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Corporate Governance Issues in Banks in India

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Abstract

The literature on corporate governance covers a range of issues such as protection of shareholders' rights, enhancing shareholders' value, Board issues including practices, the control systems, in particular internal control systems. Banks have some unique features that make their corporate governance different from, and more complicated than, that of other firms. For e.g., their balance sheets are not very transparent, they are highly leveraged, they typically have short-term liabilities and longer-term assets, they are heavily regulated and have access to government safety nets, and they are systemically very critical organizations. This paper seeks to identify the major issues in corporate governance in banks in India and to provide suggestions for possible action by the Reserve Bank of India as banking regulator. These issues relate to the composition of the Board of Directors and the duties of members, the functions of the board, the committees of the board, preventing abusive related party transactions and disclosures. The paper makes me suggestions as to the role of the Reserve Bank of India in strengthening corporate governance in Indian banks in the public as well as the private sector.

Keywords: Corporate governance in banks, financial crisis, Reserve Bank of India

Introduction

Corporate Governance is a voluntary ethical code of business of companies, a system by which companies are directed and controlled. It comprises a set of systems and processes aimed at ensuring that the company is managed to suit the best interests of all stakeholders.

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Sound corporate governance should provide proper incentives to the board and management to pursue objectives that are in the interests of the company and its shareholders and facilitate effective monitoring (OECD, 2004). The literature on corporate governance covers a range of issues such as protection of shareholders' rights, enhancing shareholders' value, Board issues including its composition and role, disclosure requirements, integrity of accounting practices, the control systems, in particular internal control systems. The origin of modern corporate governance can probably be traced to a series of scandals and collapses in the UK in the late 1980s and early 1990s, which were widely attributed to poorly managed business practices (Leeladhar 2004). Although corporate governance deficiencies may not have been causal in the strict sense of the term, there can be no doubt that they facilitated, or at the very least, did not prevent, practices that resulted in poor performance. In May 1991, the London Stock Exchange set up a Committee under the chairmanship of Sir Arian Cadbury to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing. The Cadbury Committee Report has since become the basic document for corporate governance all over the world. Corporate Governance is a dynamic concept, in terms of scope, thrust and relevance and should be viewed as an ongoing process subject to changes based on experiences and developments.

Significance of Corporate Governance in Banks

As in any organization, good corporate governance in banks regulates the relationships between banks' stakeholders, their Boards and their management. It prevents the abuse of power and self-serving conduct, restricts imprudent and high risk behavior by bank managers, and resolves conflicts of interests between managers and board members on the one hand and shareholders and depositors on the other. The current state of the world economy is in some measure attributable to the fact that bank board's did not properly discharge their duties in exercising oversight on managers engaging in high risk activities. The corporate governance of the financial sector clearly has important implications for the stability of the whole economy. The Basel Committee on Banking Supervision (under the aegis of the Bank for International Settlement) published guidelines on corporate governance in banks in 1999, but has continuously updated them, the most recent update being in 2006.

Review of Literature

It is by now almost universally agreed that corporate governance of financial institutions should be studied separately on account of the substantive differences between corporate governance of financial institutions and that of non-financial firms. Capri and Levine (2002), Macey and O'Hara (2003), Nam (2006) and Classes (2008) identify some unique features of banks that make their corporate governance different from, and more complicated than, that of other firms.

1. Financial statements of banks are more opaque, a characteristic that makes it difficult for shareholders and depositors to monitor managers, while simultaneously making it easier for managers and large investors to exploit the benefits of control.
2. Although information asymmetries exist in all sectors, evidence suggests that these asymmetries are larger with banks. In banking, loan quality is not readily observable and can be hidden for long periods. Moreover, banks can alter the risk composition of their assets more quickly than most non-financial industries, and banks can readily hide problems by extending loans to clients that cannot service previous debt obligations. The comparatively severe difficulties in acquiring accurate information about bank behavior and monitoring ongoing bank activities hinder traditional corporate governance mechanisms (Levine 2003).
3. The capital structure of banks is unique in that banks are highly leveraged. Bank balance sheets also display an asset-liability maturity mismatch, with liabilities being mainly short-term and assets that on average have longer maturities, thereby exposing them to greater risk.
4. Given the vulnerable position of depositors and the systemic importance of banks, banks all over the world are very heavily regulated, with regulations being very wide in scope, covering activity restrictions (products, branches), prudential requirements (loan classification, reserve requirements, capital adequacy, etc.) and restrictions on concentration of ownership, entry, takeover, etc. These regulations often pose a hindrance to normal corporate governance mechanisms by which shareholders could control the management.
5. Banks in every country have access to government safety nets, which can weaken the incentive of shareholders and depositors to monitor the activities of bank management, a fact that can pose great moral hazard.

6. State ownership of banks presents a problem for corporate governance since it creates a situation of conflict of interest between the state as a monitoring authority and as a regulatory authority. State ownership could also mean that the managing of the bank is handed to bureaucrats rather than professionals.
7. There could be a contagion effect resulting from the instability of one bank, which would affect a class of banks or even the entire financial system and the economy. The current global economic crisis grew out of a financial crisis, which in turn was a result of a banking crisis caused by excessive risk-taking and poor corporate governance. As stated by Bank for International Settlements (2006) "From a banking industry perspective, corporate governance involves the manner in which the business and affairs of banks are governed by their boards of directors and senior management, which affects how they:

- Set corporate objectives;
- Operate the bank's business on a day-to-day basis;
- Meet the obligation of accountability to their shareholders and take into account the interests of other recognized stakeholders;
- Align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and
- Protect the interests of depositors."

Objectives of the Study

Against the background of the significance of corporate governance in banks, this study has two major objectives:

1) To identify the major issues in corporate governance in banks in India
2) To provide suggestions for possible action by the Reserve Bank of India as banking regulator.

Main Issues & Priorities in Corporate Governance of Banks in India

Numerous bodies are involved in ensuring sound corporate governance of banks. The primary responsibility for developing and implementing sound corporate governance of banks obviously rests with the individual bank itself.

Private bodies such as banking industry associations often play an important role in assisting boards of directors and senior management of banks in fulfilling their responsibilities. Banking supervisors have the responsibility to provide a regulatory framework and guidance in terms of corporate governance of banks; they should also monitor individual banks, taking necessary measures when a bank fails to achieve the minimum corporate governance standards necessary for the banking business. In addition, the corporate governance framework also includes capital market regulators and stock exchanges. The issues raised below are therefore relevant for a wide range of participants, including banks, Reserve Bank of India (RBI) as the banking sector supervisor, Securities and Exchange Board of India (SEBI) as the capital market authority and regulator, banking industry associations such as the Indian Banks' Association and the Indian Institute of Banking and Finance, and the two main stock exchanges in the country, viz. the National Stock Exchange and the Bombay Stock Exchange. They are also extremely significant for the Government of India as the majority shareholder in the public sector banks, which account for the bulk of banking business in the country. These issues draw from the principles of sound corporate governance in banks as identified by the Basel Committee on Banking Supervision in 2006, and also from the recommendations made by the Ganguly Committee in 2002.

Responsibilities of Individual Members of the Board of Directors

Board members of banks need to be particularly conscious of their fiduciary duties – 'duty of care' and 'duty of trust' – to depositors because banks accept and manage other people's money. These duties cannot be fully, properly and effectively discharged without sufficient skills and personal abilities. It is critical that their skills and knowledge be enhanced and upgraded by ongoing training programs (provided by, for example, Reserve Bank of India, Securities and Exchange Board of India, stock exchanges or professional associations such as Indian Banks' Association, the Indian Institute of Banking and Finance, etc.) that emphasize the professional, ethical and technical demands that the fiduciary duties impose upon a bank's board members.

The Composition of the Board

The Reserve Bank of India, in its role as banking supervisor needs to ensure that bank boards have developed and maintained an appropriate level of expertise as banks have grown in size and complexity (OECD 2006).

The Ganguly Committee (RBI 2002) had recommended that bank boards be constituted by the blending of 'historical skills' set, (i.e. regulation-based representation of sectors like agriculture, small industries, cooperation etc.) and the 'new skills' set (i.e. need-based representation of skills such as, marketing, technology and systems, risk management, strategic planning, treasury operations, credit recovery etc.). In exercising its duties, the board should be able to exercise objective judgement. This will mean independence and objectivity with respect to management and controlling shareholders (including the Government of India) with important implications for the composition and structure of the board. The Organization for Economic Cooperation and Development (OECD) Principles stipulate that the review of related party transactions should be undertaken by a sufficient number of non-executive board members capable of exercising "independent" judgement to ensure that such transactions are conducted at arm's length and in the interest of the bank.

This issue is also relevant to Public Sector Banks (PSBs). The boards of PSBs should include a sufficient number of "independent" directors so that the board is able to make decisions independent of the Government's possible day-to-day intervention, while effectively monitoring the management in accordance with the objectives set by the state in its capacity as an owner or a controlling shareholder. The separation of the posts of Chairman of the board and Chief Executive Officer (CEO) can contribute to a more appropriate balance of power, increased accountability and improvement in the board's capability for decision-making, independent of management (OECD 2006).

The chairman should ideally not only be a *non-executive* but also an *independent* director so that the board which he/she chairs can make more objective, independent decisions. In the matter of 'fit and proper' status of non-executive directors and chief executives, RBI norms only seek to ensure that the candidate should not have come to the adverse notice of the law and regulations or any professional body. In the case of non-executive directors not satisfying the 'fit and proper' criteria, the RBI can disqualify such directors after due processes are followed. In regard to the CEOs of the private sector banks, since RBI approval is required for the appointment of the CEO, it can exercise its judgement on the suitability of the candidates proposed, and may seek removal also. These provisions are broadly consistent with global norms though there is scope for more effective implementation (Reddy 2006).

As of now there is no legal provision for the Reserve Bank to insist on the 'fit and proper' status of the directors nominated by the government or elected by the shareholders to the Boards of the public sector banks.

This is a matter to be decided only by the Government of India. The Government does, however, actively consult the Reserve Bank in regard to appointment of CEOs. Thus, by and large, there is *de facto* compliance with many governance requirements in public sector banks. The Ganguly Committee had also recommended the appointment of a qualified Company Secretary as the Secretary to the Board and a Compliance Officer (reporting to the Secretary) for ensuring compliance with various regulatory / accounting requirements.

The Roles and Functions of the Board

The boards are required to be more involved in the broad strategy rather than becoming immersed in management of the routine activities of banks. More specifically, the board should focus on

(i) guiding and overseeing the bank's strategic objectives, corporate values and policies, an important aspect of which is the development of a code of conduct (or code of proper practice) for the bank employees, management, and the members of the board and

(ii) setting up of clear lines of responsibility and accountability throughout the bank and strict internal control systems. This will go a long way in ensuring effective oversight.

The Committees of the Board

The Basel Committee also notes that it would be advisable to establish certain specialised committees, such as an audit committee, a risk management committee, a compensation committee and a nomination committee. The Ganguly Committee had further recommended that banks in India, which have issued shares/debentures to the public, may form a Shareholders' Redressal Committee under the chairmanship of a non-executive director.

It had also suggested the constitution of a Supervisory Committee for monitoring of the exposures (both credit and investment) of the bank, review of the adequacy of the risk management process and its upgradation, internal control system, ensuring compliance with the statutory / regulatory framework etc.

Preventing Abusive Related Party Transactions

Banks should be careful about making decisions concerning related party transactions because it is not always easy to judge whether they are on an arm's-length basis. Moreover, even if such transactions themselves are harmless, the mere appearance of conflicts of interest may undermine the ethical code of the bank. The Reserve Bank of India must strictly enforce the maximum percentage of lending exposure to a single client mandated by it (15 percent of capital funds in case of single borrower and 40 percent of capital funds in the case of a borrower group). There could also be strong firewalls set up between the controlling ownership of financial and non-financial companies. Related party transactions should be reviewed and monitored by a sufficient number of independent directors. In addition, banks may establish a committee of the board responsible for reviewing related party transactions, whose membership is ideally made up exclusively of independent directors. In accordance with international accounting, auditing and non-financial disclosure norms, banks should disclose material related party transactions. There is also the option of prohibiting banks from engaging in certain specific types of related party transactions, such as personal loans to board members and controlling shareholders.

Disclosure

The importance of co-operation between the RBI, Securities and Exchange Board of India and the stock exchanges cannot be over-emphasized. Even if the primary authority for ensuring proper disclosure of banks rests with the RBI, SEBI is not exempt from its responsibilities; it is required to exercise oversight and enforcement of standards for accounting, audit, and non-financial disclosure. Problems regarding disclosure by listed banks identified by either of the two regulatory bodies should be shared with the other organization as well, for possible corrective actions and sanctions.

Role of the Reserve Bank Of India

The Reserve Bank of India needs to place more emphasis on securing sound corporate governance of banks rather than to focus only on regulatory compliance. As the role of the board is crucial in developing sound corporate governance of banks, the RBI should assess the performance of the entire board.

This could be done by reviewing minutes of board meetings, by checking the board members' accessibility to necessary information and resources, observing board meetings of banks when it thinks it is appropriate, issuing warnings when necessary, and even asking the bank to reorganize its board framework and operational procedures in the interests of sound corporate governance. Reddy (2006) points out that there is a basic difference between the private and public sector banks as far as the Reserve Bank's role in governance matters is concerned. The RBI's regulatory framework ensures, by and large, uniform treatment of both types of banks in so far as prudential aspects are concerned. However, since public sector banks are governed by the respective legislations under which they were set up, some of the governance aspects of these banks are exempt from applicability of the relevant provisions of the Banking Regulation Act, although they have a bearing on prudential aspects. In regard to these matters, the Reserve Bank prescribes its policy framework for the private sector banks and suggests that the Government adopt the same for public sector banks. Corporate governance of banks cuts across the areas of banking supervision and securities regulation.

It would be in the interests of all concerned, that the RBI should, in conjunction with Securities and Exchange Board of India, develop and publicize a code of corporate governance of banks, based on which banks could develop their own codes. Furthermore, the RBI could provide incentives for banks to improve their corporate governance. For instance, taking into consideration the suggested code mentioned above, the RBI could develop a rating mechanism for the corporate governance of banks. Such a rating can be designed either as a rating specifically focused on corporate governance, or as a part of a broader rating mechanism within which factors regarding corporate governance play one of the major roles in determining overall ratings. Another example of incentives is the possible differentiated deposit insurance premium reflecting the ratings.

The methodology of the ratings of corporate governance of banks should be articulated as clearly as possible and should be announced well in advance in order to provide time for banks to reorganize their framework. SEBI could contribute to developing the criteria by providing its accumulated knowledge and experience about corporate governance.

Conclusion

In the years to come, the Indian financial system will grow not only in size but also in complexity as the forces of competition gain further momentum and financial markets acquire greater depth. It is vital that banks, as the major constituent of the financial sector and the country's payment system, be managed as efficiently as possible. The last six years have been a lesson in the widespread damage and misery that can be caused by ill-considered banking decisions. Although the Indian banking system was unaffected by the financial crisis, the reduced trade and investment flows impacted India's growth and impeded progress in the area of employment generation, poverty reduction and human development. Although poor corporate governance was not the cause of the crisis, it was certainly a contributory factor. Tightening corporate governance in banks is in the larger interests not only of the national economy, but the global economy as well.

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