit; (ii) CAG audit; and (iii) internal audit. More specifically:

- Statutory audit: CAG appoints the statutory auditors and directs how the statutory audit is carried out. Auditors are selected from a panel of firms maintained by CAG based on experience and size of the audit assignment. It seeks to ensure the independence of the audit by following the criteria in the CA and Chartered Accountants Act 1949 which limit the appointment of an auditor otherwise connected to the company or its success. CAG has imposed two additional requirements to maintain auditor independence: restricting the acceptance of non-audit assignments by the auditors and providing for rotation of the audit firm every four years. The auditors are required to certify the balance sheet and profit and loss account of the company and submit a copy of their report to CAG, which has the right to comment on and supplement the auditor's report;
- CAG audit: In addition to the statutory audit and (potential) tax audit that all companies must comply with, CPSEs are also audited directly by CAG, which performs three types of audits:
 - Supplementary or test audits which include a review of the statutory audit and additional auditing of CPSEs accounts;
 - Compliance audits, also known as transaction audits, which are performed on a regular basis and review transactions and other past practices for irregularities and mistakes;
 - Performance audits which go beyond examining accounts or transactions for a more in depth analysis of specific enterprises, sectors, and topics, and recommendations for improvement.
- Internal audit and control: As discussed in Chapter IV, CPSEs are required to have audit committees that oversee the disclosure process, internal audit, risk management, and internal controls. Under the CA, the work of the internal auditors is also reviewed by the statutory auditors as part of the statutory audit. Clause 49 requires management in listed CPSEs to certify that internal controls have been established and evaluated and disclosed to the board on a regular basis.

Audit standards for CPSEs are more stringent than for other companies given that CPSEs are required to conduct audits in accordance with CAG requirements in addition to the standards prescribed for all companies. This allows for extensive disclosure and a better understanding of the operations of the publicly owned sector. Statutory auditors face little potential conflict of interest or penalty for producing qualified audits, and do produce such audits on a regular basis. CAG, through its supplementary and compliance audits, finds and presents a number of shortcomings with CPSE disclosure and performance each year that might otherwise go unreported. Performance audits allow for a deeper understanding of CPSE operations, and can be an effective mechanism to evaluate otherwise opaque areas like product quality, service delivery, and management effectiveness. The fact that CPSEs can coordinate all these audits and prepare a report on time is itself a notable achievement.

Weaknesses appear to lie mainly in the internal control and audit function. While large companies like ONGC and NTPC and other major listed companies have advanced systems that in some cases are SAP compliant and have integrated risk management systems in place, for the vast majority of CPSEs the internal control function appears to be in its early stage:

- ► While many CPSEs—including non-listed companies—have voluntarily set up audit committees as per the CG Guidelines, other companies—including large listed CPSEs—have not met the mandatory requirements for independent directors, or in some cases have not set up an audit committee at all;
- Statutory auditors have also noted a number of deficiencies in internal audit and controls. According to the CAG, in 2006-07, over 60 CPSEs had some problems with their internal controls. Over 30 of these had problems specifically with internal audit, including some which had no internal audit function at all.

These deficiencies may stem from a number of different factors, including delays in recruiting independent directors to serve on audit committees, the novelty of these requirements for certain CPSEs, and limited internal capacity or resources. CPSEs also express concern that CAG supplementary audits may be duplicative of the work of the statutory auditors and contribute to delays in finalizing the accounts, resulting in non-compliance with the requirements for publishing audited results. Concern is also raised that CAG's compliance audits may lead to delays and risk aversion in commercial decision-making.

Going forward, CPSEs should be encouraged to develop and strengthen their own robust internal controls and audit function. More specifically:

- A thorough review of the internal audit function of CPSEs would be a good first step. Such a review would help identify areas in need of improvement and suggest concrete steps that need to be taken to develop and strengthen such systems;
- Development of adequate internal controls and audit function should be made a minimum mandatory requirement of the CG Guidelines. All CPSEs should be required to establish audit committees and ensure they have sufficient numbers of independent directors with adequate knowledge of financial and other relevant matters. DPE and administrative ministries should, in conjunction with CAG and SEBI (for listed companies), monitor and ensure compliance; and
- CAG should continue its ongoing efforts to reduce the time it takes to carry out supplementary audits and avoid delays in the finalization of CPSE accounts. In addition it may consider doing concurrent financial audits or resorting to supplementary audits on an exceptional rather than a routine basis. As and when CPSE internal controls are substantially strengthened, consideration should also be given to carrying out compliance audits on a more selective basis, focusing on important transactions for the largest CPSEs or those that have a history of problems. In turn, this would require that CPSE internal controls be substantially strengthened. As the 2005 AGE report points out, "overall performance should be the guiding criterion rather than review of individual commercial decision-making."

07. Next Steps

Corporate governance reforms are critical to improving CPSE performance and competitiveness, increasing market discipline and access to new sources of capital, and achieving higher levels of transparency and accountability. There is widespread recognition in India of its importance, and the governance reform process has been well under way for a number of years. What needs to be done to improve further CPSE corporate governance is also widely recognized. Numerous commissions and expert groups have studied the issues in-depth and offered recommendations for improvement. Indeed, much of this report draws from and reflects on the findings of these studies. In short, there is no dearth of information: the policy and technical solutions are known.

The challenge going forward is instead one of implementation. What can be done differently to expand and deepen the ongoing reforms? International experience suggests two broad factors for success. First, corporate governance reforms are and should be seen as part and parcel of a broader CPSE reform program rather than as a stand-alone or substitute reform. Reforms aimed at improving governance and increasing CPSE autonomy—such as board appointment and empowerment, separation of ownership from policy functions—can facilitate broader policy reforms aimed at increasing market discipline through exposure to competition, tightening of budget constraints, listing of CPSEs on the stock exchange, and disinvesting through strategic sales and public-private partnerships. Market discipline in turn puts pressure on companies to pursue sound business strategies and good governance. It also helps maximize—and sustain—the gains from improved governance. Building on this dynamic addresses the core governance challenge of striking the right balance between CPSE autonomy and accountability.

Second, governance reforms and CPSE reforms more broadly are politically contentious and challenging to implement. Entrenched groups may oppose or find other ways to resist reforms. Implementation requires fundamental changes in organization, incentives, and behavior that can be difficult to achieve. And governance reforms are ongoing processes that evolve and unfold over time. Managing these challenges will therefore require attention to the reform process itself, in particular to the need for: (i) political leadership and commitment; (ii) phasing or sequencing of reforms based on the political and institutional feasibility of reform; (iii) creation of strong institutions with dedicated reform teams to manage and sustain the process; (iv) building of public support to overcome stakeholder resistance to reform; and (v) development of monitoring systems early in the process to evaluate impacts, ensure transparency and accountability, and provide a feedback loop to adjust course as needed.

In view of the above, it is suggested that the following next steps be considered:

• Develop a strategy and action plan for implementing the CPSE reform agenda. A sequenced or phased strategy could be considered, based on political and institutional feasibility. This could involve categorizing the list of recommendations and actions into two groups: (i) "low-hanging fruit" or set of recommendations that are not particularly controversial and can be relatively easily done—for example, bringing in more independent directors from the private sector, improving MOU indicators, enhancing disclosure; and (ii) the more difficult set of recommendations that may require time and a change in mindset, for example, development of a more centralized approach to managing the state's ownership functions, disinvestment of state shares, and exit of unviable companies.

- Improve the CG Guidelines: As discussed in the report, the current Guidelines are too narrow in scope and may also require making certain provisions mandatory in order to give it teeth and enforce implementation. DPE should take stock of CPSE compliance with the Guidelines to date and based on the findings, the Guidelines should be revised with a view to also making them more comprehensive.
- Monitor compliance with the CG Guidelines and evaluate how to integrate governance indicators in the MOU system: In developing such a system, DPE could draw from the monitoring requirements established for listed companies and from international experience with performance monitoring systems in general.
- Consider implementation of company-level governance reforms in 2-3 pilot cases of Miniratnas and profitable companies. A pilot exercise along these lines may help upgrade their status and facilitate listing on the stock exchange. It would also provide tangible improvements and benefits that could create momentum for more widespread implementation across CPSEs.
- Ramp up board training programs. SCOPE should consider expanding its current director training and other programs to a wider group of CPSEs.
- Enhance DPE's capacity to carry out these tasks. Some of the above activities (e.g. development of the strategy, revision of the Code, monitoring indicators) may require inputs from specialized experts or consultants to help with design and implementation and/or exposure of DPE staff to training and international good practice. Donor agencies could help support the process.

Annex 1 Understanding the Impact of Policy Measures on the Performance of CPSEs

A. The Financial Performance of CPSEs

In the post-reform era, CPSEs showed a marked improvement in their financial performance. The number of loss-making enterprises declined, the ratio of profits in profit-making units rose and the contributions of CPSEs to national GDP held steady. The CPSEs were distributed across a wide array of sectors (Figure 1) including services, mining, petroleum, manufacturing and consumer goods. CPSEs as a group grew their sales at double digit rates for most of the past decade and contributed nearly a quarter of the country's national GDP in terms of gross sales and around 2% of the GDP in terms of profits in 2005-06.

In addition, aggregate losses of CPSEs fell dramatically in the same period and the number of loss making firms relative to profit-making firms declined. The nature of public financing to these entities also underwent a transformation - from dependence on the central government in the form of grants to budgetary supports on the basis of project justification. In the post-liberalization period, CPSEs increasingly turned to capital markets to mobilize resources. Consequently, budgetary support to CPSEs declined from a high of 50.57% in 1985-86 to 12.75% in 2004-05.

Analyzing CPSE performance in isolation from the larger Indian macro-economic environment only tells us a part of the story.

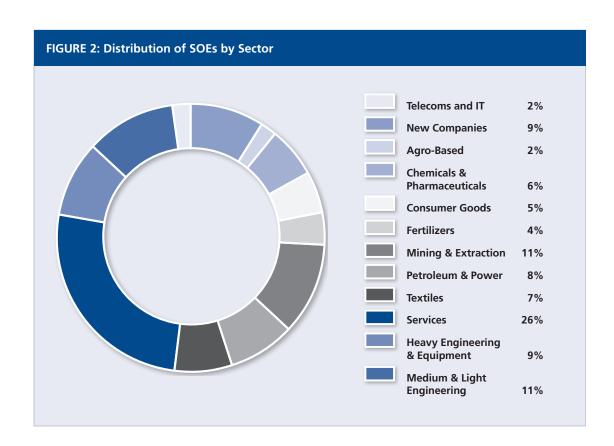


FIGURE 3: Sales to National GDP: 1997-2005

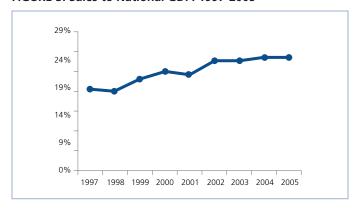


FIGURE 4: Annual Sales Growth Rate of all SOEs: 1998-2005

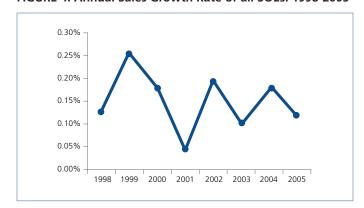


TABLE 10: CPSEs in the Sample of 25 Companies Used in Figures Below

| Company Name | Incorporated | Economic Activity |
|---|--------------|---------------------------------------|
| BEML Ltd. | 1954 | Earth moving machinery |
| Bharat Electronics Ltd. | 1954 | Electronics |
| Bharat Heavy Electricals Ltd. | 1964 | Prime movers |
| Bharat Petroleum Corpn. Ltd. | 1952 | Petroleum products (Refineries) |
| Bongaigaon Refinery & Petrochemicals Ltd. | 1974 | Petroleum products (Refineries) |
| Chennai Petroleum Corpn. Ltd. | 1965 | Petroleum products (Refineries) |
| Fertilisers & Chemicals, Travancore Ltd. | 1943 | Mixed fertilizers |
| Fertilizer Corpn. Of India Ltd. | 1965 | Urea |
| H M T Bearings Ltd. | 1964 | Ball or roller bearings |
| HMT Ltd. | 1953 | Tractors |
| Hindustan Fertilizer Corpn. Ltd. | 1978 | Urea |
| Hindustan Organic Chemicals Ltd. | 1960 | Organic chemicals |
| Hindustan Petroleum Corpn. Ltd. | 1953 | Petroleum products (Refineries) |
| Hindustan Photo Films Mfg. Co. Ltd. | 1960 | Photographic or cinematographic goods |
| Indian Oil Blending Ltd. [Merged] | 1963 | Lube oils & lubricants |
| Indian Oil Corpn. Ltd. | 1959 | Petroleum products (Refineries) |
| Kochi Refineries Ltd. [Merged] | 1963 | Petroleum products (Refineries) |
| Maharashtra Elektrosmelt Ltd. | 1973 | Ferro manganese |
| National Aluminium Co. Ltd. | 1981 | Aluminium, unwrought |
| National Fertilizers Ltd. | 1974 | Urea |
| Praga Tools Ltd. | 1943 | Machine tools |
| Rashtriya Chemicals & Fertilizers Ltd. | 1978 | Urea |
| Rashtriya Ispat Nigam Ltd. | 1982 | Finished steel (incl. saleable steel) |
| Steel Authority Of India Ltd. | 1954 | Finished steel (incl. saleable steel) |
| Tide Water Oil Co. (India) Ltd. | 1922 | Lube oils & lubricants |

While Indian CPSEs seemed to be undergoing an economic transformation in the post-reform period, their performance must be viewed in the context of the larger economy. We tracked 25 CPSEs - firms for which complete financial information was available for the years 1992-2005 from the Centre for Monitoring Indian Economy's (CMIE) Prowess database. These companies are listed in Table 2 and the financial information used is listed in Appendix 1. These companies were compared to a sample of 582 private companies for which complete financial information was available in the same time-frame.

Sales: The CPSE and the private sector samples seemed to be growing at similar annual rates between 1993-2005 indicating that both types of entities were influenced by the general economic environment in that period. What is remarkable is the level of turbulence in the economy which progressively worsened between 2000 and 2005, and that turbulence affected both CPSEs and private firms suggesting that neither of these two firm-types was insulated from economic and industrial uncertainty. Private firms, however, tended to be less volatile than the CPSEs in the same period. Despite this, the CPSEs seemed to be holding steady their share in the economy compared with private firms.

Cost Structure: CPSEs and private firms exhibited different business cost structures with private companies spending more on advertising and marketing than CPSEs in the 2000-2005 time-frame. Interestingly, CPSEs reported significant marketing costs between 1992 and 1999 but have ceased to do

FIGURE 5: Profit of CPSEs to National GDP: 1997-2005

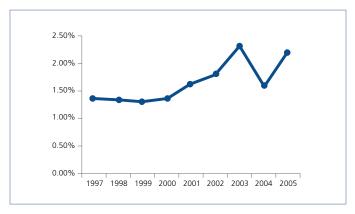


FIGURE 6: Loss of CPSEs to National GDP: 1997-2005

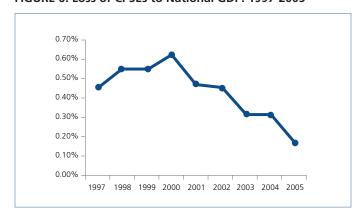


FIGURE 7: Business Costs of Private Companies, 1992-2005

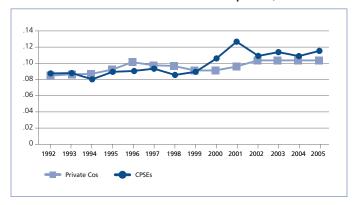


FIGURE 8: Business Costs of CPSEs, Sample of 25, 1992-2005



FIGURE 9: Business Costs of Private Companies, 1992-2005

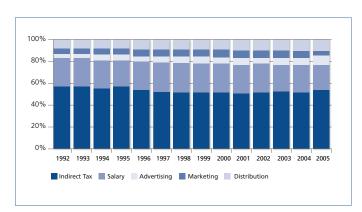


FIGURE 11: Return on Assets of Private Firms and SOEs, 1992-2005

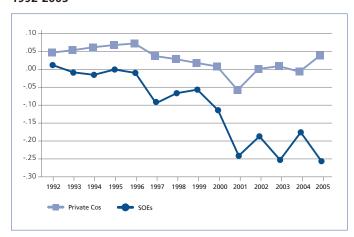


FIGURE 10: Business Costs of CPSEs, 1992-2005

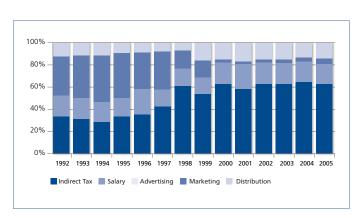
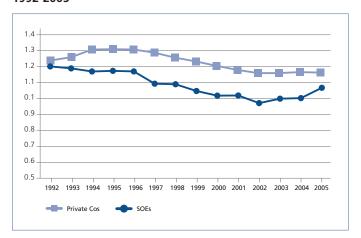
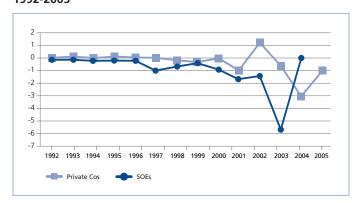


FIGURE 12: Efficiency of Private Firms and SOEs, 1992-2005



SOURCE: Prowess dataset-Return on Assets=Profit After Tax/Total Assets, Return on Sales=Profit After Tax/Total Sales and ProductionEfficiency= Value of output/Production Costs computed as average ratios for 582 private companies and 25 SOEs.

FIGURE 13: Return on Sales of Private Firms and SOEs, 1992-2005



so in later years indicating a realignment of internal resources. CPSEs have also started to pay a larger proportion of their business costs in the form of indirect taxes and also spent more on distribution costs than private companies. Private companies paid a greater proportion of their costs in salaries than CPSEs, contradicting a popular belief that CPSEs tended to be over-staffed. On the other hand, private companies maybe paying their employees better than CPSEs resulting in higher salaries.

Performance measures: Private companies performed better than CPSEs on financial performance measures such as Return on Assets, Production Efficiency and Return on Sales. Again, these charts revealed the Indian business landscape to be highly turbulent affecting the performance of both private and state firms adversely.

B. Determinants of the Financial Performance of CPSEs

Past research on CPSES in India conclude that CPSEs perform poorly compared with other firms for two key reasons. First, studies on CPSEs attribute the poor quality of performance to the level of competition in the industry concluding that low levels of competition, i.e. firms acting in monopolistic or oligopolistic environments, result in inferior performance. Second, studies attribute poor performance to the level of government ownership concluding that, on average, private firms outperform CPSEs and that the CPSEs in which the state does not hold majority shares outperform those in which the state holds majority shares.

These studies are problematic for several reasons. First, most studies do not vary both levels of competition and the level of ownership simultaneously. In aiming to demonstrate the effect of either factor on performance, they do not address the consequence of interacting competition and ownership. This inhibits the government's ability to undertake a more nuanced approach to liberalization (increasing competition) and privatization (decreasing government ownership). More problematic, however, is the omission from most of these studies of firm-specific factors such as marketing, advertising, age, size and so on that might explain performance differentials. On the one hand it could be argued that a number of these factors vary widely between private and state-owned firms and are in themselves a consequence of ownership structures. On the other hand, it could also be the management of these variables that could lead to performance changes and not the ownership of the company. This omission is compounded by the fact that almost no studies capture other policy measures that affect CPSE performance. Limiting the language of this literature to privatization or liberalization misses the impact of other measures undertaken by the Indian government and hence, makes it difficult to untangle the effects of ownership and competition from those of operational and organization improvements, governance reforms, non-budgetary supports and a more gradual and deliberate approach to privatization.

If we accept that commercial profitability is an effective performance evaluation measure for CPSEs due to its significance to both internal and external stakeholders (as mentioned in Chapter 1), there is then the question of how alternative ownership structures affect profitability. A stream of research with its roots in public administration and public sector economics by and large supports the view that private ownership results in superior commercial performance. A list of the most commonly cited reasons for supporting private over state ownership include 1) misallocation of state resources as allocation is based on *a priori* notions of equity rather than on input prices and consumer preferences, 2) pay differentials between the public and private sector that create disincentives for mangers in the state sector, 3) poor monitoring by the state, 4) government subsidization of the state-owned sector performance and 5) lack of consequences for failing state-owned companies resulting in poor accountability.

One study of the performance of Indian CPSEs in 2001 suggests that the problem lies with asking too narrow a question, in this case—"does ownership make a difference to organizational performance". The study suggests instead that scholarship explore an equally important question—"what are the conditions under which the form of ownership impacts organizational performance?" This second question could help push the debate beyond simply ownership and open it up to a host of factors including regulation, competitive intensity, national policy and governance measures that affect the ownership-performance relationship.

The above examination of literature on performance assessment of the state-owned sector reveals that while scholars have examined a few critical factors that affect the commercial performance of Indian CPSEs, few have delved into:

- 1. A comprehensive comparative assessment over time of CPSEs and private firms that incorporated the impact of multiple factors on performance including differential competitive intensity, differential ownership, varying foreign presence, sector specific characteristics and firm specific characteristics such as size, age, marketing, capital investment etc.
- 2. The differential impact of policy measures that go beyond simply ownership changes and include other efforts such as governance reforms or the MOU process in India. This is because most studies up to this point have viewed the resolution to the CPSE performance improvement debate as simply one pertaining to greater deregulation, liberalization or privatization.

C. Ownership and Performance

CPSEs, the common refrain goes, are not equipped to handle competition and are unable to respond as effectively as private companies to environmental changes because they lack marketing acumen, do not adopt newer technologies as quickly and are less focused on their cost-revenue structure. This is partly due to the difference in managerial expertise between the two types of structures with CPSEs dominated by government appointed civil servants who lack the financial and marketing skills of their private sector counterparts and who are also not given the opportunity to develop such skills (Shirley and Nellis 1991). Managerial initiative and risk-taking behaviors are also strongly discouraged in CPSEs as government bodies tend to micromanage decisions. All of these characteristics have the effect of stunting strategymaking skills and managers in CPSEs end up developing only the ability to solve routine functional problems (Wright et al. 1988).

Scholars who have assessed firm performance also discuss the impact of the degree of government ownership. Chhibber and Majumdar (1998) incorporate this element into their model of performance evaluation of CPSE versus private companies. They point out that often ownership is not clearly definable and the more critical issue is to instead "determine at what level of shareholding the state (or any other owner) can exercise strategic control over a firm". They draw on the Boardman and Vining (1989) typology that enables researchers to isolate the impact of differential shareholdings on managerial and commercial performance in mixed ownership companies. In that study, Boardman and Vining conclude that mixed enterprises are more likely to "experience higher managerial discretion and less efficiency than are private firms, but this is the case only when the government does not have a small proportion of shares and the shares of private owners are concentrated."

BOX 6: Data and Methodology for the Data Analysis

The primary data source for this project is the Prowess database provided by the Centre for Monitoring the Indian Economy (CMIE) that contains information on over 10000 Indian companies. The CMIE dataset also includes information on 196 CPSEs between 1989 and 2006. For the purposes of this study, the CMIE data was mined for all manufacturing companies for which the data set contained information between 1992 and 2005. After accounting for missing values and eliminating any company for which the data did not exist for all years the dataset companies of which only 25 were state-owned enterprises (a listed in Table). To boost the proportion of CPSEs in to 607 companies the dataset, eliminated CPSEs were added back into the set despite missing values for some years, so the CPSE could be studied for at least part of the period. This resulted in a dataset of 669 companies of which 87 were state-owned. The private companies were further divided into foreign majority-owned, private stand alone companies and private group companies. A summary of the dataset is provided below.

A random effects time-series regression was carried out with three different dependent variables to assess the effects of ownership, competition and firm specific factors on performance.²⁸ The dataset for this procedure included 25 CPSEs listed in Table and 582 private

companies and spanned 1993 to 2005. Three performance variables were considered. Return on Sales (defined as Profit After Tax/Total Sales) and Return on Assets (defined as Profit After Tax/ Total Assets) are two commonly used measures of profitability preferred by researchers in this field (Boardman and Vining 1989; Parker and Hartley 1991, Chhibber and Majumdar 1998). In addition, a measure of operational efficiency was included through a ratio of Value of output/Production Costs. Ramaswamy (2001) suggests that such a measure provides an "intermediate range of comparisons that are relatively insulated from extraneous effects" including managed output prices and social costs. Consequently we are able to compare the efficiency dimensions of CPSEs versus private companies more directly.

TABLE 11: Companies by Ownership in the Dataset

| All Sectors (1993-2005) Small Sample | No. of Companies |
|---|-----------------------|
| Central government | 25 |
| Foreign | 91 |
| Private | 180 |
| Private group | 311 |
| Total Companies | 607 |
| | |
| All Sectors (1993-2005) Large Sample | No. of Companies |
| | |
| Large Sample | Companies |
| Large Sample Central government | Companies 87 |
| Central government Foreign | Companies 87 91 |

²⁸ In order to run the multiple regression analysis using the pooled data, we tested for the founding assumptions of multiple regression analysis. The four assumptions of Normality, Linearity, Constant Variance and Multicollinearity were tested using residual plots and histograms. The dependent and independent variables were normally distributed for all data sets. Linearity and constant variance for the independent variables were confirmed by the conformance of the residual plots to the null plot. We did not detect an multicollinearity amongst the independent variables through the use of correlation coefficients. Any pair of independent variables with correlation above 0.4 was considered to exhibit the multicollinearity problem and none were found exhibit this problem.

Chhibber and Majumdar (1998) isolate the impact of differential ownership levels in the post-reform Indian context. In a study that focuses on a cross-sectional analysis of 1100 companies (private, mixed and wholly owned by government) listed on the Bombay Stock Exchange in competitive industries (thus eliminating the problem of comparing companies in heavily regulated or monopolitistic sectors), they conclude that higher levels of government ownership has a more detrimental impact on performance than lower levels in competitive sectors.

Findings from the data analysis: Companies wholly or majority owned by the private sector (both domestic and foreign) seemed to have a performance edge over CPSEs in terms of production efficiency, Return on Sales and Return on Assets.

D. Deregulation, Competition and Financial Performance

Studies indicate that regulatory policy and product market competition have a bigger impact on performance than ownership (Vickers and Yarrow 1988). Scholars have found that CPSEs that are privatized in non-competitive markets demonstrate no significant improvement in performance and the improvements were dramatic when they were privatized into competitive contexts (Megginson, Nash and Van Randenborgh 1994). Ramaswamy (2001) pushes this notion further and tests for the interaction of ownership and competitive intensity in the Indian manufacturing industry while positing that "the performance advantage of privately owned enterprises over CPSEs will be positively related to the degree of competitive rivalry in the industry". In a study of 110 Indian firms divided equally between private and CPSEs in four manufacturing sectors over a three year period, Ramswamy (2001) finds that 1) CPSEs do not perform as well as their private counterparts 2) the performance differential increases with increasing competitive intensity.

Findings from the data analysis: All firms performed poorly in terms of production efficiency and Return on Sales in regulated sectors compared with deregulated sectors. When we used the larger sample of CPSEs in the dataset as that sample had a fair representation of both regulated and unregulated CPSEs, CPSEs perform more poorly in regulated sectors than deregulated industries compared with private companies in terms of efficiency.

E. Firm Specific Factors and Performance

Firm-specific factors such as marketing, advertising, age, size and so on that might explain performance differentials are discussed below:

Size: Firm size is known to affect performance through a large firm's ability to reap economies of scale, to reap synergies through diverse product groups, through formal organizational structures and organizational clout in affecting and shaping policy in that industry. Large firms are expected to generate larger returns on assets and sales and also to provide a better value to cost ration compared with smaller companies. Large firms are not without problems, however, as they are likely to less flexible and receptive changes in the competitive environment (O.E Williamson). While this study does incorporate a variable for market rivalry, size has an added relevance in controlling for the level of the firm's market power in the industry (Boardman and Vining 1989). We used the log value of sales as variable. We also include variable that captures the change in size by including a variable on annual sales growth.

Finding from the data analysis: The size of the firm had a positive impact on Production Efficiency and Return on Assets.

Age: Organizational literature indicates that age is a decisive factor in performance as older firms tend to be more experienced and tend to make better and more educated decisions. On the other hand, older firms also tend to be slower in reacting to rapidly changing environment and are likely to be less flexible and prone to bureaucratic inertia. We use the aged and the squared value of age as the variables.

Marketing, Advertising and Distribution: It has been documented that advertising and marketing have a positive impact on firm-level performance. These variables control for firm-level operational factors and, more critically, these factors are known to vary significantly between private and state-owned firms (Comanor and Wilson 1974). In addition, these variables are the most likely to reflect the CPSEs capacity over time to learn from private companies and to undertake operational measures to boost financial performance. We used the ratio of marketing, advertising and distribution to total costs.

Finding from data analysis: Marketing, advertising and distribution had a very strong positive effect on the efficiency of companies. Salaries: We expect a higher wage bill to result in lower returns on assets and sales. In addition, we expect companies that are over-staffed and hence paying a greater proportion of their costs in salaries to also be more inefficient. This is likely to be worse for CPSEs. We used a ratio of salaries and wages to total costs.

Capital intensity: The level of assets of a firm could be an important positive determinant in firm performance. This variable is also likely to vary by industry and over time. We used the log of total assets as control variables for the efficiency and Return on Sales dependant variables.

Indebtedness: Chhibber and Majumdar (1998) discuss the usefulness of debt as a measure of the institutional environment and suggest that while normally the principal-agent relationship states that firms with higher debt to equity ratios are likely to have better financial performance due to lender monitoring, lax government regulations and poor monitoring in the Indian context have turned this relationship on its head. Yet, a changing banking environment in the last decade has introduced better lending regulations and incentives to attain superior performance. This combined with CPSEs' ability to raise money through borrowing leads us to conclude that better debt management will be associated with better performance. We used firms' solvency ratio to measure the impact of indebtedness on performance. Solvency ratio is measured by the ratio of after tax income to firm indebtedness and we expect firms that managed their debt better, perform better.

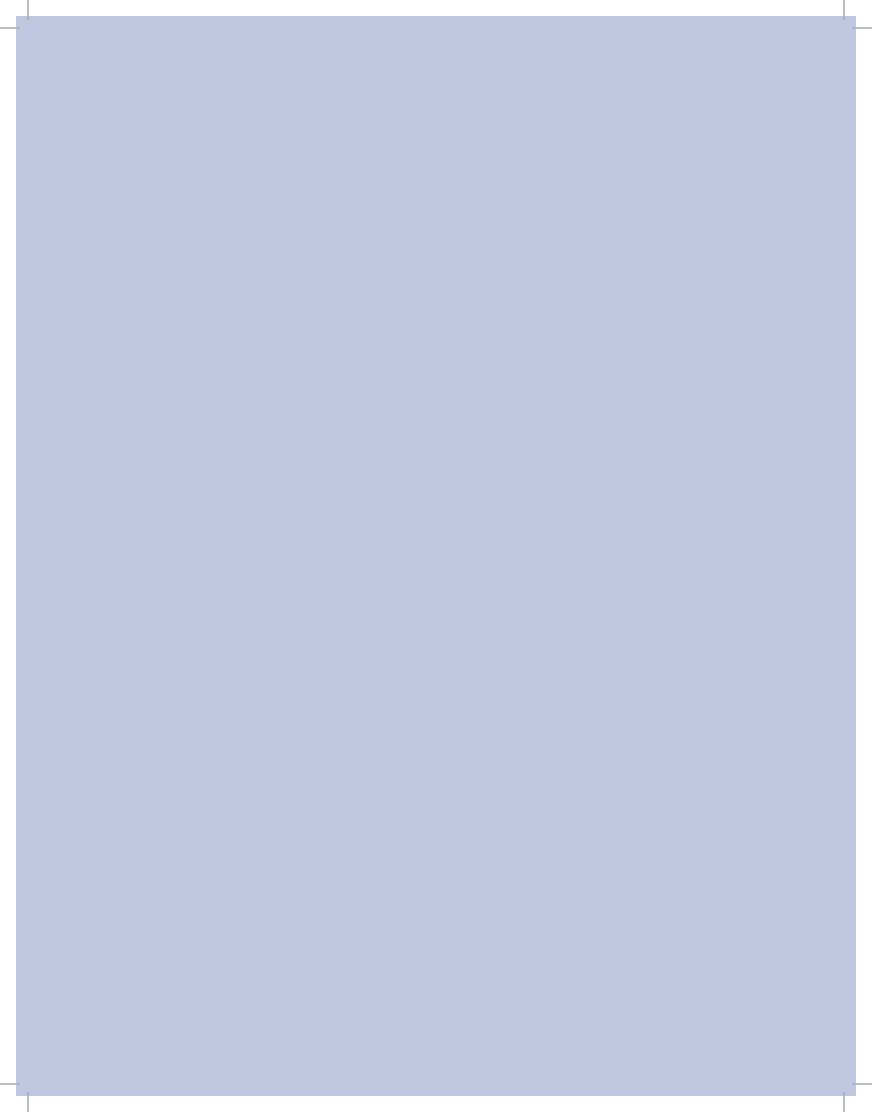
Indirect taxes: The Indian government collects a significant proportion of its revenues through indirect taxes such as excise duties. These duties vary widely between sectors and across geographical areas and form a significant component of firms' costs. The variations in taxes is likely to result in performance variations and are, in addition, likely to act as a performance disincentive as firms might view themselves as an "indirect revenue-raiser" (Chhibber and Majumdar, 1998).

Finding from data analysis: Salaries seemed to have a positive effect on the Return on Assets variable while other factors such as capital intensity, indebtedness and indirect taxes were largely unrelated to the three variables of ROA, ROS and efficiency.

F. The MOU System and Performance

As the above section demonstrates, firm specific factors emerged as critical to explaining performance differentials across companies and the results provided support for the study of policy variables that attempt to improve management. In the past 15 years, CPSEs have selectively opted into a Memoranda of Understanding (MOU) system under which the government and the CPSE negotiated and set annual performance targets and the CPSE was ranked according to its ability to meet those targets. CPSEs that surpassed performance expectations were rewarded with greater operational autonomy that freed them from constant government and bureaucratic oversight.

The MOU system is the most significant attempt made by the Indian government to improve CPSE performance without altering ownership structures and it is likely that firms that belong within this system exhibit greater attention to market oriented management initiatives such as marketing, advertising and distribution that have significant payoff in terms of performance. Testing for the effect of this policy measure on performance is therefore essential to a more nuanced understanding of the effectiveness of tools in the Indian government's arsenal in managing the state-owned sector.





This report was prepared jointly by the World Bank's South Asia Region and Finance and Private Sector Vice Presidency.

The World Bank helps client countries assess corporate governance and benchmark legal and regulatory frameworks and company practices against international standards. The assessments help to increase understanding of corporate governance, transparency in financial markets, and assist country-level and global reform initiatives. They have informed technical assistance and capacity building efforts and supported legal, regulatory, and institutional changes to improve corporate governance.

To learn more about corporate governance, please visit www.worldbank.org/corporategovernance