Corporate Governance in Indian Banking Sector

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Abstract

Today the concept of Corporate Governance has taken a new dimension due to globalization and liberalization. With the opening up of economy and to be in line with WTO requirements, if the Indian corporate have to survive and succeed amidst increasing competition globally, it can only be through transparency in operations. The excellence in terms of customer satisfaction, return, product and service, return to promoters and social responsibilities towards society and people cannot be achieved without practicing good corporate governance. The fundamental objective of Corporate Governance is to enhance the long-term shareholder value while protecting the interests of other stakeholders, maximizing long-term shareholder value in a legal and ethical manner, ensuring fairness, courtesy and dignity in all transactions within and outside the bank with customers, employees, investors, partners, competitors, the government and the society. The system of corporate governance is important for banks in India because majority of the banks are in public sector, where they are not only competing with one another but with other players in the banking system as well as in financial services system including Financial Institutions, Mutual Funds and other intermediaries Further, with restrictive support available from the Govt. for further capitalization of banks, many banks may have to go for public issues, leading to transformation of ownership. This paper focuses on corporate governance in banking sector and how they adhere to Corporate Governance practices. It further indicates the role and relationship of corporate governance with Indian Banking Sector. Both private and public sector banks are adhering to mandatory requirements of corporate governance attributes as a result it is bringing more transparency and minimizing the chances of fraud and malpractices.

Keywords: Corporate Governance, Indian Banking Sector, Public and Private Banks, Bank Governance

Introduction

Corporate Governance has becomes a “buzz word” these days mainly due to Globalization and is a key element in enhancing the investor’s confidence, promoting competitiveness and ultimately improving economic growth. It is the set of processes, customs, policies, laws, and institutions affecting the way a corporation is directed, administered or controlled. Corporate Governance in the

present day context encompasses the interests of not only the shareholders but also many stakeholders, which includes employees, customers, suppliers and the community and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs. Due to the unique role of banks in national and local economies and financial system systems, supervisors and Governments are also stakeholders.A good corporate governance mechanism improves the health of the corporate sector, thus enhancing national competitiveness.

*Corporate Governance in today's context::-*According to Milton Friedam**,** "Corporate Governance is to conduct the business in accordance with owner's or shareholders desires, which generally will be to make as much money as possible" but this context is based on marked maximization that underpins shareholder capitalism. But this context was further expanded by J.Wolfensohn, President, World Bank, has said that "Corporate Governance is about promoting corporate fairness, transparency and accountability.

Corporate Governance in Banks: **-** Corporate Governance has become very important for banks to perform and remain in competition in this era of liberalization and globalization. Banks in a broad sense are institutions whose business is handling other people's money. A Joint stock bank also known as Commercial Bank which is nothing but a company whose business is banking. Protecting the interest of depositors becomes a matter of paramount interest to banks.
In banking parlance, the Corporate Governance refers to conducting the affairs of a banking organization in such a manner that gives a fair deal to all the stake holders i.e. shareholders, bank customers, regulatory authority, society at large, employees etc. The significance of corporate governance in banking sector weighs very much due to very nature of banking transactions. Banking is the crucial factor effecting economic development of an economy. It is the life-blood of a country. It is responsible for the flow of credit and for maintaining the financial balances of the economy. In India, since the nationalization process banks emerged as a tool of economic development along with social justice. As per Basel committee Report 1999, Banks have to display the exemplary of corporate governance practices in their financial performance, transparency in the balance sheets and compliance with other norms laid down by section 49 of corporate governance rules. Most importantly, their annual report should disclose accounting ratios, relating to operating profit, return on assets, business per employee, NPAs, maturity profile of loans, advances, investments, borrowings and deposits. Similarly the audit reports of bank should highlight those disclosures which are in line with corporate governance rules. Hence, auditors should have the complete know how about all the features of the latest guidelines given by Reserve Bank of India (RBI) and ensure that

the financial statements are made in a fraud free manner and should mirror the implementation of corporate governance. Apart from auditor's seriousness to bring those requirements appropriately in audit report, there should be adequate internal control systems in the operational activities of banks. It is very much essential for banks to devote adequate attention on internal control system so as to maximize their returns on each unit of capital inducted through an effective funds management strategy and mechanism. (Basel Committee Report, 1999)

Need for Corporate Governances in Bank

1. Since banks are important players in the Indian financial system, special focus on the Corporate Governance in the banking sector becomes critical.
2. The Reserve Bank of India, as a regulator, has the responsibility on the nature of Corporate Governance in the banking sector.
3. To the extent that banks have systemic implications, Corporate Governance in the banks is of critical importance.
4. Given the dominance of public ownership in the banking system in India, corporate practices in the banking sector would also set the standards for Corporate Governance in the private sector.
5. With a view to reducing the possible fiscal burden of recapitalizing the PSBs, attention towards Corporate Governance in the banking sector assumes added importance.

Literature review

Wei'an Li, Yekun Xu, Jianbo Niu, Aichao Qiu 1(2012) aimed to review some domestic studies with an intention to discover the evolution logic of corporate governance practices in China under a complicated and exclusive context and to provide future research directions. This paper surveyed recent literature in the field of corporate governance, intending to find out the development trends and extract the main line of literature on and practices of Chinese corporate governance. The author found that recent literature on corporate governance provides some new insights into subtle characteristics of governance, governance effects of relational network, political connections, corporate governance evaluation and financial institutions governance. *Themistokles Lazarides, Evaggelos Drimpetas 2(2011)* aimed to establish a benchmark for the evaluation of the quality of corporate governance (CG) and to detect the factors that affect it in Greece. The author constructed an index of corporate governance quality using binary variables. Data from annual reports were used to identify the mechanisms and practices of corporate governance. The author used an ordinal probit model to identify the drivers of corporate governance. The author found that CG quality in Greece is quite low, in terms of international best practices. The main drivers of CG quality are firm size,

leadership or power concentration and board characteristics. *Maria Aluchna, 3(2009)* investigated the relationship between compliance with corporate governance best practice and corporate performance within Poland. The analysis is based on the regression of corporate governance compliance rating and corporate performance on a sample of Polish public listed companies for years 2004-2006. *Gabriella Opromolla 4(2008)* described the Bank of Italy's new comprehensive regulatory framework containing guidelines on the organization and corporate governance of banks. The author covered the structure of the regulatory framework and the content of the rules, including rules on a bank's choice of board model, a bank's corporate governance project representing bylaws and internal organization, tasks and powers of governing bodies, composition of governing bodies, compensation and incentive mechanisms, and information flows. The paper revealed that the new rules are in line with recent prudential measures that assign a central role to corporate organization and require banks to establish appropriate corporate governance arrangements and efficient management and control mechanisms aimed to support the risks to which they are exposed. *Samy Nathan, Vincent Ribière 5(2007)* explored the concepts and relationships between intellectual capital, knowledge, wisdom and corporate responsibility in the context of the corporate governance of Islamic financial institutions. The author used an adaptation of the Nicholson and Kiel intellectual capital model of the board of directors including the role of the Shari'a Supervisory Board (SSB). The author concluded that the need for organizations to continue their knowledge management journey by integrating organizational wisdom with their decisions and actions. Corporate social responsibility is perceived as being a first step to reach organizational wisdom. *Zororo Muranda 6(2006)* intended to investigate the relationship between corporate governance failures and financial distress in Zimbabwe's banking sector. The study used the case study method. It discussed cases of banks currently in financial distress. The study showed that financial institutions in Zimbabwe underestimated the competitive forces that resulted from first, economic deregulation and later economic decline coupled with political meltdown. In order to survive, banking institutions significantly shifted from their core business.

Objective of the study

1. To study the concept of corporate governance in Indian banking sector (Public Banks and Private Banks).
2. To identify the role of corporate governance in Indian Banking sector.
3. To find out the guidelines issued by SEBI in the context of corporate governance.

Concept of Corporate Governance

An effective system of corporate governance in banks will impose appropriate standards of conduct on managers and control and monitoring procedures on banks in order to maximize opportunities for legitimate profits subject to the best interests of depositors and shareholders. Good corporate governance regulates the relationships between banks' stakeholders, their Boards and their management. It prevents the abuse of power and self-serving conduct, as well as 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. Indeed, the current state of the world economy is in some measure attributed to the fact that boards (and their risk management committees) have not properly discharged their duties in exercising oversight on managers engaging in high risk activities. The corporate governance of the financial sector, therefore, has important implications for the stability of the whole economy.

From the perspective of banking industry, corporate governance also includes in its ambit the manner in which their Board of Directors governs the business and affairs of individual institutions and their functional relationship with senior management. This is determined by how banks:

- set corporate objectives (including generating economic returns to owners);
- run the day-to-day operations of the business and;
- consider the interests of recognized stakeholders i.e., employees, customers, suppliers, supervisors, governments and the community and
- Line up corporate activities and behaviors with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and of course protect the interests of depositors, which is supreme.

Corporate Governance in Public Sector Banks

A substantial chunk of Indian Banking sectors still remains under the control of public sector banks despite the strong wave of Globalization, Liberalization and privatization and entrance of private and foreign banks in the arena. The major shareholding of the public banks with the Government the reasons for such ownership may include solving the severe informational problems inherent in developing financial systems, aiding the development process or supporting the vested interests and tributional cartels. Basel Committee has underscored the need for the banks to establish the strategies and to become accountable for executing as well as implementing them. The existing legal institutional framework of public sector banks is not aligned with principles of good corporate

governance. The bureaucratic hassles, red tapes and de motivated work culture add further fuel to the fire. So far banks have been burdened with "social responsibility " and compelled to tow the line of thinking dictated by the political party in power, healthy banking policies will not be able to become the top priority. Monopoly of PSB in banking business had protected them from competition and bank Managements have thereby became complacent. Corporate Governance in PSBs is important, not only because PSBs happen to dominate the banking industry, but also because, they are unlikely to exit from banking business though they may get transformed. To the extent there is public ownership of PSBs, the multiple objectives of the Government as owner and the complex principal-agent relationships cannot be wished away. PSBs cannot be expected to blindly mimic private corporate banks in governance though general principles are equally valid. Complications arise when there is a widespread feeling of uncertainty of the ownership and public ownership is treated as a transitional phenomenon. The anticipation or threat of change in ownership has also some impact on governance, since expected change is not merely of owner but the very nature of owner. Mixed ownership where government has controlling interest is an institutional structure that poses issues of significant difference between one set of owners who look for commercial return and another who seeks something more and different, to justify ownership. Furthermore, the expectations, the reputation risks and the implied even if not exercised authority in respect of the part-ownership of government in the governance of such PSBs should be recognized. In brief, the issue of corporate governance in PSBs is important and also complex. From the banking industry perspective, the attributes of corporate governance provide guidelines to the directors and the top level managers to govern the business of banks. These guidelines relate to how banks establish corporate aims, carry out their daily activities, and take into account the interest of stakeholders and making sure that the corporate activities are in tune with the public expectations that banks will function in an ethical and legal manner thereby protecting the interest of its depositors (Basel Committee, 1999). All these broad issues relating to governance apply to other companies also, but they assume more significance for banks because they deal with public deposits directly.

Corporate Governance in Private Sector Banks

Private sector banks have entered niche areas, listed their scrip and being market driven they have been more transparent in their functioning. They have also been more tech savvy, growth oriented and have less of NPAs. Private sector banks has to conform with standard of good banking practices such as

- Ensuring a fair and transparent relationship between the customer and bank

- Instituting comprehensive risk management system and its adequate disclosure
- Proactively handling the customer complaints and evolving scheme of redressal for grievances.
- Building systems and processes to ensure compliance with the statutes concerning banking.

Role of Corporate Governance in Banking Sector

Since the market control is not sufficient to ensure proper governance in banks, the government does see reason in regulating and controlling the nature of activities, the structure of bonds, the ownership pattern, capital adequacy norms, liquidity ratios, etc. In the case of traditional manufacturing corporations, the issue has been that of safeguarding and maximizing the shareholders' value. In the case of banking, the risk involved for depositors and the possibility of contagion assumes greater importance than that of consumers of manufactured products. Further, the involvement of government is discernibly higher in banks due to importance of stability of financial system and the larger interests of the public. The RBI has made it clear that with the abolition of minimum lending rates for co-operative banks, it will be incumbent on these banks to make the interest rates charged by them transparent and known to all customers. Banks have therefore been asked to publish the minimum and maximum interest rates charged by them and display this information in every branch. Disclosure and transparency are thus key pillars of a corporate governance framework because they provide all the stakeholders with the information necessary to judge whether their interests are being taken care of. Another area which requires focused attention is greater transparency in the balance sheets of co-operative banks. The commercial banks in India are now required to disclose accounting ratios relating to operating profit, return on assets, business per employee, NPAs, etc. as also maturity profile of loans, advances, investments, borrowings and deposits. At the initiative of the RBI, a consultative group, aimed at strengthening corporate governance in banks, headed by Dr. Ashok Ganguli was set up to review the supervisory role of Board of banks. The recommendations include the role and responsibility of independent non-executive directors, qualification and other eligibility criteria for appointment of non-executive directors, training the directors and keeping them current with the latest developments. Some of the important recommendations on the constitution of the Board are to participate in the meetings of the board regularly and ensure that their participation is effective & contributory, they must study the reports submitted to them by the management team and enquire about follow up reports on definite time schedule. They should be actively involved in the matter of formulation of general policies, they should be familiar with the road objectives of the bank, and the policies laid down by the govt. and the changes in the various laws and legislations time to time. They should be loyal to the bank and must remember that they should not reveal any

information relating to any constituent of the bank to anyone. In the past, when banks considered the issue of how best to differentiate themselves from their competition, Good Corporate Governance was undoubtedly not applied. Due to the fallout from past corporate failures, more and more banks are looking at good corporate governance from a new perspective. With Indian economic growth increase and major stock Indices reaching record level, the time has come to position corporate governance as a strategic force in Indian banks. Indian banks must drive growth and profitability while continuing to focus on enhancing corporate governance practices. Indian government has mandating corporate governance reforms at banks, can create the necessary infrastructure to ensure the continued flow of investment into the region. Expanding global and regional banks, such as State Bank of India, Bank of Baroda, Bank of India, Punjab National Bank, ICICI Bank, HDFC Bank, Standard Chartered, HSBC, Citibank and others along with major investments by large institutional investor, are enhancing corporate governance practices, increasing competitiveness and permanently changing the competitive landscape of Indian banking environment. Due to rapidly changing banking environment, Indian banks must continue to implement strong corporate governance practices. They must now approach corporate governance as a competitive differentiator in an environment of strong foreign entrants and growing regional competitors.

Mandatory Recommendations of the SEBI's Committee on Corporate Governance

The Securities and Exchange Board of India (SEBI) had constituted a Committee on Corporate Governance and circulated the recommendations to all stock exchanges for implementation by listed entities as part of the listing agreement vide SEBI's circular SMDRP/Policy/CIR-10/2000 dated February 21, 2000. A summary of the mandatory recommendations of the SEBI Committee as applicable to banks is furnished here under:

1. The Committee recommends that a qualified and independent audit committee should be set up by the board of a company.
2. The Committee recommends that the audit committee should meet at least thrice a year. One meeting must be held before finalization of annual accounts and one necessarily every six months.
3. The quorum should be either two members or one-third of the members of the audit committee, whichever is higher and there should be a minimum of two independent directors.
4. Being a committee of the board, the audit committee derives its powers from the authorization of the board. The Committee recommends that such powers should include powers:
   - To investigate any activity within its terms of reference.

- To seek information from any employee.
- To obtain outside legal or other professional advice.
- To secure attendance of outsiders with relevant expertise, if it considers necessary.

5. The Committee recommends that the board should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.
6. The Committee therefore recommends that board meetings should be held at least four times in a year, with a maximum time gap of four months between any two meetings. The minimum information should be available to the board.
7. The committee recommends that a director should not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore, it is a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.
8. As a part of the disclosure related to Management, the Committee recommends that as part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the annual report to the shareholders.
9. The committee recommends that disclosures be made by management to the, board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies which have shareholding of management and their relatives etc.
10. The Committee recommends that information like quarterly results, presentation made by companies to analysts may be put on company's website 6r may be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own website.
11. The Committee recommends that a board committee under the chairmanship of a non-executive director should be formed to specifically look into the redressing of shareholder complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. The Committee believes that the formation of such a committee will help focus the attention of the company on shareholders' grievances and sensitize the management to redressal of their grievances.
12. The Committee further recommends that to expedite the process of share transfers the board

of the company should delegate the power of share transfer to an officer, or a committee or to the registrar and share transfer agents. The delegated authority should attend to share transfer formalities at least once in a fortnight.

13. The Committee recommends that there should be a separate section on Corporate Governance in the annual reports of companies, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory recommendation with reasons thereof and the extent to which the non-mandatory recommendations have been adopted should be specifically highlighted. This will enable the shareholders and the securities market to assess for themselves the standards of corporate governance followed by a company.

Conclusion

Globalization and liberalization is sweeping across the sectors of economy and banking industry is not an exception. In this era of revolutionary changes, banks shall confront various risks and managing these risks shall be the future challenges of banks. In competitive business environment, organizations that adopt good corporate governance and best practices will be able to survive and attain sustainable growth levels. Public Sector Banks need greater functional autonomy in a deregulated environment. Such autonomy, however, needs to be accompanied by greater accountability on the part of their boards to the stakeholders. A Corporate Governance Policy shall serve as an effective instrument for achieving this goal.The success of corporate governance rests on the awareness on the part of the banks of their own responsibilities. While law can control and regularize certain practices, the ultimate responsibility of being ethical and moral remains with the banks. It is this enlightenment that would bring banks closure to their goals. The following aspects require special mention while judging the standard of corporate governance in a banking institution:

a) Constitution of the Board of directors:
b) Transparency
c) Policy formulation
d) Internal controls
e) Committees of the Board

By fixing prudential standards, the regulators can improve the corporate governance and RBI has already taken a no. of steps during the recent years to enhance the usefulness of good corporate governance. However, there is lot, which the banks themselves have to do, since adherence to prudential norms is the minimum level of compliance and banks have to achieve higher standards for good governance. The success of corporate governance lies in minimizing the regulatory norms and adoption of voluntary codes.

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