Can regulation influence governance behaviour?

The risk with investing in poorly governed companies is clear and significant. Bad corporate governance is an express highway to losses and, sometimes, big failures. Every stakeholder loses out. Yet, awareness and voluntary acceptance of best practices never been forthcoming. The need to regulate corporate governance is clear. The Kotak committee report has moved the good governance agenda forward by proposing new rules. Among all the recommendations in the report, the regulatory capacity aspect stands out the most. Compared to past reports on governance, the Kotak report has specific recommendations on how to build infrastructure for monitoring and enforcing laws. It is notable that over the last two decades, India’s listed marketplace has grown many times over in both complexity and size, outmatching the increases in regulatory capacity.

Why enforcement

Enforcement and disincentives are as critical to regulatory frameworks as water is to life. Without these mechanisms, laws suffer and often become toothless. Counterproductively, such laws end up encouraging a mindset that rationalizes dishonest behaviour. Regulatory systems then become a silly burden, waiting to be managed, many times illegally. Jumping signals and over-speeding are easy case studies to reflect on. Detecting, monitoring and enforcing rules are, therefore, more important than the laws themselves.

India’s corporate governance rank

According to the Hong Kong-based Asian Corporate Governance Association’s latest findings, India’s corporate governance score has been improving. But compared to our 10 Asian peers, India is ranked seventh, one notch above South Korea. Two areas where we need to improve the most are: enforcement and accounting/auditing. Unsurprisingly, the World Bank’s 2017 report on ease of doing business ranks India near the bottom of all countries in the “Enforcing Contracts” category. This dismal World Bank ranking is not disconnected from corporate governance challenges. It highlights some of the weakest links financial markets face.

India, like other countries in Asia, has not had much time to change from a promoter-led “insider” corporate governance system. In insider systems, the biggest issue to deal with is the conflict of interest between strong promoters and weaker minority shareholders. Promoters’ controlling stakes provide manoeuvrability in the initial stages of corporate life. But several studies highlight the succession problems family owned businesses invariably face. Embracing corporate governance best practices is important for family managed firms not just for protecting minority shareholder interests but also for ensuring the survival of the firm itself.

Behavioural nudge

Is there a way to avoid habits that lead to bad governance? Nobel laureate Gary Becker’s *Simple Model Of Rational Crime* is insightful: Our decisions on honesty are based on economics. If the net gain from an illegal activity is positive, we don’t mind overstepping illegalities. Becker has provided a discerning understanding on our attitudes towards illegal parking. Becker identified net economic gain as a key driver for dishonesty. Another behaviourist, Dan Ariely, explored Becker’s limitations. The biggest: All of us develop a private definition of honesty. We permit our illegal activities if we comply with our perception of what honesty is. Becker’s work thus evolves into a model that requires three necessary conditions for illegal activities to occur: sufficient opportunity, a net positive incentive and, importantly, rationalization around one’s image of honesty. Extensive monitoring and a disproportionate cost of non-compliance strike fear at the heart of all incentives to commit illegal activities. These mechanisms introduce reinforcing feedback loops. Complying with laws can then become personal effortless behaviour. Exemplary penalties on non-compliance act as reminders and can provide a strong behavioural nudge towards better governance.

Improving regulatory capacity

The Kotak committee report has made three important recommendations for enhancing regulatory capacity: scaling up employee strength, setting up units for data science/risk and building cross-regulator platforms for enforcement. The actual recommendations on these aspects are more of a guideline. Given that this part of the report is the most important, for longer-term policy impact there is a need to deliberate more.

For instance, it would be appropriate to find global benchmarks on employee strength across comparable regulatory departments. It will also be necessary to identify operational best practices around the world. How do employees under these functional areas operate? What is the role of technological innovation? Evidence-based inputs on these aspects could contribute to better policymaking in these areas.

End note

Why do companies exist? The idea of duty to all stakeholders as the essence of long-term corporate success is not a castles in the air, difficult-to-practise Gandhian philosophy. It is being increasingly embraced now by many parts of the Western world—notably the UK. On the other hand, almost all corporate failures highlight practices that need to be avoided. Bad governance is often a result of misconceived values and blind biases. Robustly equipped regulatory systems, however, can influence and nudge companies towards better behaviour. Such systems have a key role to play in bringing about a meaningful shift towards a superior governance culture.

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Comments are welcome at views@livemint.com

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